SECONDARY BUYOUTS

By Francisco Aldavero, Partner
Araoz & Rueda

With weakness and volatility in the traditional IPO and trade sale markets, private equity funds have seen in transactions between buyout funds ('secondary buyouts') a successful way to exit their maturing portfolio investments and return funds to investors.

Supply and demand play the same role in buyouts as in any other market. Secondary buyouts play a useful role for funds and their investors as they have introduced a healthy degree of liquidity to the private equity market. Also, because of the cyclical nature of private equity, the good returns obtained by private equity houses from secondary deals will attract new investors in their future fund rising processes.

Predictability is also an important factor in secondary deals. A deal between private equity houses that speak the same language will be -in most cases- a process under control. A negotiation with a self-made entrepreneur may not be.

This probably explains why secondary buyouts were without doubt one of the most popular forms of exit in the European market last year. Secondary buyouts represented 35% of all European buyouts by value and 27% by volume in 2005 and Spain was not an exception. During the last two years, Spain has seen a dramatic increase in secondary buyout deals, with the number of deals increasing from 3 in 2004 to 20 in 2005. Indeed, the amount divested through this formula represented 28% of the total divestment by value in 2005.

However, secondary buyouts are not easy deals. Efficient companies are harder to improve. With the exception of fast-growing companies, improvement on high returns will be a hard task if the seller has done his homework properly.

Leaving aside commercial considerations, there are some practical issues that need to be taken into consideration in the context of arranging for a secondary buyout.

Conflicts of interests will certainly arise. In primary buyouts, conflicts for target's management team will exist between their duties to the target, their desire to achieve a successful buyout and their future plans for 'newco'. However, in secondary deals, these conflicts are compounded by the need to manage their relationship on the sale with both the buying and the selling private equity houses and by the fact that they are themselves sellers and re-investors.

Alignment between the management team and the buying private equity investor is more difficult to achieve, particularly if the target's management team earns a significant amount of cash-out. In this case, they might be less motivated by the eventual exit from the secondary deal and the new investor will need to seek additional protection by reinforcing the customary "bad leaver" clauses with other formula, such as deferral of a part of the consideration payable or an attractive ratchet, etc.

ARAOZ & RUEDA

Finally, but not less important, reference to the warranty gap should be made, as the selling private equity investor will almost always refuse to provide any warranty or indemnity protection.

In any case, statistics and data related to more mature markets clearly show that secondary buyouts will be an increasingly essential part of the private equity practice in Spain in the near future.

****

ARAOZ & RUEDA