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Secondary Buyouts on the Rise – Will it Last?

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In a time when exit strategies have pivoted, and options might be more limited, it is no surprise that secondary buyouts have rebounded. According to recent coverage from PitchBook, secondary buyouts are making up a larger share of private equity exits as firms look to speed up sales of portfolio companies.

What the data indicates

In a secondary buyout (SBO), a private equity firm sells a portfolio company to another private equity firm. These can be very attractive options for the speed and efficiency they offer and the instant liquidity for the seller. PitchBook's data indicates these deals accounted for 30.5% of PE exits in the first quarter of this year, compared to 25.2% in the same time frame in 2023. Notably, they come commensurate with a decrease in total value and volume of PE exits.

Their coverage indicates a need for more certainty or predictability in deals today, with PE firms looking to close faster. There is also a large amount of dry powder at PE firms today, so they might be better positioned to make investments and acquisitions than other types of investors.

What factors should PE firms consider

When considering a secondary buyout, there are numerous factors that investors should consider. Speed, efficiency, and liquidity value are positive considerations. On the flip side, the data does not indicate that they necessarily yield higher valuations.

SBOs can also allow firms to better manage their portfolios and help with diversification. Additionally, they give investors an off-ramp at an earlier stage as opposed to waiting for a traditional acquisition or even an IPO, which requires a PE firm to hold an asset for much longer until it is very late in its life cycle. For a PE firm to hold an asset longer, it has to increase that much more in value to justify the impact on the internal rate of return, which is measured annually.

As with any exit option, the potential disadvantages of an SBO must also be weighed. One of the most obvious factors to consider is what you might be walking away from. There is always the risk that an early exit means you are forgoing a much larger exit down the road. For the buyer, SBOs do come with the risk of overpayment and the possibility of issues with the leadership team at the company level.

Finally, in a very tough fundraising environment for alternative asset classes and fund managers, generally, for PE firms looking to raise their next fund, engineering an exit via an SBO, thereby returning capital to limited partners, can help encourage LPs to recycle or deploy additional capital.

What the future holds

While no one can predict what the future holds for SBOs, it is a safe bet that these will continue to be popular, at least through the first half of this year as investors look for more predictable exits. We are seeing a nascent recovery in IPO activity in the spring of 2024, providing some hope to investors that IPOs will once again become a viable exit option. There is also hope of a resurgence in traditional M&A transactions. with McKinsey pointing to healthy optimism this year from dealmakers and preparation for a market upturn. So, it remains to be seen whether the SBO will continue its surge if traditional M&A and IPOs bounce back to the level many are predicting. You can be sure we will be watching closely.

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