

Swedish Private Equity Market

A footprint analysis

SVCA
03 July 2017

How the private equity industry creates value for the Swedish economy and Stockholm's position as an international financial centre.

Authors:

Sigurd Næss-Schmidt, Partner
Christian Heebøll, Economist
Henrik Karlsson, Analyst

Preface

The Swedish Private Equity & Venture Capital Association (SVCA) has asked Copenhagen Economics to do a footprint analysis of how the Swedish private equity (PE) funds create value, and how they perform compared to their peers.

The analysis should review four key questions, which are closely related to the organisation of the four chapters in this paper:

1. How does PE work and create unique value for the individual companies in which they invest?
2. How does PE contribute to overall Swedish national economic growth and how important is it to Stockholm's financial ecosystem and local job creation?
3. How strong is the international competitiveness and export potential of the Swedish PE industry?
4. What are the potential and current key regulatory opportunities and threats for the future performance of the industry from an international perspective?

As part of the project, Copenhagen Economics has interviewed a number key stakeholders in the Swedish PE market, produced a case analysis of Swedish PE portfolio companies, and provided new econometric estimates of the effects of PE ownership on Swedish growth, productivity and company performance.

The project takes an economic perspective and does not comprise an overview of the legal structures of the private equity industry in Sweden. It focuses on buyout and growth PE, while venture capital and business angles are largely excluded from the analysis.

Table of contents

Sammanfattning	6
Executive summary	9
1 Unique value creation in individual companies	12
1.1 How do PE firms operate?	12
1.2 What are the main contributing factors of PE ownership?	13
1.3 Value creation through management incentives and active ownership	16
1.4 Two types of PE investment cases	17
1.5 Growth PE: An important part of the capital food chain	19
1.6 Buyout PE: A wake-up call for the sleepy companies	21
1.7 PE ownership increases the individual companies' innovation, productivity and competitiveness	23
1.8 Implications for production and productivity in individual Swedish companies	24
1.9 Case examples of how PE firms apply their active management strategies and increase performance	26
2 Creation of national economic growth and value	28
2.1 A framework of how to understand the growth implications of PE ownership	28
2.2 PE investments cover a share of the Swedish market	29
2.3 Effects on national productivity and competitiveness	31
2.4 Effects on national economic growth	33
2.5 A great support for Stockholm's financial ecosystem	36
2.6 Activity related to the PE industry in Stockholm	37
2.7 PE as part of asset management	39

3	An international competitive sector with large export potential	42
3.1	An international benchmark analysis	42
3.2	A historical success and high international performance	43
3.3	Performance of the investments	47
3.4	A large international focus	48
3.5	Supporting a high performance in other related markets	49
4	A future perspective	52
4.1	Continued improvement of the business model	52
4.2	Preserving the political stability driving the current success of Swedish PE	53
4.3	Cross-European market regulation	54
	References	56
	Appendix	59

List of tables

Table 1.1 PE investment by company size and age (2007-15).....	18
--	----

List of figures

Figure 1.1 The lifespan of PE funds	12
Figure 1.2 The unique value creation of PE firms.....	14
Figure 1.3 Earlier empirical results on active ownership and tendencies to change the CEO/MD (2006-17)	17
Figure 1.4 Share of PE investments in Sweden in different categories (2007-15).....	18
Figure 1.5 Number of SMEs in Sweden and share of PE investments in SME 2007-15.....	19
Figure 1.6 Food chain for growth companies.....	20
Figure 1.7 Share of Swedish growth PE investments in the different sectors (2007-15)	21
Figure 1.8 The optimisation done by PE buyouts	22
Figure 1.9 Share of Swedish buyout PE investments in the different sectors (2007-15)	23
Figure 1.10 Increasing performance, innovation and job creation	24
Figure 1.11 PE ownership increase profitability and productivity.....	25
Figure 1.12 PE ownership increases growth but not necessarily the number of employees.....	26
Figure 2.1 A framework of how to understand the contribution of PE investments	28
Figure 2.2 Large share of PE investments in the Swedish economy	30
Figure 2.3 Size and sector intensity of Swedish PE investments (1996-2017).....	32
Figure 2.4 Estimated PE sector ownership share (2000-2017).....	33
Figure 2.5 Estimated sector growth effects of PE ownership (2005-16)	35
Figure 2.6 Estimated national growth effects of PE ownership	36

Figure 2.7 A market involving many different markets and service providers.....	37
Figure 2.8 Employees in the Swedish PE sector (2016).....	38
Figure 2.9 Distribution of employees in PE firms by size (2016)	39
Figure 2.10 Return from Swedish buyouts compared to a broad stock market index	40
Figure 2.11 Increasing interest from pension and public funds	41
Figure 3.1 Ranking the Swedish PE industry after 2011	42
Figure 3.2 Annual fund value relative to GDP (3-year moving average).....	43
Figure 3.3 Number of transactions and total value of PE buyouts of Swedish companies	44
Figure 3.4 The journey of Swedish PE industry	44
Figure 3.5 PE investments as share of GDP	46
Figure 3.6 Size of the PE market in Sweden	46
Figure 3.7 Large funds and many investments.....	47
Figure 3.8 Average returns on PE investments, net IRR	48
Figure 3.9 A high international orientation	49
Figure 3.10 Inflow of PE funds and large markets in Sweden	49
Figure 3.11 PE exits and a well-functioning IPO market.....	50
Figure 3.12 Supporting M&A and earlier capital markets	51

List of boxes

Box 1.1 The micro econometric model	24
Box 1.2 Hard facts about the companies	27
Box 2.1 Our methods to estimate sector and national economic growth effects of PE investments	34
Box 4.1 The 3:12 rules.....	54

Sammanfattning

En unik form av kapital

Private Equity-fonder (PE-fonder) driver och skapar värde och produktivitet på ett unikt sätt, i jämförelse med andra typer av investeringsfonder och den publika kapitalmarknaden. För det första, söker PE-fonder upp företag med outnyttjad potential och hjälper dem att utveckla den under en relativt lång investeringshorisont. Ofta investerar fonderna i mindre företag, som saknar tillgång till de publika kapitalmarknaderna. På så vis är riskprofilen, investeringshorisonten och företagsfokuset unikt för PE-fonderna.

För det andra, vilket är av ännu större vikt, tillhandahåller PE-fonder ett så kallat kompetenskapital, inklusive specifik sektorkunskap och en tydlig affärsplan för hur företagets fulla potential kan utnyttjas. På så vis är PE ett utmärkt exempel på aktivt ägandeskap och incitamentsbaserat ledarskap, vilket är av största vikt för att öka produktiviteten i företag.

Behovet av aktivt ägandeskap och det värde det skapar är en fråga som fått allt större uppmärksamhet globalt och som har lyfts fram som en prioriterad fråga för stora publikt ägda företag.

Värdeskapandet i individuella företag

Förenklat, finns det två sorters företag eller investeringsfall för PE-fonder; tillväxtfall eller tillväxt PE (growth capital), vilket vanligtvis är yngre företag som behöver kapital, riktning och professionell ledning, samt optimeringsfall eller buyouts, vilket är mer etablerade företag med outnyttjade potentialer. I båda fallen bidrar PE med stöd, kompetens och som en källa till kapitalförsörjning för företagen.

I linje med flera empiriska studier finner vi att svenska PE-finansierade företag efter förvärvet upplever en kraftigt ökad produktivitet, lönsamhet och konkurrenskraft, i förhållande till jämförbara företag. Denna utveckling är vanligtvis ett resultat av aktivt ägandeskap och drivs av digitalisering och andra typer av operativa förbättringar. Ett antal studier visar även hur PE ökar värdet av företagens investeringar i forskning och utveckling samt patent.

Därtill, efter perioden av omstrukturering och ökad lönsamhet (1-2 år), finner vi att det sker en betydande tillväxtökning i företagen. Detta sker vanligtvis när företagen blir mer konkurrenskraftiga och börjar exportera till nya marknader.

Betydande vinster för den svenska ekonomin som helhet

Under de senaste tio åren har mer än 1 000 svenska företag fått PE-investeringar, vilket sammanlagt motsvarar ca 150 miljarder kr. Det är ungefär lika mycket som de totala börsnoteringarna på Nasdaq Stockholm under samma period. De 1 000 företagen har haft ledde dessa företag till att över 270 000 anställda i Sverige, vilket motsvarar 7,5 procent av alla svenska privatanställda och 5,5 procent av Sveriges BNP. För nästa alla dessa företag har PE-investeringen haft en direkt påverka på deras tillväxt samt på hur bra de presterat.

Vidare visar akademisk forskning hur intensiva PE-investeringar inom en specifik sektor också har stor indirekt påverkan även på de icke-PE-finansierade företagens resultat inom samma sektor. Den ökade produktiviteten och konkurrenskraften hos de PE-finansierade företagen skapar arbetstillfällen för underleverantörer och tvingar andra företag att förbättra sina resultat.

När vi lägger samman de direkta och indirekta effekterna av PE finner vi att den kumulativa effekten av PE-finansierade investeringar i svenska företag kan ha höjt Sveriges BNP med 6 procent sedan 2005, vilket motsvarar drygt 0,4 procent per år. Effekterna var av betydande storlek under perioden 2007-2011 till följd av de intensiva PE-investeringarna i svenska företag fram till finanskrisen. Vidare har tillväxteffekterna varit störts i PE-intensiva sektorer: information- och kommunikationsteknik, finans, tillverkning och andra tjänster.

En central del av Stockholms finansiella ekosystem

PE-industrin är stor i Stockholm, i förhållande till de flesta andra jämförbara städer. Industrin stöttar ett brett finansiellt ekosystem av kapitalmarknader, leverantörer av finansiella tjänster, advokater och revisorer i Stockholm.

Våra uppskattningar tyder på att 6 000-7 000 arbetstillfällen i Stockholmsregionen är beroende av PE-industrins verksamhet. Branschen anställer på egen hand 500-600 partners, investerare och andra experter, enbart i Stockholm. Vidare är 2 000-2 500 anställda inom rådgivningssektorn bestående av revisorer, bankanställda och advokater och ytterligare 2,500-3,400 arbeten skapas genom andra underleverantörer och inducerad ekonomisk verksamhet.

Slutligen skapar PE värde genom att erbjuda en mycket attraktiv form av kapitalförvaltning för stora pensionsfonder och andra institutionella investerare, som vanligtvis förvaltar hushållens pensionssparande. I synnerhet för pensionsfonder har PE-investeringar blivit alltmer populära de senaste åren, som en typ av långsiktigt och stabilt sparande med hög avkastning, jämfört med andra typer av investeringar. Mellan 2000 och 2008 har den genomsnittliga avkastningen från svenska PE-fonder varit betydligt högre än avkastningen från jämförbara investeringar i det svenska aktieindexet, med en årlig avkastning på 18 procent, jämfört med 12 procent på aktiemarknaden.

Ur ett internationellt perspektiv

Sverige är ledande när det gäller PE. I synnerhet är den svenska buyout-marknaden stor i jämförelse med andra länder och givet storleken på ekonomin, och inkluderar några av de största och mest specialiserade PE-företagen i Europa. Detta beror framförallt på de många historiska framgångsexemplen, inklusive de stora PE-aktörerna EQT, Nordic Capital, Triton och Altor, som har skapat ett kompetenskluster för PE-sektorn i Stockholm.

Idag kännetecknas den svenska PE-marknaden av ett särskilt stort internationellt fokus och därmed en stor export- och tillväxtpotential. På finansieringssidan kommer runt 80 procent från internationella investerare, särskilt från USA och övriga nordiska länder, medan runt 35 procent av investeringarna görs i utländska företag. Storbritannien är det enda landet i Europa som överträffar den svenska PE-marknadens internationella orientering.

Framgångarna inom den svenska PE-sektorn verkar även överföras till andra delar av finansbranschen. Detta inkluderar både "inträdesmarknader" där PE-fondernas rådgivare hittar investeringsmöjligheter – exempelvis riskkapital – och IPO- och M&A-marknaderna, där de vanligtvis överlämnar sina investeringar. I synnerhet för det senare fallet presterar Sverige bättre än de flesta andra länder.

Ur ett framtidsperspektiv

Som en del av Stockholms finansiella sektor har Sverige genom PE-sektorn en unik möjlighet att de närmaste åren utöka sin roll i att skapa arbetstillfällen, bli en källa till exportinkomster genom att locka internationellt kapital samt investera i företag internationellt. Både Brexit och EU:s planer att utvidga kapitalmarknadsinstrument till små och medelstora företag (Capital Market Union) erbjuder en unik möjlighet för Sverige.

Två frågor är prioriterade, för att denna potential ska kunna förverkligas. *Den första frågan har ett nationellt fokus.* Den historiska framgången inom den svenska PE-sektorn beror främst på strukturreformerna som började i början av 1990-talet samt en fortsatt förståelse för de ekonomiska fördelarna med ett starkt policyramverk för investeringar. Det är viktigt att detta bibehålls under de kommande åren.

I detta sammanhang understryker vi behovet av ett förutsägbart och attraktivt investerings- och beskattningsklimat som kan konkurrera med andra viktiga jurisdiktioner, inom och utanför EU. Detta gäller både beskattning av fondförvaltare (3:12-reglerna, moms m.m.) samt beskattning (fullständig skatteneutralitet) av internationella investerare som investerar i svenska PE-fonder. Vi rekommenderar att relevanta tillsynsmyndigheter får ett tydligt, balanserat tvåfaldigt mandat: hur kan Sverige balansera hinder i lagstiftningen kopplade till regleringsåtgärder, för att skydda den svenska skattebasen, och samtidigt tillhandahålla ett attraktivt investeringsklimat. Ett sådant tvåfaldigt mandat behöver inkorporeras i konsekvensbedömningar gällande ändringar av regelverket samt omfatta en dialog med intressenter om de praktiska konsekvenserna, som input till arbetet.

Den andra frågan är kopplad till internationell reglering. För att svenska PE-fonder ska behålla och få tillgång till finansiering från internationella investerare och kunna investera globalt är det viktigt att centrala EU-direktiv och internationell finansiell lagstiftning med tredjeländer fokuseras på att minska hindren för alla gränsöverskridande PE-investeringar – både inom och utanför EU, exempelvis Direktivet om förvaltare av alternativa investeringsfonder (AIFMD). En starkare inre marknad ska inte komma till priset av att integrationen med marknader utanför EU försvagas. Det är också viktigt att reglering inte leder till hinder för institutionella investerare, exempelvis Solvens II-effekter på försäkringsbolagens investeringar inom PE-industrin. Dessa investerare har i allt högre grad varit en finansieringskälla för investeringar eftersom de har värdesatt PE-industrins förmåga att leverera relativt stabil, hög avkastning över långa perioder i förhållande till andra typer av investeringar.

Executive summary

A unique type of capital

Private equity (PE) funds are unique in the way they operate and create value and productivity when compared to other types of investment funds and public equity.

Firstly, PE funds seek out companies with large, untapped potential and help them to exploit this over a relatively long investment horizon. These are often smaller companies or companies without access to public capital markets. As such, the risk profile, investment horizon and company focus of PE funds are themselves unique.

Secondly, and even more importantly, PE funds provide so-called competent capital, including special sector knowledge and a clear business plan of how to utilise the full potential of the company. As such, PE is the epitome of active ownership and incentive-based management, extremely important factors in increasing productivity in companies.

The need for active ownership and contribution in the running of companies is indeed an issue that is gaining increasing attention globally and highlighted as priority for large publicly owned companies.

The creation of value in individual companies

There are roughly two types of companies or investment cases of PE funds; *growth cases* or *growth PE*, which are typically newer companies in need of capital, direction and professional management, and *optimisation cases* or *buyouts*, which are more established companies with other untapped potential. In both cases, PE provides support and a source of capital through the capital food chain and growth path of companies.

In line with many empirical studies, we find that companies backed by Swedish PE experience a large increase in productivity, profitability and competitiveness after an acquisition relative to comparable companies. This typically happens as a result of active ownership and is driven by digitalisation and other types of operational improvements. A number of studies also show how PE increases the value of R&D investment and patents in the companies.

Furthermore, after a period of restructuring and increasing profitability (1-2 years), we find significant increased growth in these companies. This typically happens as the companies become more competitive and start exporting to new markets.

Significant gains for the Swedish economy as a whole

Through the last 10 years, more than 1,000 Swedish companies have received PE capital, adding up to around € 15 billion. This is about the same as the total IPO capital supplied by Nasdaq Stockholm over the same period. These companies represent more than 270,000 jobs in Sweden over the time period, equivalent to 7.5 per cent of Swedish private employees and around 5.5 per cent of Sweden's GDP. For almost all of these companies, PE capital has had a direct effect on performance and growth.

A number of studies show how intense PE investments in a given sector also have large indirect effect on the performance of the non-PE funded companies in that sector. The increase in productivity and competitiveness of PE backed companies creates jobs for subcontractors and forces other companies to step up as well. Further, successful companies and ideas often result in spin-offs and new start-ups.

When we added the direct and indirect effects of PE together, we found that the cumulative effect of PE capital investments in Swedish firms since 2005 may have raised the current GDP level by up to 6 per cent, equivalent to just over 0.4 per cent per year. The effect was been particularly high from 2007 to 2011 as a result of the intense PE investment in Swedish companies up until the financial crisis. Additionally, the largest growth effects have been in PE-intensive sectors: ITC, finance, manufacturing and other services.

Key part of Stockholm's financial ecosystem

The PE industry is large in Stockholm compared to most other comparable cities. It also supports a large financial ecosystem of equity capital markets, supporting financial service providers, lawyers and auditors in Stockholm.

Our estimates suggest 6,000 to 7,000 jobs in the Stockholm region depend on the activities of the PE industry. The industry itself employs 500 to 600 partners, investment professionals and other experts in Stockholm alone. A further 2,000 to 2,500 are employed in the supporting industry of auditors, investment bankers and lawyers, while another 2,500 to 3,400 jobs are created through other subcontractor and induced economic activity.

Finally, PE creates value as a highly attractive form of asset management for large pension funds and other institutional investors, typically managing the pension savings of households. PE investments have become more and more popular in recent years as a long-term, stable and high return alternative to public equity investments especially for pension funds. In fact, from 2000 to 2008, the average return from Swedish PE funds has been significantly higher than the return from a comparable investment strategy in a Swedish public equity index; a yearly return of 18 per cent vs. 12 per cent on the public equity markets.

International perspective

Sweden is a leading country when it comes to PE. The buyout market is especially large compared to other countries and the size of its economy; it includes some of the largest and most specialized PE firms in Europe. This is principally due to the long historical track record of large Swedish PE firms, such as EQT, IK, Nordic Capital and Altor, which have created a competence cluster in the PE sector in Stockholm.

Today, the Swedish PE market is notable for its concentrated international focus, and thereby its large export and growth potential. On the funding side, around 80 per cent comes from international investors, especially in the US and the other Nordic countries, while about 35 per cent of the investments are in foreign companies. In Europe, the international orientation of the Swedish PE market is only surpassed by the UK.

Success in the Swedish PE sector also seems to spill over to other parts of the financial industry. This includes both the “entries markets” in which PE fund advisors find the investment opportunities – e.g. venture capital – and the IPO and M&A markets where they typically exit their investments. Sweden is also performing better than in most other countries especially in terms of the latter.

Future perspective

As a part of Stockholm's financial sector, the PE sector has a unique opportunity in the coming years to expand its role in creating jobs in Sweden, become a source of export income by attracting international capital, and invest in firms at an international level. Indeed, both Brexit and the EU's plans to extend capital market instruments to small and midcap companies (Capital Market Union) offer a unique opportunity for Sweden.

To realise this potential, two priorities are important. *The first is domestic.* The historic success in the Swedish PE sector is very much due to the reforms that began back in the early 1990s and a continued understanding of the economic benefits of a strong policy framework for equity capital. It is important that this also be maintained in the coming years.

In this context, we underline the need for a predictable and attractive investment and taxation climate, which can compete with other key jurisdictions within and outside the EU. This goes for both taxation of fund managers (the 3:12 rules) and taxation (full tax neutrality) of international investors investing through a Swedish PE fund. We recommend that relevant regulators be provided with a clear, balanced dual mandate: how can Sweden square legitimate concerns linked to prudential standards and protecting the Swedish tax base while at the same time provide/maintain an attractive investment climate. Such a dual mandate would need to be embedded in impact assessments related to changes in the regulatory framework and include a dialogue with stakeholders about the practical consequences as input to that work.

The second is linked to international regulation. For the Swedish PE to keep and gain access to funds from international investors and to invest globally, it is important that key EU directives and international financial regulation with third countries be focused on reducing barriers to all cross-border PE investments – both within and outside of the EU, for example, the Alternative Investment Fund Manager Directive (AIFMD). As such, a stronger internal market should not come at the price of weakening integration with non-EU markets. It is also important that prudential regulation does not provide non-warranted barriers for institutional investors, e.g. the effects of Solvency II on insurance companies investments in the PE industry. These investors have increasingly been a source of finance for investment as they have recognised the ability of the PE industry to deliver relatively stable, high returns compared with other investments over a longer period.

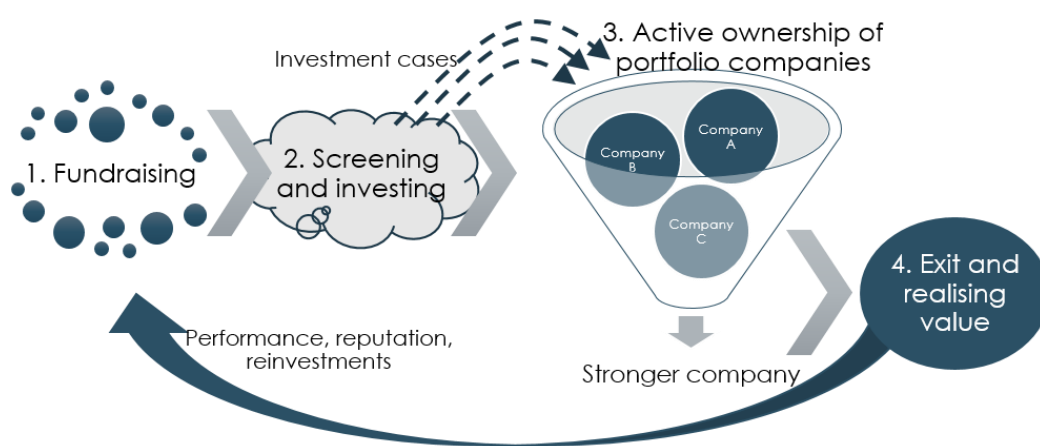
Chapter 1

Unique value creation in individual companies

1.1 How do PE firms operate?

Private equity (PE) firms invest in companies through individual funds, each with a certain life span (typically ten years) and investment focus. To understand how PE firms work and create value, it is useful to look at how they work with their funds throughout their life span (see Figure 1.1). This consist of four overall interrelated stages.

Figure 1.1 The lifespan of PE funds



Source: Copenhagen Economics

1. Fundraising

First of all, a PE fund needs to find investors/funding. The funds are typically organised as limited partnerships, where the PE fund manager acts as a general partner (GP), managing the fund with complete discretion, while the limited partners (LPs) are the investors providing most but not all the equity capital.

The fundraising process varies a lot depending on the fund size, its past performance and the reputation of the GP. Large PE firms and GPs that are performing well typically have a large share of returning investors and do most of their fundraising internally. Smaller and newer PE firms have to spend more time building relations and reputation, often through external fundraisers. To that extent, long-term success in the PE industry is a lot about reputation and keeping a high and relatively stable performance in the individual funds – as has been the case for the many successful Swedish PE firms.

Typically, most of the capital is provided by institutional investors, such as pension funds, insurance companies, university endowments and family offices. Once the large investors are in place, smaller investors, wealthy individuals etc., may also contribute. In that sense, it is a precondition for a strongly functioning PE market to have a well-structured investor landscape, with many institutional investors interested in this type of alternative investment exposure. This is also visible to a large extent in Sweden (see Chapter 4).

The funds typically have a certain target size from the outset and once this is reached the fund closes. From here on the LPs have each promised to deliver a certain amount of equity capital to the fund as new investment opportunities arise, and they will not be able to step out of this commitment and get their money out until after the individual investments have exited.¹

2. Screening and investing

Over the next five years (typically), the PE fund manager and advisors will search for opportunities within the mandate of the fund to put the investment capital to work. Hence, they will look through a large number of companies in order to find investment cases of the right size, in the right sector and with the right opportunity, management etc. A good investment case both specifies the company to invest in and – just as important – a business strategy of how to create value in this company through active ownership, especially for PE funds. In the next sections, we will look into what typically characterizes a good investment case. Over its life span, a fund typically invests in several companies (portfolio companies).

3. Active ownership

For each of the portfolio companies, the PE fund typically buys out a majority stake in the company, partly using equity and partly debt financing – called leveraged buyout (LBO). Hereby the PE fund is in full control of the company, which enables them to implement their desired business strategy and changes to the company. From the beginning, PE introduces certain management incentive plans (MIPs), often (but not always) including some changes to the management and to the board etc. Furthermore, the business strategy may include several stages where the management is restructured more than once. This is a key point in the understanding of how PE firms create value, and we will return to this in the next sections.

4. Exit and realising value

At some point, typically, when the business strategy has been more or less been executed and the performance and value of the portfolio company is optimised in a certain way, the PE fund manager and advisors will start looking for potential buyers.

1.2 What are the main contributing factors of PE ownership?

Compared to publicly listed companies (public equity), there are a number of characteristics that make PE special. In early literature from the late 1980s, PE ownership structure is even seen as superior to public equity in general.² Back then, many publicly listed companies were bought by PE funds in so-called public-to-private (PtP) transactions, but these

¹ There exist secondary markets for PE investments.

² See e.g. Jensen (1989).

have fallen out of favour. The PE ownership structure does have a range of unique qualities that can be suitable for certain types of companies. We can sum up these in four factors, covered under financial, corporate governance and operational management, see Figure 1.2.

Figure 1.2 The unique value creation of PE firms



Source: Copenhagen Economics

1. Local sector knowledge

First of all, by themselves and through their network and business partners, the PE firms have a unique local sector knowledge and knowledge about the situation and market of the companies they invest in. As a main part of the investment strategy, the PE firms gather their information to arrive at well-designed business plans for the companies they invest in. These often include rather radical changes and business optimisations.

2. Concentrated active ownership

PE funds invest in order to have a majority stake in companies to put them in full control and allow them to execute their ambitious business plan. For example, the business plans often include changes implying large, short-term new investments and cutbacks in performance measures that are more difficult in publicly traded companies with many minority owners that have different investment horizons.

Active ownership is an important part of the success of PE, as will be discussed in more depth in Section 1.3. It is particularly important as it allows PE firms to more quickly execute their business strategy than if the company was publicly traded. Large investments and changes do not need to await voting and acceptance of the board or owners etc. Often the CEO, chairperson of the board and the representative of the PE firm have meetings on a regular basis (often weekly or biweekly), as we also experience from our interview study:



As a rule of thumb, a PE owned company can execute changes in a quarter that a publicly traded company would do in a year.

Source: Jarl Dahlfors, CEO of Anticimex

3. Management incentives and finding the right people

As part of their active ownership, PE firms often start by setting up a new board of directors in the companies they invest in, where each new member has unique knowledge about some part of the business plan, the market or sector of the company. Furthermore, they may even appoint new management in the company, more suited to the job outlined in the business strategy.

PE firms are able to hire very competent, successful people as managers in their portfolio companies, given their network and ability to support future career opportunities. People like to be part of a success, which is seen as one important driving force.

PE also make use of so-called management incentive plans (MIPs) meaning members of the board, the management and leading employees all own a certain share of the company. Since they are all in the same boat as owners of the company, this rules out so-called principal agent problems and free rider problems between the management and owners of the company (see more in the next section).

4. Risk profile and financial optimisation

The risk and investment horizon of PE is, by definition, different from public equity given the closed end structure of the funds. Out of the approximately 300 Swedish portfolio exits since 2007, the portfolio companies had an average holding period of five years, and only 10 per cent had a holding period of less than four years.³ Furthermore, PE funds have different risk profiles depending on the investment focus in the fund, and some types of businesses and business strategies are more suited for PE ownership than public equity.

This alternative risk profile and investment horizon is a key part of why PE investments are attractive to institutional investors. They invest to maximise their returns, while diversifying their risk into different types of investments. PE is normally known to be more risky than public equity, although recent data does not support this claim.⁴ At the same time, PE allows for more diversification in the risk profile and typically also a higher return than public equity.

PE firms may also optimise some of the financial structure in portfolio companies. This was a previously larger part of PE firms' value creation. PE companies now have better access to capital from banks and capital markets and, hence, they are able to optimise the capital structures of the portfolio companies compared to other types of ownership.

³ These numbers are based on all PE exits from Zephyr data.

⁴ See more in Section 2.7.

1.3 Value creation through management incentives and active ownership

Active ownership makes a big difference

There is strong evidence that companies without strong active ownership tend to underperform in a number of dimensions. This is the case for many publicly traded companies. What typically happens is that they:⁵

- Too much focus on short-term performance because management lacks the backing of investors focused on longer term returns.
- Too little investment in R&D and unfocused and reluctant management in their business strategies.

This is a reflection of two challenges. Firstly, from the principal-agent theory, managers of publicly traded companies do not always act in the interests of the shareholders. Typically, the management is more risk averse and reluctant to make radical changes and investments because they are the ones to blame in case of failure, which could ruin their careers. Secondly, due to the so-called free-rider problem, a diversified ownership structure implies many different investment horizons, risk profiles and weak incentives for each individual owner to monitor the management and apply their skills to do that which is necessary for the long-term performance of the company.

The empirical results show how a range of tendencies/measures of active ownership are important to companies' appetite for long term investments, R&D and innovations, CEO discipline, and, ultimately, a good performance of the company.

PE ownership means active ownership

The tendencies for active ownership are all central principles of PE ownership: PE ownership often use external (unaffiliated) directors and experts in board representation. In many cases they have to (by law) separate the CEO and chairperson roles (and GP), and they have large ownership concentration. Often, the Swedish labour union is also represented on the boards, in accordance with Swedish law. Furthermore, as part of the MIP, PE ownership almost always requires that board members and management are invested in the company. This rules out the problem where, e.g., the CEO has a different risk appetite compared to the owners of the company or a shorter time perspective etc. Here the board, CEO and the owners are all in the same boat, with the same upsides, downsides and risks.⁶

For all three Swedish PE portfolio company cases we have looked into, there have been large changes in the management and board (sometimes more than once) over the PE period of ownership. This is also what we see when we consider all PE funded companies since 2006, see Figure 1.3. In 66 per cent of the cases the CEO/MD was changed as the PE fund came in as owner, or after. Our impression from interviews is that the tendency for changes of CFOs, chairs of the board and board members is even higher. For example, in the case of

⁵ See Appendix A and Copenhagen Economics (2017): Active Ownership: A Crucial Role for Institutional Investors (<https://www.copenhageneconomics.com/publications/publication/active-ownership-a-crucial-role-for-institutional-investors>).

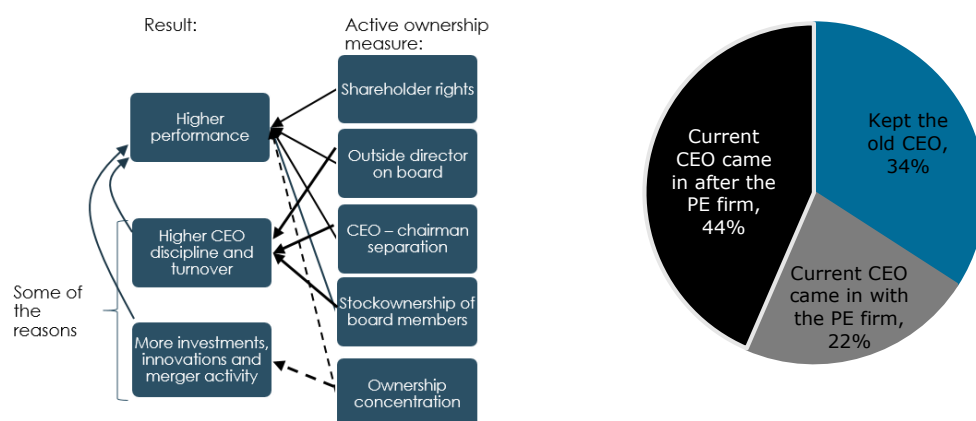
⁶ See e.g. Kaplan and Strömberg (2009).

Anticimex, the CEO has been changed several times throughout the PE ownership period of EQT, in order to ensure the right competences needed for the given part of the business strategy, see Appendix C.

Figure 1.3 Earlier empirical results on active ownership and tendencies to change the CEO/MD (2006-17)

a) Effects of active ownership

b) PE investments and the tendency to change CEO/MD



Note: Panel b): This covers 639 PE investment since 2006 in companies where we have data on who is the current CEO/MD and when he/she was appointed. For 287 PE investments since 2006 we do not have data on the CEO/MD

Source: See literature in Appendix A. Panel a): Bhagat and Bolton (2008) and reference therein, Guo & Masulis (2015), Belloc et al. (2016), Wang & Shailer (2015), Lehmann and Weigand (2000), Weisbach (1988), Knyazeva et al. (2013). Panel b): Zephyr, Amadeus and Copenhagen Economics

1.4 Two types of PE investment cases

In short, a good investment case is one where the PE firm can optimise the performance and business strategy of the company through one or more of their three unique contributing factors (financial and operational management, corporate governance). Roughly speaking, there are two types of PE portfolio companies/investment cases:

1. **Growth cases:** Typically, younger companies in need of capital, direction and professional management in order to grow.
2. **Buyouts and optimisation cases:** Generally, more established and larger companies with potential to improve their business model and competitiveness. This also includes some companies close to distress caused by poor management (rescue/turnarounds).

A third type used in a few cases is rescues/turnarounds, where companies are in distress (close to bankruptcy). Of course, many investment cases can lie somewhere in between and include a bit of both company types.

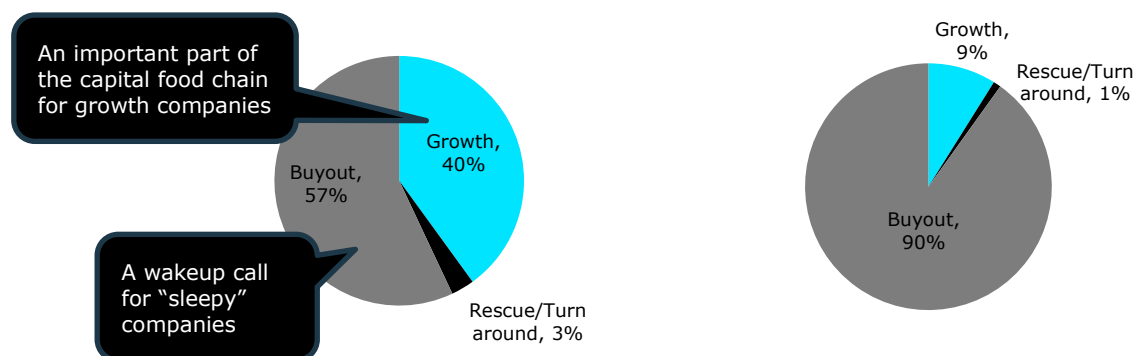
Since 2007, the Swedish distribution of PE investments (number of companies) has been relatively stable; most are buyouts (57 per cent), a somewhat smaller share are growth companies (40 per cent) and only few are rescues/turnarounds (3 per cent), see Figure 1.4a.

The number of rescues/turnarounds was significantly higher just after the 2008 crisis. The buyout investments of more established companies are larger in value, which is why they take up a much larger share when we look at investment value, see Figure 1.4b.

Figure 1.4 Share of PE investments in Sweden in different categories (2007-15)

a) Based on number of companies

b) Based on value



Source: Invest Europe

When we investigate investments by age and size, most companies are rather young (less than 15 years old), but there are also quite a number of mid-age companies (15-40 years old). Most companies are in the small category, with between 10 and 50 employees, but there are also many medium sized and micro companies see Table 1.1.

Table 1.1 PE investment by company size and age (2007-15)

Size/age	Old	Mid-age	Young
Large	4%	4%	6%
Medium	2%	9%	13%
Small	2%	9%	27%
Micro	1%	3%	22%

Note: Young companies are less than 15 years old, mid-age are between 15 and 40. Micro companies have fewer than 10 employees, small companies have between 10 and 50 employees and medium companies have between 50 and 250

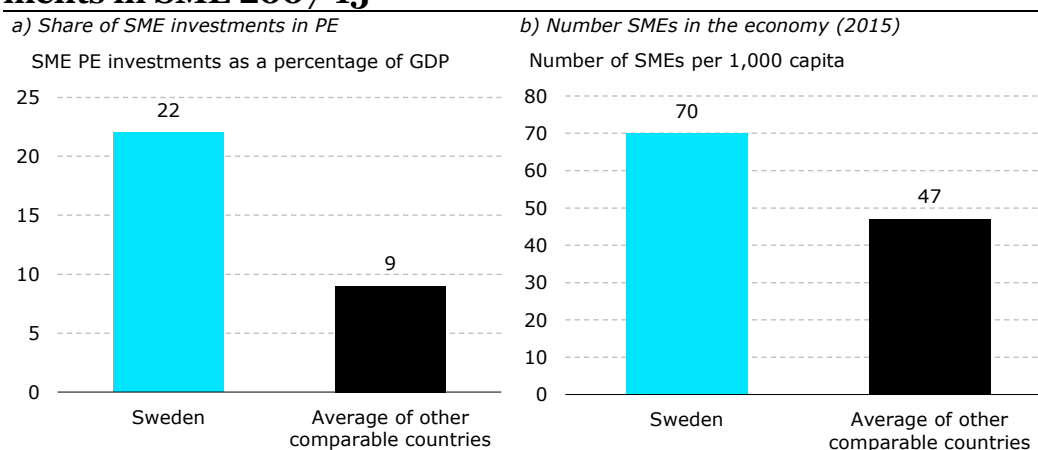
Source: Zephyr

A strong potential for small and medium sized companies

The tendency for many SME investments goes well in hand with the fact that Sweden is a country of many entrepreneurs and growth companies. Since 2007, PE investment in SMEs as a share of GDP has been about twice as big in Sweden compared to other European countries, see Figure 1.5a. Sweden also has around 70 SMEs per 1,000 capita, where the comparable countries on average have 47, see Figure 1.5b.

This support for small growth companies is by itself important for productivity and growth. Small young companies typically require a lot of equity capital, e.g. PE or VC. However, they are also important suppliers of innovations to the economy, and some new small companies today will be the young large corporations in 10-15 years.

Figure 1.5 Number of SMEs in Sweden and share of PE investments in SME 2007-15



Note: The other comparable countries include Germany, Norway, Denmark and the Netherlands. The right most figure includes both PE and VC investments

Source: Invest Europe and SCB

1.5 Growth PE: An important part of the capital food chain

Seen broadly, most SMEs are in a potential growth process, where they seek risk and competent capital (knowledge) in different markets. Here is a typical growth path, see also Figure 6:⁷

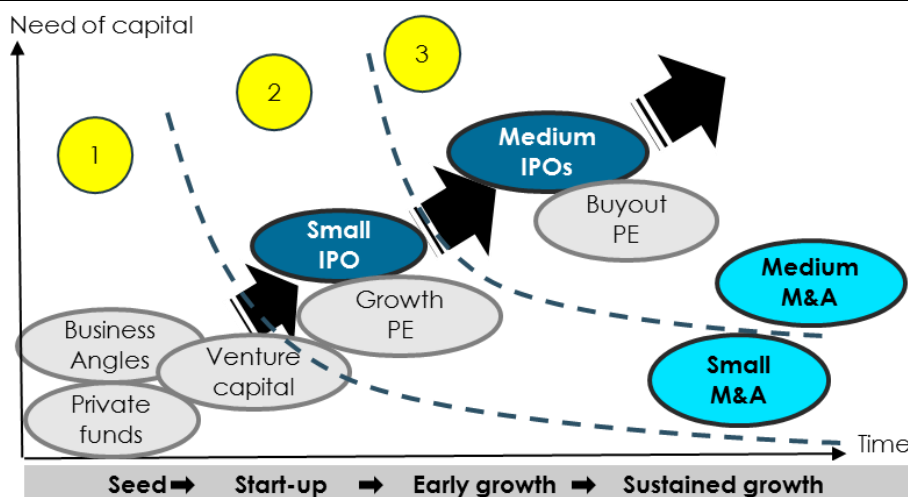
- **Seed and start-up stage:** Early in the growth process, companies are often financed by private and family funds, a business angel or venture capital fund. The latter two typically supply knowledge (competent capital) about how to run the business.
- **Growth stage:** Thereafter, an early type of growth PE fund may come in, the company may be fully or partly sold to other private players or - depending on how well the markets work at the time - a small IPO may occur.
- **Sustained growth:** Finally, a PE buyout fund can enter, or larger IPO or M&A trade sale may occur. The PE buyouts can be so-called public-to-private transactions, where a PE fund buys a majority stake in publicly listed companies. As such, the growth path of companies may include a shift back and forth between public and private equity markets. An M&A trade sale to another company in the same industry is typically an alternative exit route.

In this food chain, each part is important for the functioning of the other. For example, if the growth PE market is relatively weak, it may slow down the growth of younger businesses and more will go into or stay in a “sleeping state”. Alternatively, the companies may have

⁷ See also Copenhagen Economics (2016).

to seek capital in other markets, perhaps abroad. Thus, the performance of the various markets and the companies in these stages are interdependent.

Figure 1.6 Food chain for growth companies



Note: This is a simplified picture to show the general market tendencies.

Source: Copenhagen Economics (2016)

Characteristics of growth PE

The key characteristics, which growth PE advisors look for in the investments, are:

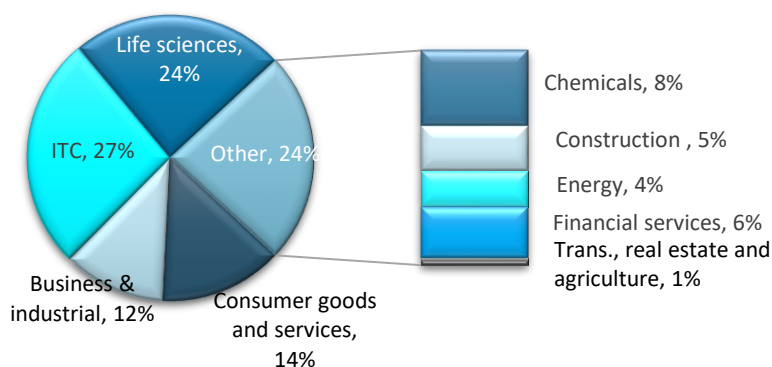
- Potential in professionalizing the business.
- Operational potential through large new investments, acquisition, digitalization, R&D etc., made possible as a result of the capital and experience provided by the PE firm.
- Potential in seeking expanding markets.

These factors have indeed been present in most of the Swedish growth PE portfolio companies acquired in recent years. One example we have looked into is Scope Capital's acquisition of Happy Socks in 2015, which is a classic example of a growth company (see Appendix C).

Sectors

As a result of the focus on growth companies in general, growth PE is invested quite broadly across many sectors, see Figure 1.7. That said, compared to the sector distribution in all Swedish companies, growth PE is overrepresented in ITC, life science and financial services, these being very innovative sectors. On the other hand, Growth PE is very limited/underrepresented in sectors such as real estate, construction, transportation and agriculture where the amount of new innovative growth companies is low.

Figure 1.7 Share of Swedish growth PE investments in the different sectors (2007-15)



Note: The figure is based on total value of investment (not number of investments).

Source: Invest Europe

1.6 Buyout PE: A wake-up call for the sleepy companies

Even though Sweden is a country of many new growth companies, large and older companies still make up a relatively large share of the economy, especially in value and number of employees.

Some of these older (family owned) businesses may often end up in a “sleepy” situation where miss out on fulfilling their potential. This is generally related to two areas:

- **Profitability/productivity:** Companies can increase their productivity and profit from digitalisation and new technologies, effective R&D etc.
- **Growth potential:** Furthermore, often as a result of increased productivity, companies can grow markets, export to new countries, etc.

As shown in Figure 1.8, this can be seen as an efficiency frontier, indicating where a given company could be in terms of growth and profitability if it is steered in the right direction by the right management etc.

Characteristics of buyouts cases

There are a number of characteristics which PE buyout fund advisors look for in their investments. Some of the general ones are:

- Low uncontrollable risk (business cycle risk etc.)
- An industry without overly strong competition.

Also, they look for various types of potential:

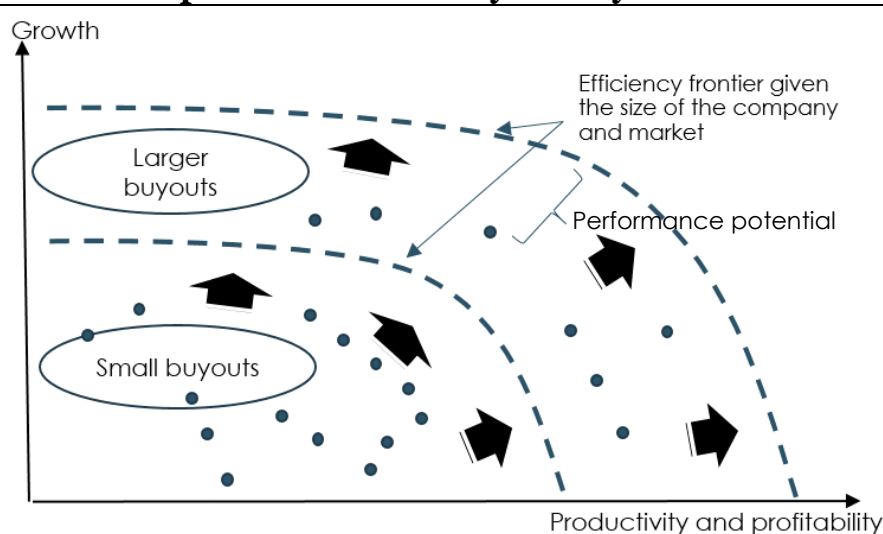
- A good brand with potential in focusing and strengthening the core business.
- Operational potential through large new investments, digitalization, R&D etc.
- Management potential.

- Growth potential in seeking new markets, export etc.

In all cases, PE firms and advisors search for companies below the efficiency frontier, aiming to add value to the company by increasing the innovation, productivity and competitiveness (as we will get back to in the next sections).

These factors have indeed been present in most of the Swedish PE buyout portfolio companies in recent years, see the cases on Anticimex and AniCura in Appendix C.

Figure 1.8 The optimisation done by PE buyouts



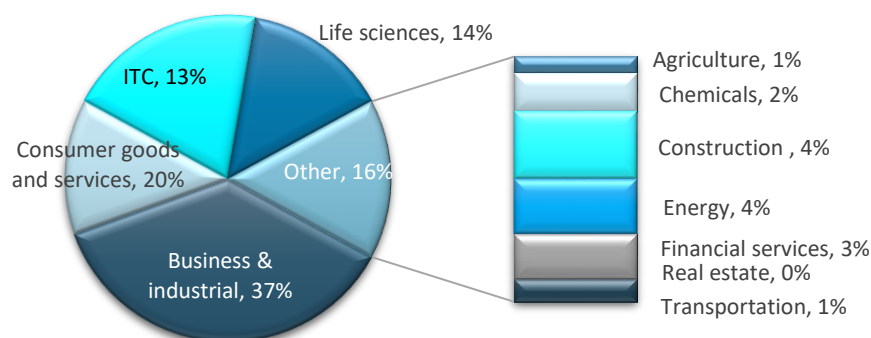
Source: Copenhagen Economics

Sectors

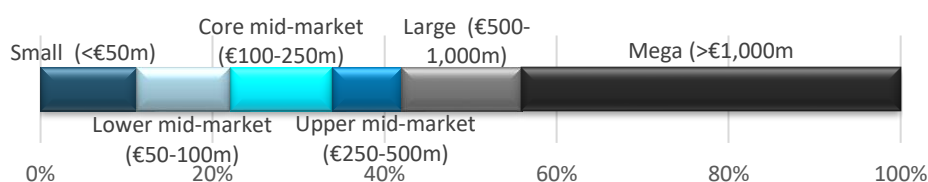
These characteristics are also seen in the buyout intensive sectors. PE buyouts are largely present in R&D-intensive high-tech sectors in need of active ownership and equity capital such as ITC (19 per cent) and the life sciences (25 per cent), see Figure 1.9. On the other hand, real estate, construction, transportation, materials and agriculture are sectors with very little PE investment, possibly because of strong existing competition, high business cycle risk and/or little R&D intensity and innovation potential.

Figure 1.9 Share of Swedish buyout PE investments in the different sectors (2007-15)

Sectors:



Sizes:



Note: The shares are based on the total value of investments (not number of investments).

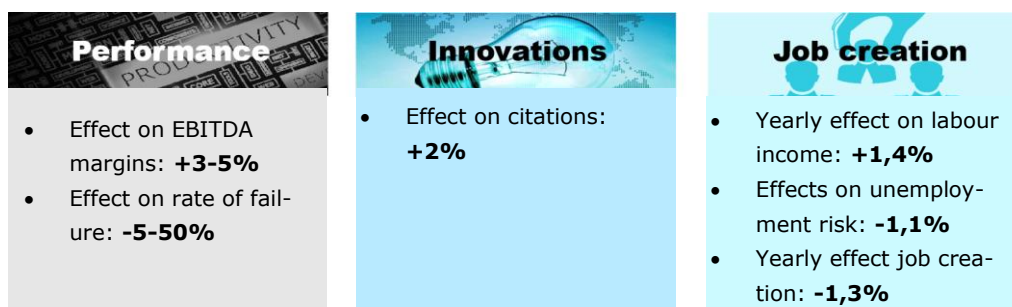
Source: Invest Europe

1.7 PE ownership increases the individual companies' innovation, productivity and competitiveness

There is evidence (even recent Swedish evidence) that PE ownership does increase the performance of companies in various ways. It is shown that PE ownership (see Figure 1.10):

- Increases the productivity measured by income margins (EBITDA to revenue) and cash flow ratios.
- Increases the performance of R&D investments, typically measured by the number of patents of the companies. Here, mostly the efficiency of the investments increases, while the amount invested may actually decrease.
- Results in lower risk of layoffs and positive effects on wages. Still, the literature typically shows smaller effects on job creation relative to comparable non-PE owned companies. This indicates that PE ownership is focused on increasing the profitability and competitiveness of businesses, which means more high-skilled jobs, and not necessarily more jobs in the short- and medium run.

In the next section, we will do a micro econometric analysis on most recent Swedish data, to see if these effects are indeed present in the data.

Figure 1.10 Increasing performance, innovation and job creation

Source: Copenhagen Economics and literature review in Appendix A

1.8 Implications for production and productivity in individual Swedish companies

Our way to analyse this

To analyse how the performance of Swedish companies is affected by PE ownership, we apply a micro econometric approach using accounting data on all Swedish companies from 2006 to 2015. Knowing when the PE fund take ownership, as well as a range of background information on each company, we are able to isolate the effect of PE ownership on performance. See the Box 1.1 to the right for details.

Box 1.1 The micro econometric model

- To analyse how PE investments affect individual companies' profitability, number of employees etc., we setup a fixed effects (FE) difference-in-difference type of modelling framework based on accounting data for almost all Swedish companies from 2006 to 2015 (the Amadeus database, approx. 1 m. companies).
- We identify around 1500 first-time buyouts, which allows us to analyse performance measures at differ phases in the ownership period, both in the years before PE ownership, the years just after the PE acquisition and in the longer run.
- By using a FE, we indirectly control for everything that is rather constant about the companies' size category, age range, sector, legal form etc. Further, we also control for year specific effects.

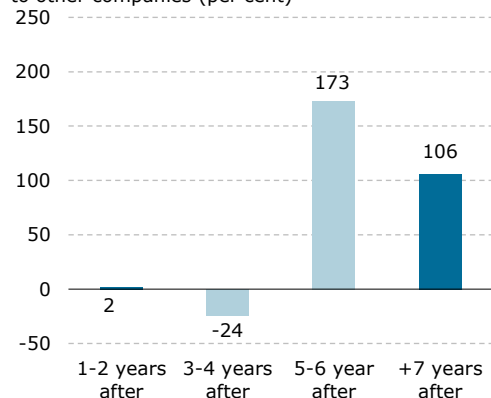
Source: Copenhagen Economics

PE ownership increases productivity

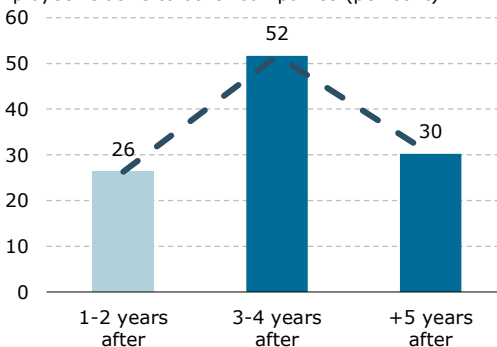
PE funds often invest in companies that are doing rather bad in terms of profitability, i.e. companies where they see a potential. This is also indicated in the data, where e.g. EBITDA per employee in the first years of PE ownership is very low, and often even negative, compared to similar companies, see Figure 1.10a.

Figure 1.11 PE ownership increase profitability and productivity**a) Effect of PE ownership on profitability**

Difference in EBITDA pr. employee relative to other companies (per cent)

**b) Effect of PE ownership on productivity**

Difference in growth in value added pr. employee relative to other companies (per cent)



Note: The results are based on fixed effects regressions using accounting information on all Swedish companies from 2005 to 2015 (all available in Amadeus which is more than 1,2 m observations), see Box 1.1. Given that we use data on all companies, the results are quite noisy and should be interpreted with care. The dark blue columns are significant effects, while the light blue are insignificant.

Source: Copenhagen Economics based on Amadeus and Zephyr accounting and transaction data

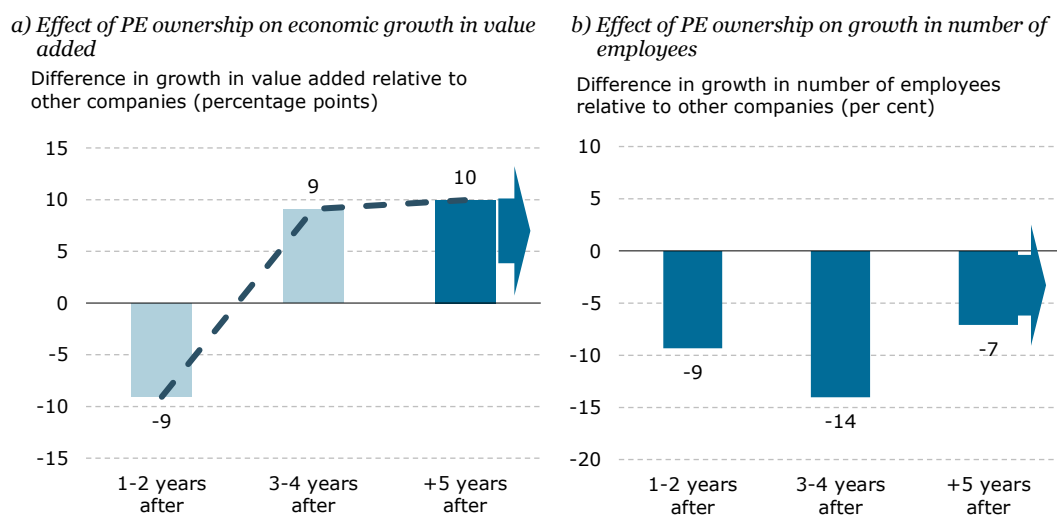
In the first four years of ownership, the profitability does not change much. This is typically because of restructurings in the companies, new investments, higher sales margins etc., which has negative effects on the profitability measures. After 5 years of PE ownership, we see increasing profitability while after 7 years we see a significantly higher profitability compared to similar non-PE funded companies.

We do see some tendencies for higher growth in employment productivity (value added pr. employee) already from the first years, although it is not statistically significant, see Figure 1.10b. However, after three years we see a significantly higher productivity compared to non-PE funded companies.

Increased economic growth

When we look at total economic growth in the companies, we see a picture similar to the ones for profitability and productivity, see Figure 1.12a. The growth is actually negative the first couple of years, after which it becomes slightly positive (statistically insignificant). After five years, we see significant positive growth of around 10 per cent higher per year, as compared to similar non-PE funded companies.

Figure 1.12 PE ownership increases growth but not necessarily the number of employees



Note: The results are based on fixed effects regressions using accounting information on all Swedish companies from 2005 to 2015 (all available in Amadeus which is more than 1,2 m observations), see Box 1.1. Given that we use data on all companies, the results are quite noisy and should be interpreted with care. The dark blue columns are significant effects, while the light blue are insignificant. These results are based on an FE regression including all Swedish companies, which is why the results are quite noisy.

Source: Copenhagen Economics based on Amadeus and Zephyr accounting and transaction data

Decreased number of employees in the short run

Similarly to the results in the literature, we do not find the same positive effect of PE ownership on job creation. In fact, the job creation is lower than in comparable companies, see Figure 1.12b. However, this result should be viewed with care, as a large share of the job creation in PE owned companies could happen in other companies that are supplying the PE owned companies (in cases where the business strategy includes outsourcing/sell off and focus on core actives). This is found in Davis et al. (2014), where they also find job decreases in the individual PE owned companies, but job creation in total when they account for the related jobs creation in subcontractors etc. to the PE owned companies.

1.9 Case examples of how PE firms apply their active management strategies and increase performance

In order understand how PE firms operate, we have analysed three successful portfolio company cases. As an important part of the analysis, we interviewed the CFO or CEO of the companies, as well as representatives of the PE firms who invested in the companies.⁸

⁸ Looking at three successful cases generally means that any negative effects of the ownership can be harder to identify. Nevertheless, the three cases provide valuable real-world input to how the PE ownership model is assumed to provide value in terms of enhanced company performance. Thus, an important prerequisite was to identify the circumstances and specific phase that each company was in. The interviews were focused on the active ownership model influencing the respective companies, both as regards to corporate governance, operational management as well as financing

The PE ownership of these companies to a large extent resemble the general tendencies for PE owned companies as discussed above. Our first case (Happy Socks) is a typical-growth PE company, our second (AniCura) is a special type of buyout, while our last (Anticimex) is a typical buyout company, see the highlight in Box 1.2 and more details in Appendix C. In addition to the effects on economic performance, it is worth highlighting how PE ownership in these companies also has a socioeconomic dimension. For example, EQT has helped digitalise the products of Anticimex, increasing the general investments in new equipment in the niche-sector of pest control. Nordic Capital has consolidated and professionalised the niche-sector of veterinary care and animal hospitals, resulting in higher quality of treatments.

Box 1.2 Hard facts about the companies

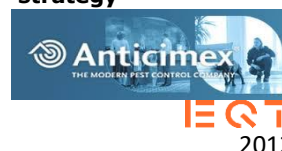
Happy Socks –growth company



AniCura – growth and consolidation



Anticimex – buyout and refocusing of strategy



Placement in the capital food chain

- Happy socks was founded in 2008 with the idea of providing a new product on a classical market (footwear – socks). The company's development was driven by the entrepreneurial spirit of its founders.
- The PE firm Scope Capital invested in a majority stake in 2015, with the aim of supporting the company on its continued growth path.
- Scope Capital's business strategy was mainly built around introducing corporate standards at the company, in order to ensure a good structure around the business. This meant getting the right people in place (management recruits) as well as facilitating knowledge sharing.
- Prior to 2011, the market for veterinary care consisted of several smaller clinics and hospitals and was thus very fragmented. Together with Evidensia, AniCura has been the main driver behind market consolidation.
- The PE firm Nordic Capital entered as a majority shareholder in 2014 and contributed both with capital and knowledge in order to support the further development of the company.
- Nordic Capital's business strategy was built around utilizing the opportunities in a consolidating market, with the goal to facilitate economies of scale. The PE firm has contributed with sector knowledge and supported the company through the rapid growth phase.
- Anticimex was founded in 1934 and has been a strong player within the pest control industry for a long time. During the later years, technological developments have led to new possibilities within the industry.
- The PE firm EQT bought the company from another PE firm in 2012, with the aim of taking the company in a slightly new direction.
- EQT's business strategy was built around focusing on the core strengths of the business in combination with an international expansion through acquisitions and technological developments. Digitalization made the business model scalable and the PE ownership provided a structure where the ambitious strategy could be executed upon during a shorter time span.

Chapter 2

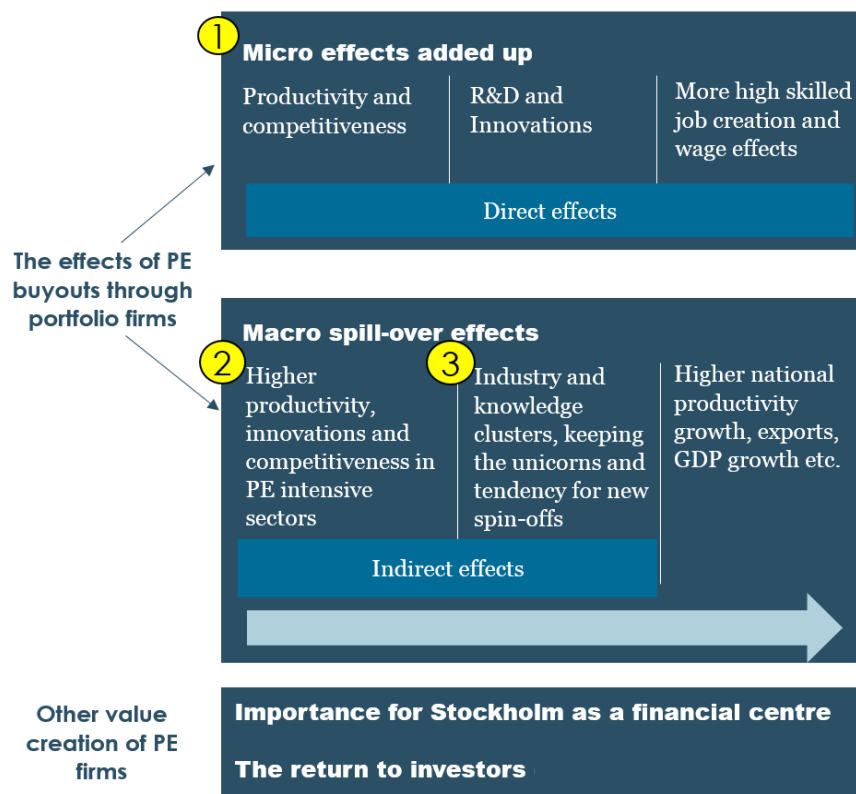
Creation of national economic growth and value

2.1 A framework of how to understand the growth implications of PE ownership

Effects of working through higher performance in portfolio companies

When analysing the macro effects of PE investments, we have to consider several dimensions of effects, see Figure 2.1.

Figure 2.1 A framework of how to understand the contribution of PE investments



Source: Copenhagen Economics

1. In the first dimension, we have the increased productivity and competitiveness in all the PE funded companies together (as analysed in previous section). This we can label as the direct effects of PE investments on the national economy.

Perhaps even more importantly, this will have a number of further indirect effects in the sectors of high PE investments, potentially even larger than the direct effects:⁹

2. Higher productivity, innovations and competitiveness of PE owned companies may increase the competition in PE intensive sectors, and other companies in the sectors will have to step up their productivity and innovation in order to keep their market share. This increased competition can have large ongoing effects in the individual sectors that earlier were in a “sleeping stage”.
3. Through the increased productivity and expertise in certain sectors, the PE industry also helps create so-called industry and knowledge clusters. These are sectors where Sweden is a global leading player, such as ITC, BioTech and Finance. This ensures that younger, very successful Swedish companies will stay in Sweden and not move e.g. to Silicon Valley. Also, these industry clusters often create spin-offs in terms of new growth companies.

Ultimately, this results in large positive effects on national productivity, job creation and growth.¹⁰

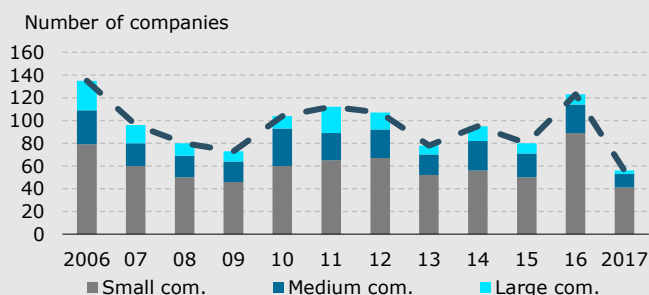
2.2 PE investments cover a share of the Swedish market

A large share of the Swedish equity capital market

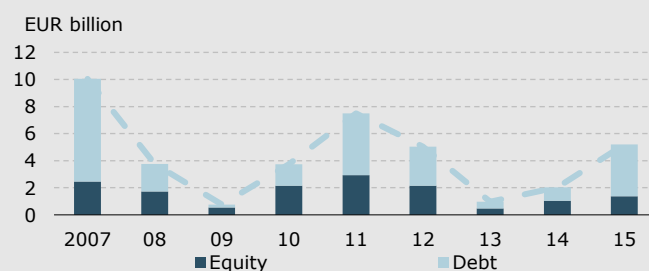
When we look at all PE deals since 2006, we find that the equity capital provided through PE investment in Swedish companies account for well over €15 billion, while the total capital (including leverage) accounts for about €40 billion, see Figure 2.2.

⁹ Bernstein et al. (2014) find indications that the indirect growth effects of PE investments are larger than the direct effects.

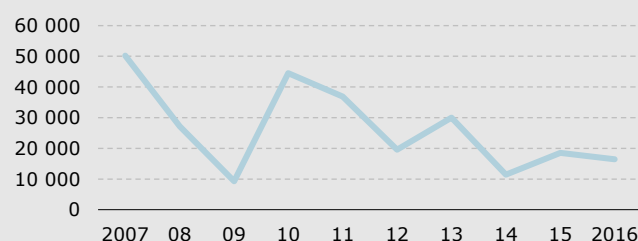
¹⁰ Only a few earlier studies have tried to estimate the sectoral and national (macro) effects of PE ownership intensity, see Bernstein et al. (2014).

Figure 2.2 Large share of PE investments in the Swedish economy**PE funded companies in Sweden and their number of employees**

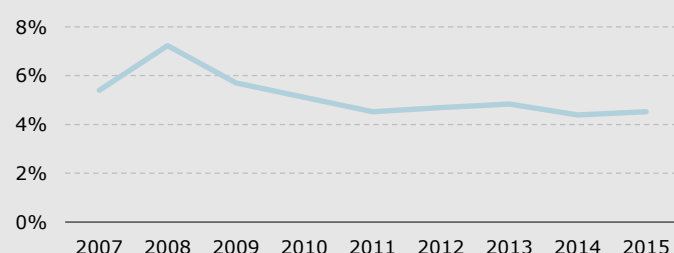
- At least 1,000 companies since 2007
- Equivalent to at least 1 per cent of all Swedish private companies

PE investments, equity and debt

- Around €15 billion equity and €40 billion in total investments since 2007
- Equal to the total listed (IPO) capital on Nasdaq Stockholm

Number of employees in PE funded companies in Sweden per year

- At least 270,000 jobs in PE funded companies since 2007 (in more than 1,000 companies)
- Equivalent to 7.5 per cent of Swedish private employees

Value added (VA) from companies with PE investments (share of national VA)

- Companies with PE investments has a share of at least 5.5 per cent of Swedish national value added (\approx GDP)

Note: The data may be missing some transactions. Hence, these are low estimates. The true share may be somewhat higher

Source: Zephyr and Invest Europe, PE Yearbook 2016

Putting this in perspective, the public equity market at the Stockholm Stock Exchange provided approximately the same amount of IPO equity capital over this period. Seen in comparison to the market value of the small- and mid-cap market, the PE investments since 2006 account for around five per cent.

PE market activity was quite high just before the crisis in 2007, further it dropped quite a lot because of both the financial crisis (2009) and the sovereign debt crisis (2013). This is quite typical for the PE market – as for most other capital markets – since they are highly dependent on the risk appetite in the economy.

A large share of Swedish companies and jobs

When we look at the company level, PE financed more than 1,000 Swedish companies since 2007. Out of these, around 60 per cent were relatively small companies, 25 per cent were medium sized companies while the final 15 per cent were large companies. To put it into perspective, this adds up to around one per cent of all Swedish companies (excluding micro companies). The companies together account for almost 270,000 jobs, which is about 7.5 per cent of the Swedish private labour market.

2.3 Effects on national productivity and competitiveness

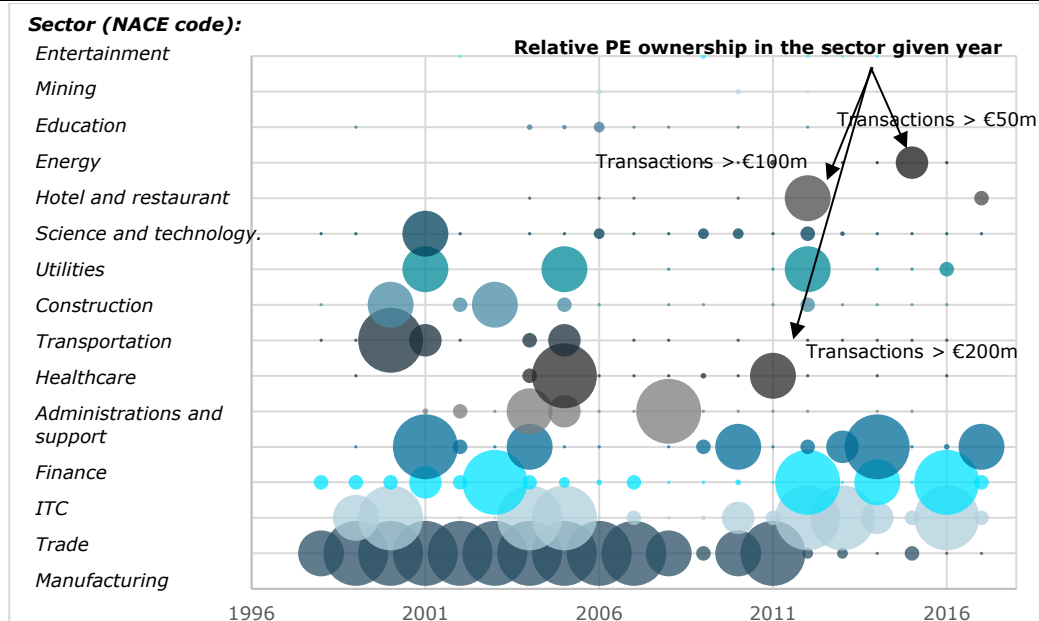
In the next sections, we will estimate the effects of PE investments on macroeconomic growth, productivity and job creation. Here, we will rely on two broad research findings:

1. The previous micro econometric results regarding direct effects of PE investments in individual companies.
2. The results from the sparse literature on macroeconomic spill-over effects of intense PE investment in individual sectors.

PE intensive sectors

For both the direct and indirect effects it is important to first point out which sector historically has been PE intensive. This is shown in Figure 2.3, where the size of the bubbles indicates the intensity of PE investments in the sector for a given year. The PE ownership in individual companies will typically last 5-10 years and, hence, the effect on the relative sector ownership share last for some years after we see large deals.

Figure 2.3 Size and sector intensity of Swedish PE investments (1996-2017)

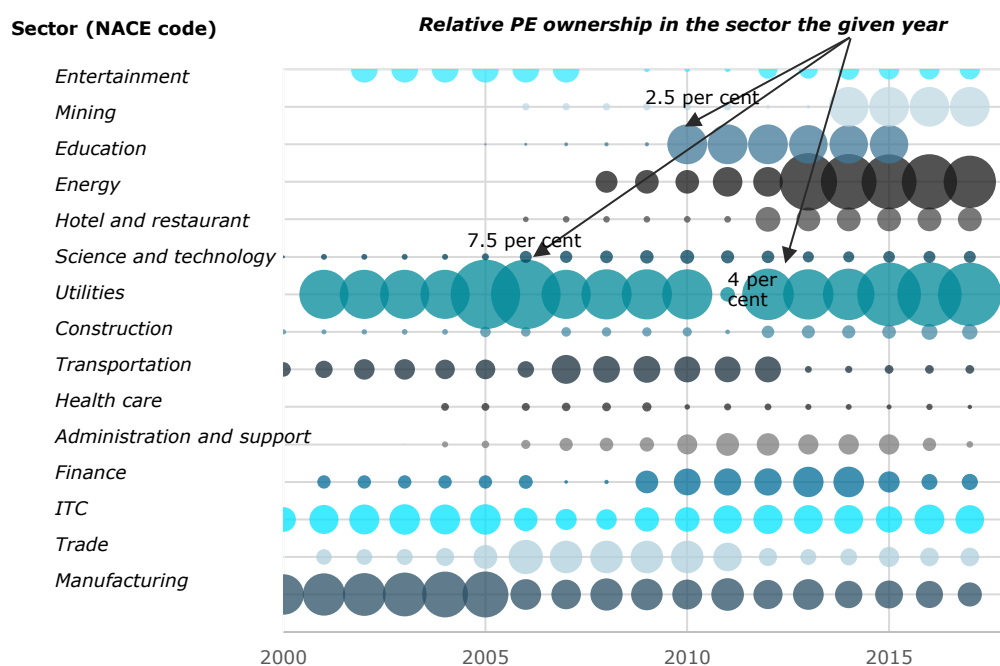


Note: The size of the bubble indicates the size of the PE investments in the specific sector in the specific year, measured in value.

Source: Zephyr database

As seen, we have manufacturing standing out as a sector of intense PE investments during the 1990s and early 2000s, while the investment intensity has decreased since then. The manufacturing sector is large in Sweden, and therefore it is relevant to see the PE investment and ownership relative to the sector size. Despite the size of the manufacturing sector in Sweden, we estimate a PE sector ownership share of around 1,5 per cent on average since 2006, see Figure 2.4.

This also indicates how the ownership share is very dependent on the size of the given sector. The sectors with the largest PE ownership shares are relatively small sectors (in terms of employment) – utilities and energy – even though the investments in these sectors was not as large as in some of the large sectors.

Figure 2.4 Estimated PE sector ownership share (2000-2017)

Note: The size of the bubble indicates the size of the relative PE ownership of the companies in the sector (based on employment) in the specific year. We generally assume a 6-year holding period.

Source: Zephyr data and SCB data on total sector employment

2.4 Effects on national economic growth

Calculating overall growth effect of PE ownership

To calculate the direct effect of PE ownership, we have used micro econometric results, indicating that PE owned companies on average have a 10 per cent higher growth in gross value added (profit/loss before tax plus compensation of employees).

For the indirect effects, we use the results of Bernstein et al. (2014) indicating that sectors with some degree of PE ownership on average grow significantly faster as a result of the PE ownership, while sectors with a higher degree of PE ownership grow even faster. We use a combination for our micro results from last chapter and Bernstein et al. (2014) results regarding indirect effects to analyse the macroeconomic growth effects of Swedish PE investment in the period from 2005 to 2017, see Box 2.1.

Box 2.1 Our methods to estimate sector and national economic growth effects of PE investments

Our estimation of national economic growth effect are based on estimations of (total) sector growth effects. For each sector we estimate two types of growth effects, the direct effects happening through the companies reviewing PE funds, and indirect effects happening through non-PE companies having to step up their performance, sub-contractor, spin-offs etc. For each sector, effects are calculated as follows:

1. **Direct effects:** These are calculated by first estimating the share of the sector's PE ownership in each given year. Here, we use Zephyr data on more or less all Swedish PE investments and assume that each PE ownership lasts for six years. Knowing the share of PE ownership, we use the micro econometric results from Section 1.8 to estimate the direct growth effect of PE ownership in the sector the given year.
2. **Indirect effects:** These are estimated using the results of Bernstein et al. (2014). When sectors see a smaller PE ownership share, Bernstein et al. (2014) finds an effect on total value added growth of the sector (in the given country and year) of between 0.6 and 1.2 per cent. For sectors with a large PE ownership share they find an effect on total value added growth between 0.4 to 1.7 per cent. Here, we have used the average effects found in Bernstein et al. (2014), and we assume that a small PE ownership share is above 1 per cent and a large is above 5 per cent. The indirect effects are found as a residual (minimum zero); taking the total effects and subtracting the direct effects.

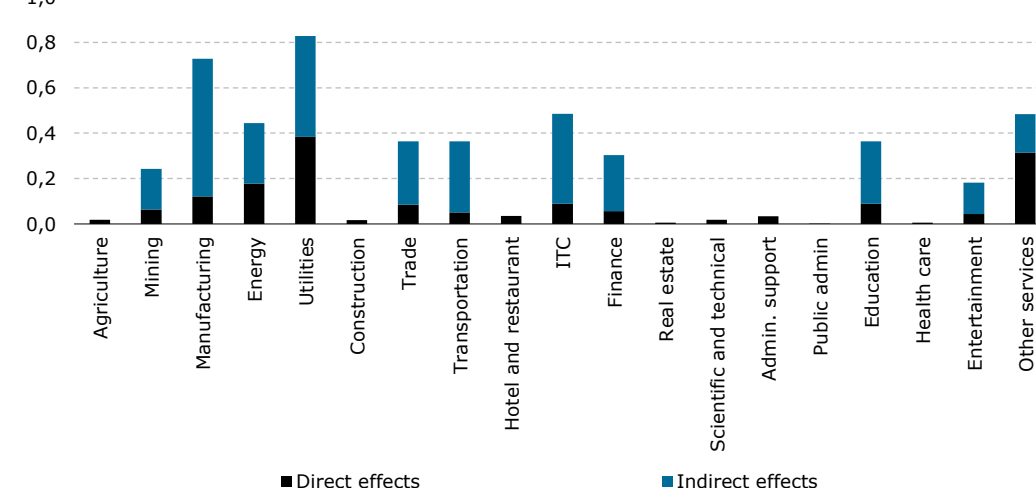
Source: Copenhagen Economics

Large effects in certain sectors

As seen in Figure 2.5, the estimates indicate that in the sectors of high PE ownership, the average yearly growth effect is as high as 0.8 per cent per year. This is the case for manufacturing and utilities, where the degree of PE ownership has been relatively high over the period. For utilities and other services, the direct growth effect of individual companies is found to be quite high. In most other sectors, the indirect effect seems to dominate, as was also indicated in Bernstein et al. (2014). Here, a couple of sectors have seen a yearly growth contribution of PE ownership of around 0.4 per cent.

Figure 2.5 Estimated sector growth effects of PE ownership (2005-16)

Effect of PE investments on yearly growth in sector value added (percentage points)



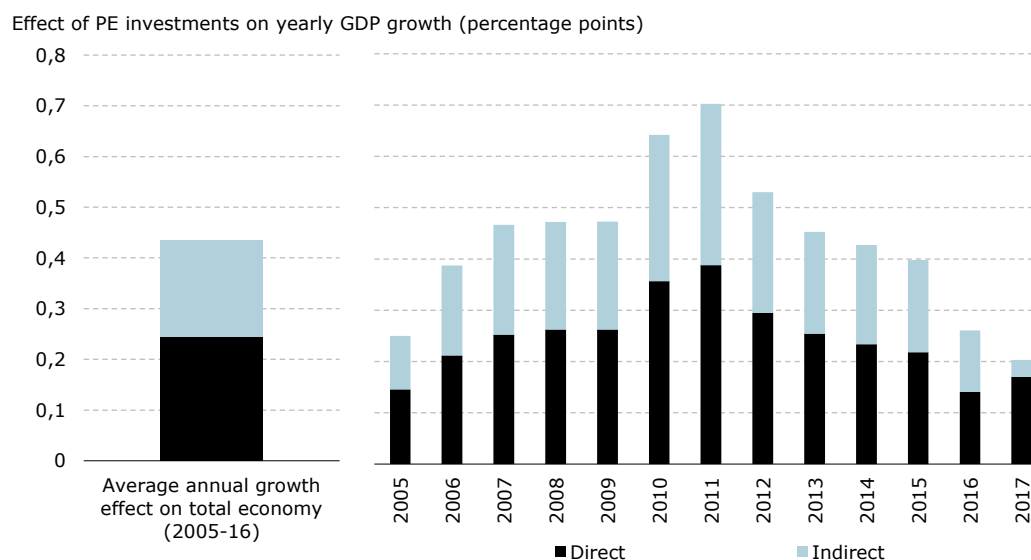
Note: See Box 2.1 for details on the calculations.

Source: Copenhagen Economics estimates based on Amadeus, Zephyr and Bernstein et al. (2014)

Significant but varying national effect

When we add up to a national level we find a growth contribution to GDP of PE ownership of around 0.4 per cent per year, where a bit less than half is related to the direct effect of PE ownership in individual companies.

Looking at the growth effects over times, we see a significant increase in the effect of PE ownership from 2005-2007 until the end of the 2000s. Thereafter, the effect seems rather stable until 2015 where it seems to decrease. The accumulated GDP effect of PE investments from 2007 to 2017 is found to be around 6 per cent, i.e. Swedish GDP would have been 6 per cent lower today without the PE investments.

Figure 2.6 Estimated national growth effects of PE ownership

Note: See Box 2.1 for details on the calculations.

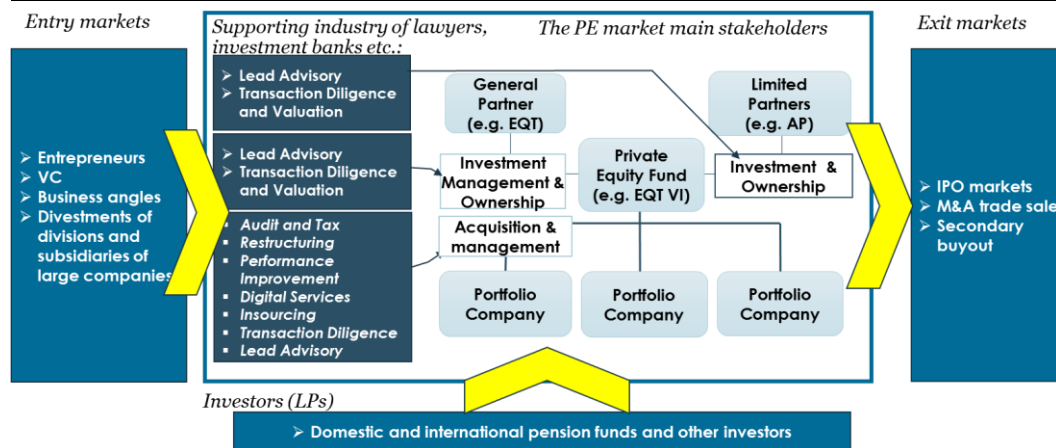
Source: Copenhagen Economics estimates based on Amadeus, Zephyr and Bernstein et al. (2014)

2.5 A great support for Stockholm's financial ecosystem

As discussed in Chapter 1, the business structure of PE funds involves many different activities, supporting different related markets, firms in the financial and legal advisory sector as well as the asset management industry.

Starting with the core business of PE firms, as shown in Figure 2.7, PE firms employ a lot of in-house and external professionals in the fundraising process, the screening for profitable investment opportunities and, even more so, in the actual acquisitions, sales and management of portfolio companies. The main part of these activities is to be found in the financial centre of Stockholm. In the related markets, as shown on each side, PE firms indirectly support Stockholm's growing industry of VC funds and BAs as well as investment banks and other financial and legal advisors in the IPO and M&A markets related to exit and entry transactions.

Figure 2.7 A market involving many different markets and service providers



Note: This is still a simplified picture.

Source: Copenhagen Economics

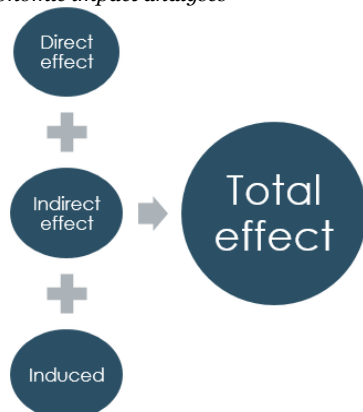
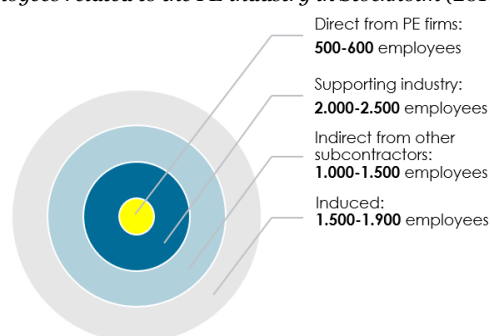
In the end, the clients/customers of PE firms are the investors. Here, PE firms are an important part of the asset management industry, ensuring high and stable returns for both international and domestic investors. The ultimate investors are to a large extent pension funds (private households' pension savings) and private individual households e.g. through insurance companies. Here, Stockholm also comprises a large industry of pension funds and other institutional investors (funding) investing money through the PE funds.

2.6 Activity related to the PE industry in Stockholm

When analysing the economic activity and jobs related to the PE industry, there is a number of effects we need to control for, see Figure 2.8a:

- First, we have the direct economic activity and jobs in the PE firms.
- Secondly, we have the indirect effects, related to sub-contractors of the PE firms.
- Thirdly, we have the induced effects, from the consumptions related to the labour income created by the direct and indirect economic activity.

When bringing all this together, we find that the PE industry in Stockholm supports somewhere between 5,200 and 6,400 jobs, see Figure 2.8b.

Figure 2.8 Employees in the Swedish PE sector (2016)*a) Economic impact analyses**b) Employees related to the PE industry in Stockholm (2016)*

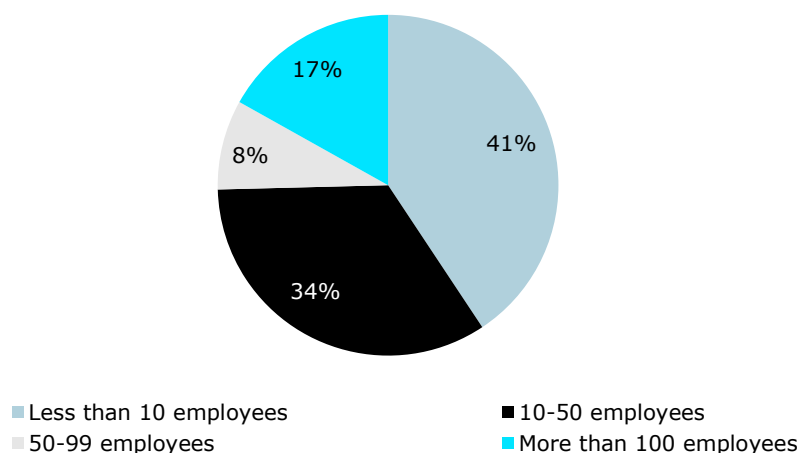
Note: These are rough estimates based on different sources

Source: SCB, Amadeus/Zephyr, I/O tables, interviews with the different PE firms and BVCA (07): The Impact of Private Equity as a UK Financial Service

The employees related to the PE sector in Stockholm

We estimate that almost 3,000 people are employed in the PE and supporting financial and advisory industry in Stockholm. Out of these almost 500 to 600 people are working directly in the around 70 PE firms operating in Stockholm. Most of the people are working in the large number of smaller PE houses with less than 10 full-time employees, but there is also a large share in the bigger PE houses including one (EQT) with more than 100 employees, see Figure 2.9. This comprises almost all people working in the Swedish PE sector.

Furthermore, the PE firms annually purchase financial and legal supporting services for around SEK 4.5 billion from investment banks, auditors, lawyers etc. This is equivalent to around 2,000 to 2,500 employees. As such, the close supporting industry to the PE firms is larger than the PE industry itself: for every employee in the PE firms, there are 4 to 5 full-time equivalent employees in the financial and legal supporting companies.

Figure 2.9 Distribution of employees in PE firms by size (2016)

Note: This covers PE firms in Sweden as a whole

Source: SCB

Further economic activity in Stockholm

On top of this, the PE and supporting industry give rise to further job and value creation in other sectors, including earlier in PE value chain. These are, for example, IT companies and telecommunication service providers, real estate and restaurants. Here, we estimate around 1,000 to 1,500 jobs. Many of these are also sub-contractors to the financial and legal advisors. In the end, we find an induced effect of another 1,500 to 1,900 employees.

2.7 PE as part of asset management

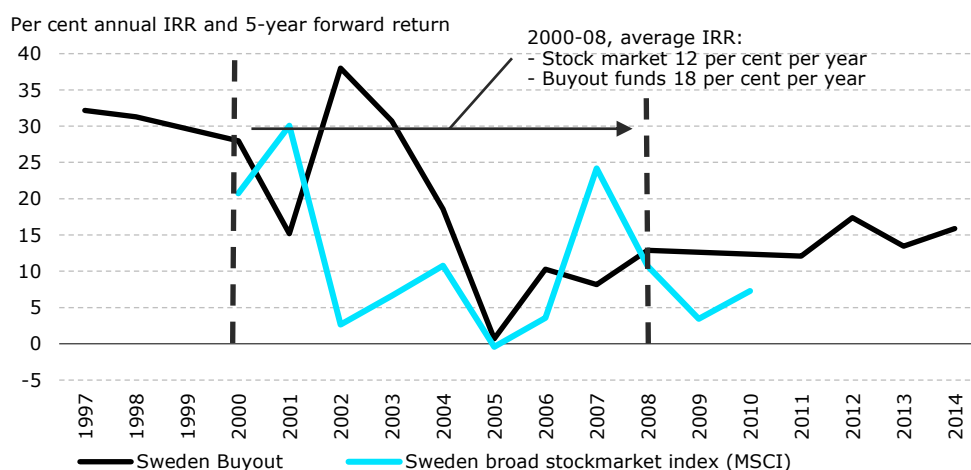
Investments through PE funds are becoming more and more popular for institutional investors such as pension funds, insurance companies, endowments and family offices. The reason is that PE funds provide attractive long-term investment returns and risk diversifications, as compared to public equity investments.

PE may be investing in the same industries and with similar risk factors as public equity. However, PE investments are still fundamentally different in their long-term investment perspective, the focus on smaller companies and niche sectors as well as the active management of the companies they invest in.

Stable returns for many years

Over the last 20 years, the internal rate of return (net IRR) from Swedish buyout funds has been high (a bit over 18 per cent). There have been some fluctuations, especially because of the IT bubble and financial crisis. In general, however, the returns have been quite stable.

Figure 2.10 Return from Swedish buyouts compared to a broad stock market index



Note: Here we compare the yearly return of PE funds by vintage year by a strategy of buying and holding a broad public equity index for five years

Source: Pegin

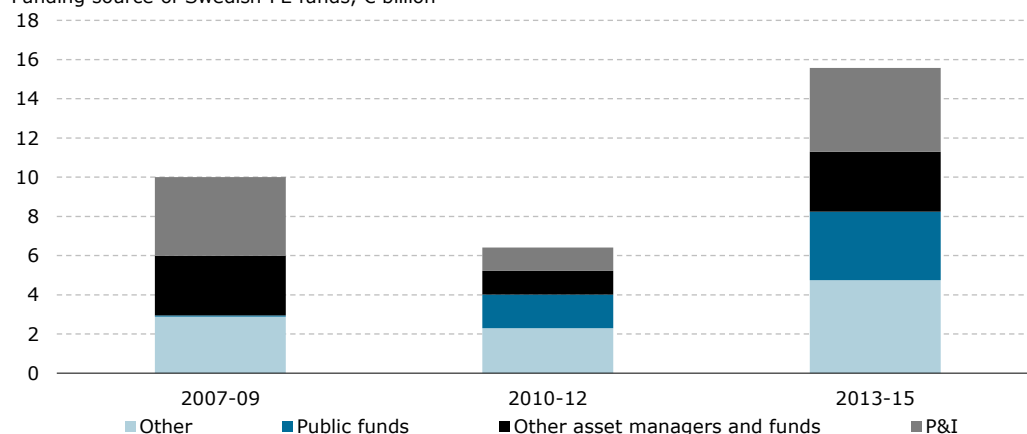
Compared to similar long-term (5 year) investment strategies in public equity, we find that Swedish buyout have out-performed public equity to a large degree. For example, from 2000 to 2008 public equity saw an average return of 12 per cent, where Swedish buyout funds on average had a return of 18 per cent. More so, the fluctuations in the returns are smaller for the buyout funds.

Large and increasing interest from institutional investors

Since the financial crisis, there has been an increasing amount of funding for Swedish PE firms coming from both institutional investors such as pension funds and insurance companies, as well as other asset managers and fund of funds (often investing on the behalf of smaller pension funds), see Figure 2.11. Further, from 2010 to 2015, public funds greatly increased, starting from zero investments in 2007 to 2009. To that extent, and given the high return on investments, PE funds also contribute positively to Swedish households' pension savings as well as other savings.

Figure 2.11 Increasing interest from pension and public funds

Funding source of Swedish PE funds, € billion



Note: Here *public funds* include government agencies and sovereign wealth funds. *Other asset managers and funds* include other asset managers and fund of funds. *Other* include private and family offices, academic institutions, endowments and foundations, banks and corporate investors.

Source: Invest Europe

Chapter 3

An international competitive sector with large export potential

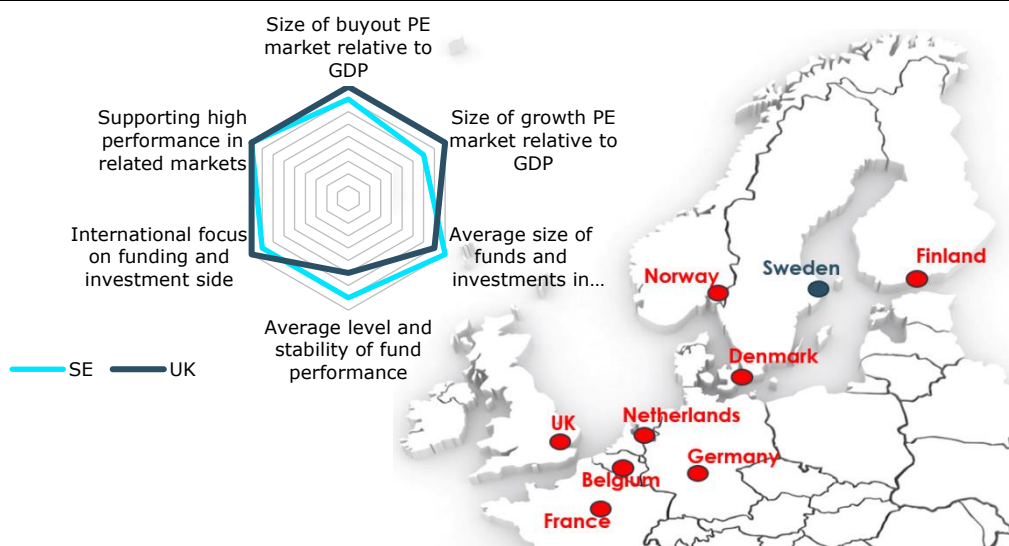
3.1 An international benchmark analysis

Although Sweden is a smaller country in Europe, the Swedish PE market is relatively large and contains future growth and export opportunities. This is something which should be exploited and there are currently a number of circumstances – e.g. the internationalization of Europe's financial sector, CMU and Brexit – which are opening up new growth opportunities.

In this part of the project, we do a benchmark analysis of the Swedish PE market. We will generally compare with the countries, see Figure 3.1 to the right:

- *The Nordic neighbours; Denmark, Norway, Finland.*
- *Other European countries: Germany, Netherlands, France, Spain, Italy, UK and Belgium.*

Figure 3.1 Ranking the Swedish PE industry after 2011



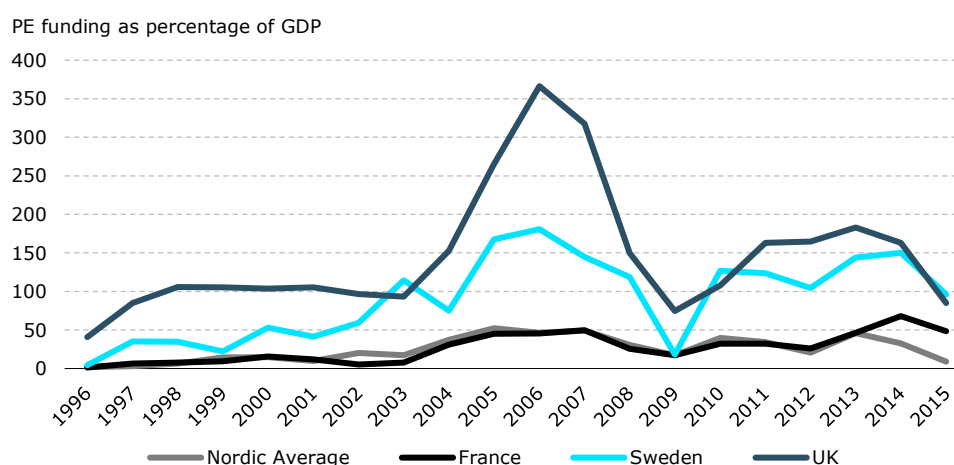
Note: Ranking compared to 8 other countries in the analysis (the above listed except for Italy and Spain)

Source: Copenhagen Economics

In summary, the international success of the Swedish PE market can be seen in the historic development of the market. For many years, annual fund value of Swedish PE firms has been the second highest in Europe (the countries we consider here) as a share of GDP, only surpassed by the UK market. In fact, in the recent year the Swedish market has been almost as large as the UK market (measured relative to GDP). Compared to the rest of continental

Europe and Scandinavia, the Swedish PE market is three to four times as big, see Figure 3.2.

Figure 3.2 Annual fund value relative to GDP (3-year moving average)



Note: For each year, the graphs show the funding over the last three years relative to total GDP over the same period. Central Europe includes Germany, France, Belgium, Netherlands

Source: Preqin

The high international standard of the Swedish PE market is also seen through many other market performance measures: size of funds and investments in larger companies, fund performance, international funding and investments, as well as the support for other capital markets in the economy. This we will exploit in the following.

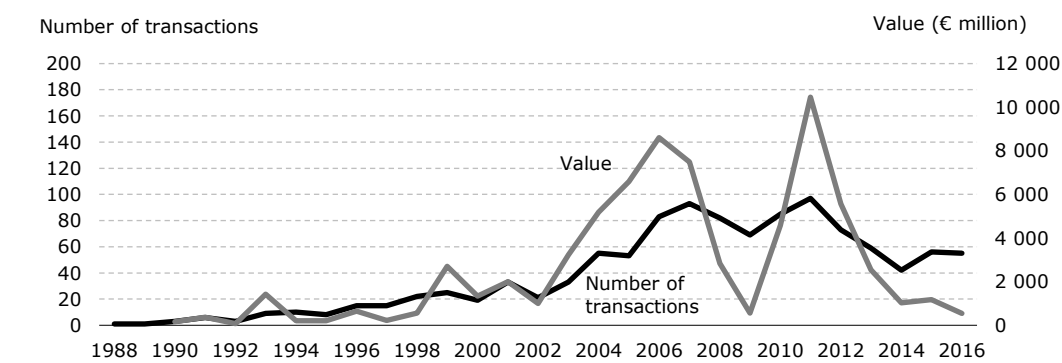
3.2 A historical success and high international performance

A story starting back in the 1980s

The success of Swedish PE started back in the late-1980s/early 1990s, as one of the first countries for PE investments in Europe. In this early boom period, the two PE firms: Nordic Capital (1989) and IK Investment Partners (1989) mainly started the market together with Procuritas (1986). Two of them came out of the banking sector; Nordic Capital was started by two former employees in Svenska Handelsbanken while IK came from SEB.

The Swedish PE market had success from the beginning, partly by exploiting the opportunity to buy assets on a discount during the banking crisis in the early 1990s. Seen from the number of transactions, there was a relatively steady growth in the first couple of years, while the value of the transactions saw a boom period in the early 1990s, see Figure 3.3 and Figure 3.4.

Figure 3.3 Number of transactions and total value of PE buyouts of Swedish companies

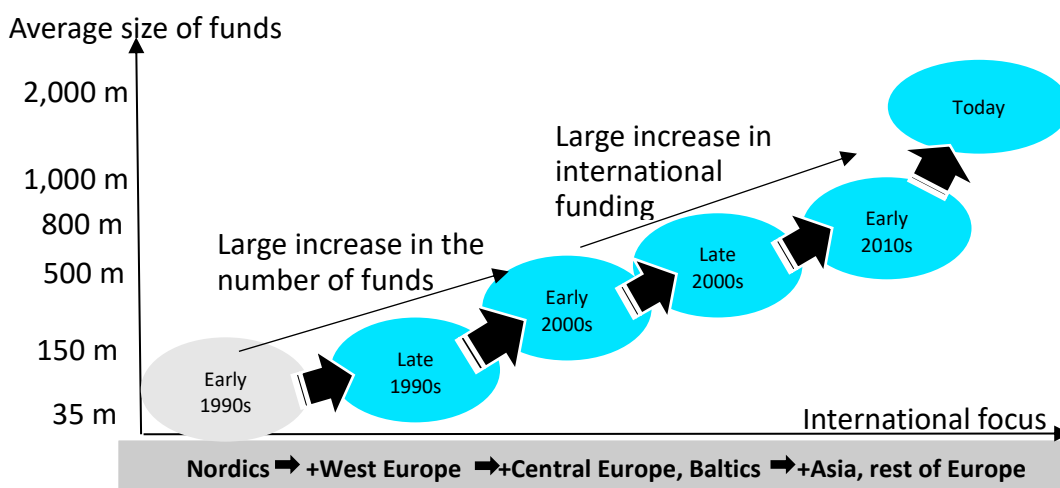


Source: Capital IQ

From the middle to the late 1990s came a second boom period, where large PE firms like EQT were also started. This was characterized by an increasing number of transactions and a larger international focus behind the Nordic countries towards Western Europe.

After a set back after the IT bubble, the market had a large boom in the mid-2000s until the 2008 financial crisis. This was also characterized by increasing transaction sizes, helped by decreasing interest rates, higher leverage as well as larger international investor interest and funding. The financial crisis and sovereign debt crisis in Europe both also had negative effects on the market dynamics.

Figure 3.4 The journey of Swedish PE industry



Source: PE Yearbook 2016, Preqin and interview results

Some driving forces of the market

There are several factors making this success possible in Sweden. Continuing success in the PE industry is all about keeping high and stable returns in the individual funds, incentivising investors come back and invest again. This is made possible through four general factors:

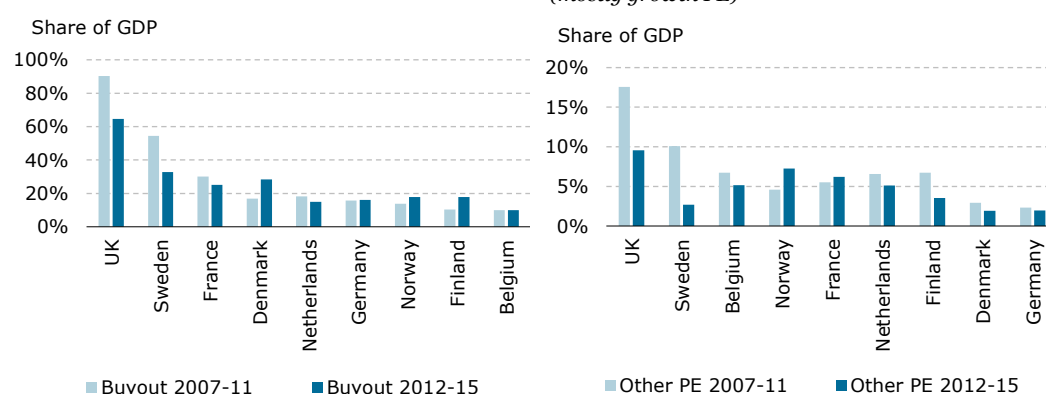
- **A good start:** The timing of the birth of the Swedish PE market was important for creating a good performance and reputation from the start.
- **Initial domestic funding and financial infrastructure:** This includes the presence of large domestic and international banks in Stockholm, e.g. SEB and SHB, who were important fundraisers for the first PE firms in Stockholm. The broad landscape of institutional investors and smaller family offices in Sweden has also been crucial, e.g., the insurance company Skandia and the AP-funds were large contributors to the PE industry from the start.
- **Large deal flow:** Historically, Sweden has had many industrial giants, such as Ericsson, Volvo, ABB, Telia etc. These contributed to the good entrepreneurial environment in Sweden by bringing good investment cases for PE funds to invest in. This is visible from the fact that Sweden has a very large number of SMEs compared to other countries.
- **Knowledge and talent pool:** Both the financial infrastructure and the fact that Stockholm has a strong tradition for management consulting have created an important talent pool for PE firms.
- **Supportive and stable political environment:** Political and economic stability since the crisis in the early 1990s is also a typically mentioned factor contribution to the Swedish PE success.

A large market in Sweden given the size of the economy

From 2007-15, the Swedish buyout investments as share of GDP was the second largest in Europe, only surpassed by the UK market, see Figure 3.5. As for all the other countries, the market activity was significantly larger in the years before the crisis (2007-08).

Figure 3.5 PE investments as share of GDP

a) Total value of PE buyout investments

b) Total value of other PE investments
(mostly growth PE)

Note: The figures show investments by country of PE firms

Source: Invest Europe, PE Yearbook 2016

A somewhat similar picture is seen when we look at other PE investments, which mostly consist of growth PE. Here, Sweden also has the second largest market as share of GDP, although the market activity has been rather low from 2012 to 2015.

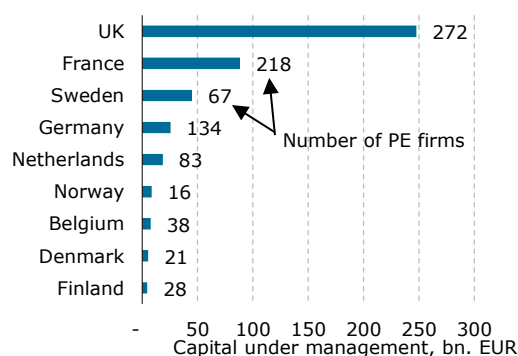
Some of the largest funds in Europe

When we look at capital under management, the Swedish market is also the third largest in absolute numbers, see Figure 3.6a. In 2015, Swedish PE firms had around €45 billion under management, where France, as the second highest, had €88 billion and the UK had €248 billion.

Figure 3.6 Size of the PE market in Sweden

a) Capital under management in PE firms and number of PE firms (2015)

b) Global and European ranking (by size) of Swedish PE firms (2016)



Note: Panel a): The bars show the amount of capital under management, and the numbers represent the number of buyout firms (including general PE firms). Panel b): Rankings from PEI 300 (2016)

Source: Panel a): Invest Europe, PE Yearbook 2016. Panel b): Private Equity International

The reasons for this is that Sweden has some of the largest PE firms in Europe. From the 2016 PEI 300 list, EQT is the second largest PE firm in Europe (and the 10th largest in the world), while Nordic Capital is the seventh largest PE firm in Europe, see Figure 3.6b. Hence, when looking at the number of Swedish PE firms, the market is not significantly large; it only has 67 PE firms where the UK has 272 and France has 218. This indicates that Swedish funds are, on average, larger than other funds.

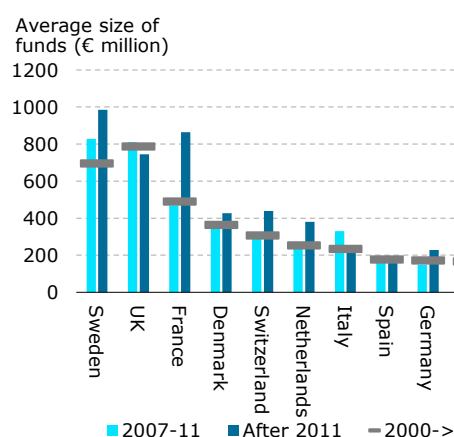
3.3 Performance of the investments

The size of the PE funds

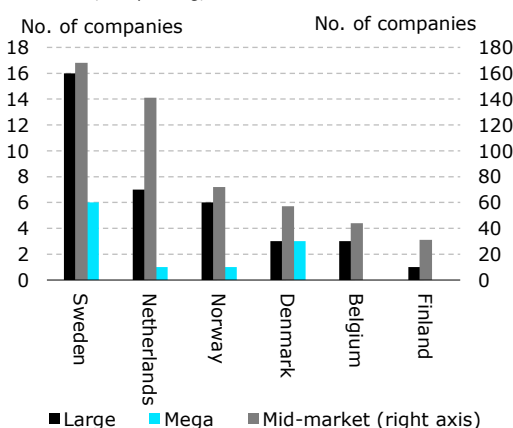
The size of the Swedish PE sector is visible through the average size of the individual funds, as depicted in Figure 3.7a. In fact, after 2010 the average size of Swedish PE funds was larger than all countries – even the UK.

Figure 3.7 Large funds and many investments

a) Average fund size of PE buyout funds



b) Number of investments by size for the smaller countries (2007-2015)



Note: Panel b): Mega deals have equity investments above €300 million, large are €150-300 million, while mid-market are €50-150 million. The figure only compares countries of similar size (hence not UK)

Source: Panel a): Preqin. Panel b): Invest Europe, PE Yearbook 2016

Generally, fund sizes have increased for all countries, except for Italy, from 2000 and onwards. The increase in Sweden has however been sharper and continued throughout the period – a testament to the relative success of Swedish PE firms and funds.

Importantly, the large funds also allow Swedish PE firms to invest in significantly larger companies compared to other countries. As seen from Figure 3.7b, the Swedish PE market have a larger share of its investments in large and mega deals (over €150 million).

A stable performance

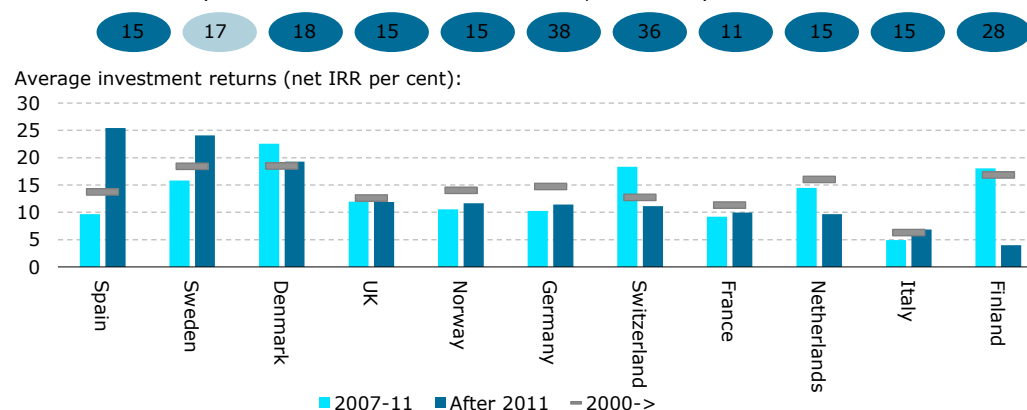
Stable and competitive returns are important for keeping existing investors as well as attracting new ones. Except for a downturn in the years around the financial crisis (2006-2010), Swedish PE funds have shown a stable return throughout the whole period from

2000 to 2016, see Figure 3.8. Furthermore, the average size of the Swedish funds does not seem to influence their performance in any negative way. UK and France – the other two countries with relatively large average fund sizes – have seen average returns of 12.6 per cent and 11.3 per cent respectively, whereas the average net return of the Swedish funds is considerably higher at around 18.4 per cent.

The fund performance is also evaluated according to how much the returns vary between the different funds and over time. Swedish PE funds show relatively stable returns also given the high (and increasing) average fund size, see the standard deviations of returns in the top of Figure 3.8.

Figure 3.8 Average returns on PE investments, net IRR

Risk of investments (standard deviation of net IRR fund level, 2000-2016):



Source: Preqin

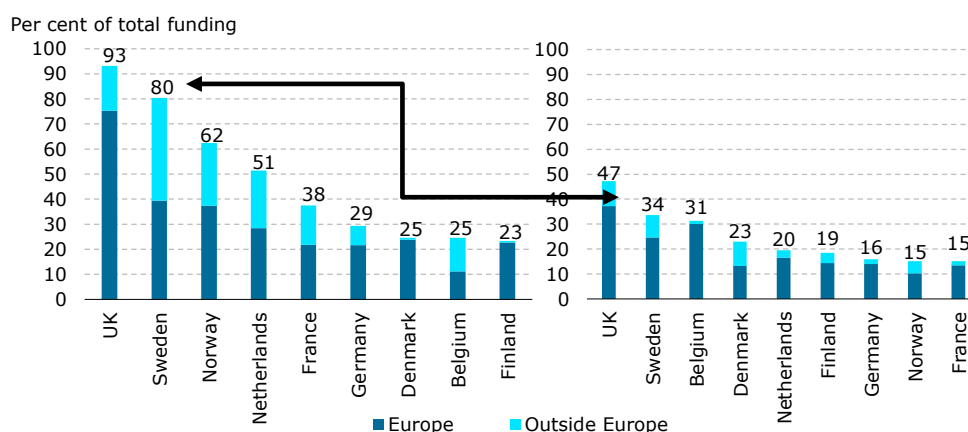
3.4 A large international focus

A high international interest on the funding sides

As a result of the high international and historical performance/reputation of Swedish PE funds, the international investor interest is very high relative to most other countries. From 2007-2015 as much as 80 per cent of total funding of Swedish PE funds came from abroad, with half of that share from non-European countries, see Figure 3.9.

Figure 3.9 A high international orientation

a) Share of funding which is international (2007-15) b) Share of investments which are international (2007-15)

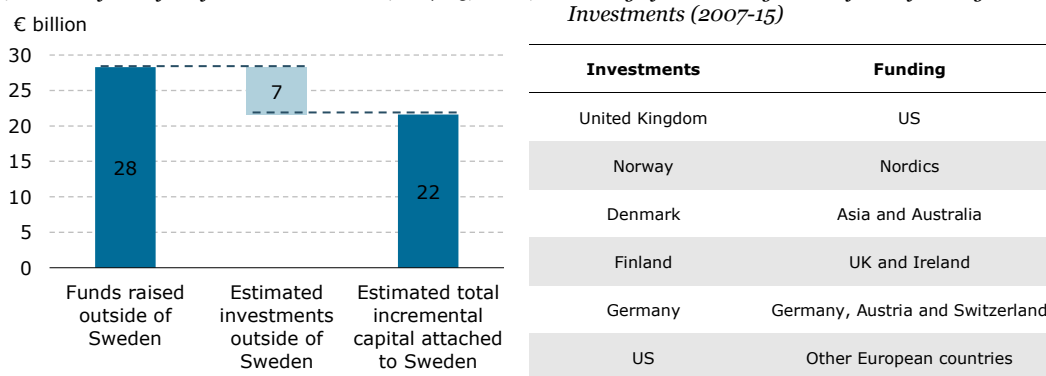


Source: Invest Europe, PE Yearbook 2016

The biggest share of foreign funding comes from the US, while the Nordics and Asia/Australia in the second and third largest see Figure 3.10b. This is indeed one of the main reasons for the historical growth of Swedish PE funds and the Swedish PE market as such.

Figure 3.10 Inflow of PE funds and large markets in Sweden

a) Net inflow of PE funds into Sweden (2007-15) b) Raking of counties by share of total funding and Investments (2007-15)



Source: Invest Europe, PE Yearbook 2016

3.5 Supporting a high performance in other related markets

Supporting markets in the exit sides

There are three broad ways PE firms can exit successful investments:

- Through a trade sale, typically to a company in the same sector as the portfolio company;
- Through a partner sale to another PE fund;

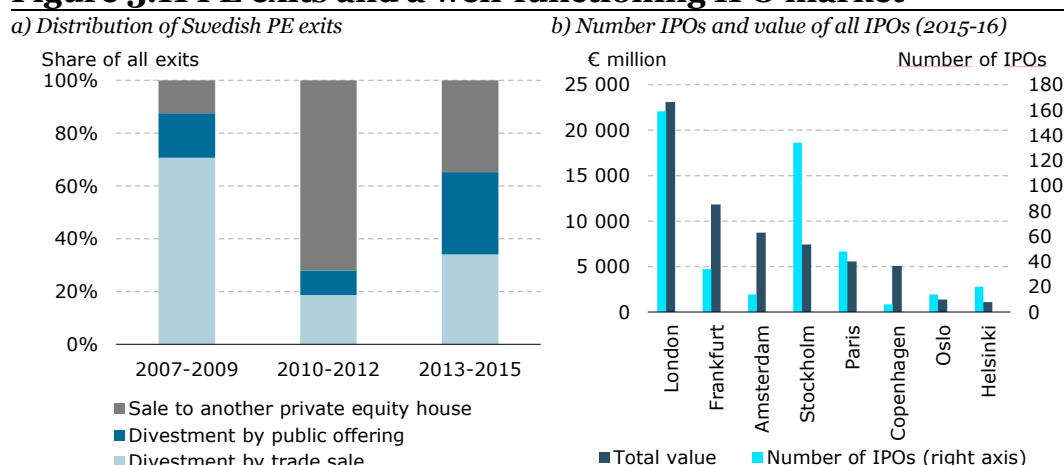
- Through an IPO.

Since 2007 the distribution for buyout fund exits has been more or less a third of each option (this is not quite so true for IPOs), see Figure 3.11a. Just after the crisis, most exits were made to other PE firms since the other exit markets were not well functioning. In the last couple of years, IPO exits have been very popular. One reason is that the stock prices are high.

In comparison to other countries, IPO exits are quite popular in Sweden. As such the PE market may be supporting the great current success of the Swedish IPO market (and stock market in general) – and *vice versa*, see Figure 3.11b.

The same goes for the M&A market, where Sweden has some of the highest number of M&As relative to the size of the country, where especially the number of small-medium sized M&As is high, see Figure 3.12a.

Figure 3.11 PE exits and a well-functioning IPO market



Note: Panel a): We have not included write-offs, which were quite typical just after the crisis.

Source: Panel a): Invest Europe, PE Yearbook 2016. Panel b): Zephyr

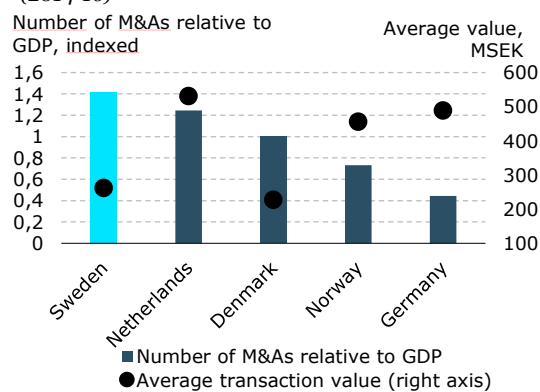
Supporting the earlier capital markets

Sweden also has a large market for SME financing earlier in the capital food chain; including VC, BA and other types of early PE, see Figure 3.12b. This may also be affected by and support the strongly performing PE market in Sweden. First, for BA and VC funds to keep funding new young growth companies, it is important that they have well performing markets enabling them to exit their earlier acquired positions; the risk they take in their investments is lower when they have well-functioning exit markets. To this end, the capital food chain is a bit like an assembly line, where the performance of each part of the line depends on the functioning of the rest (in both directions).

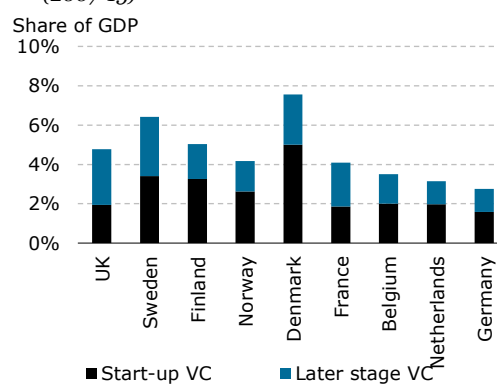
Furthermore, as discussed above, high degrees of PE activity also support industrial and knowledge clusters, which are important for new ideas, entrepreneurs and growth companies. For example, earlier literature finds up to 10 new companies are created as a result of the creation of a new private equity-backed company, see Samila and Sorenson (2011).

Figure 3.12 Supporting M&A and earlier capital markets

b) Number and average size of M&A transactions
(2014-16)



a) Capital supplies by the early equity capital
(2007-15)



Source: Invest Europe and Zephyr database

Chapter 4

A future perspective

There is currently a widespread need for equity capital and a large potential to increase productivity and competitiveness in most European countries. At the same time, the European capital markets are becoming more and more integrated and financial services are becoming more mobile. This is partly a result of recent new EU regulations, aiming to ensure a level playing field and equal access to capital markets across Europe.

This opens up a clear window of opportunities for the Swedish PE and other capital markets. As shown in last chapter, the Swedish PE market is very competitive, and given the right framework conditions, the Swedish PE industry will be able to expand a lot in the coming years and become an even larger exporter and a centre for the PE and other equity capital market in Europe.

Still, the Swedish and cross-European market conditions for equity capital and PE especially can be improved in several ways. In this chapter, we will first discuss where the PE markets are going in the years to come. Thereafter we will discuss national market barriers, followed by the opportunities and barriers in the cross-European market regulations.

4.1 Continued improvement of the business model

Given the Swedish and European market conditions, it is clear that future value creation in the PE portfolio companies will need to come from operational improvements and not from lower interest rates and other macroeconomic factors – as we have seen to some extent in recent years.¹¹ Given the historical large Swedish industries and management culture, this is also the parts of PE value creation where Swedish PE firms are most international competitive.

This also relates to a high and increasing competition when it comes to finding the profitable investment cases in the Swedish market. We foresee an increasing competition in this area going forward, while the competition related to fundraising will be smaller – especially for Swedish PE firms with large international funding networks – as a result of the increasing interest for alternative investments:

”

Competition has increased dramatically, and finding new businesses to invest in is the larger problem compared to fund raising.

Source: Per Franzén, Partner EQT

¹¹ This is largely supported by our interview analyses, Appendix B.

As a natural consequence, Swedish PE funds are expected to grow in fund size in the years to come, and the investment focus will expand to areas with less competition regarding profitable investment cases and strategies. This means a higher competition for Swedish companies and creativity/innovation in the business strategies to increase the profitability of companies. Will there be more verticals or will opportunistic investment continue to be the rule. More so, the funds will have more focus on international companies, and focus on new sectors:

”

PE firms and funds are likely to expand into new sectors and increase their international presence in order to continue to find good investment opportunities.

Source: Per Franzén, Partner EQT

Thereby the national productivity effect of PE investment in Sweden may increase even further, and at the same time, the export potential of the Swedish PE sector will increase.

4.2 Preserving the political stability driving the current success of Swedish PE

The success in the Swedish PE market is largely related to a stable economic environment since the crisis in the early 1990s and political certainty related to regulation and taxation of domestic and international investors and fund managers.

However, the increasing international mobility of financial services implies high competition when it comes to country of operation for large financial companies, including PE funds and firms. When the national market conditions in Sweden are highly unfavourable or unsecure, large PE firms simply operate their funds from other countries. Currently all large PE funds are domiciled in Jersey. It is worth mentioning three areas where the Swedish market conditions should be improved:

1. **The tax conditions and stability of Swedish fund managers and advisory companies:** A large concern raised by the PE firms during our interviews regards to the so-called 3:12 tax rules and a recent related and ongoing tax law cases, see Box 4.1 for details. The 3:12 rules can be a potential burden and hurdle for future growth in the Swedish PE sector. Fund managers are reluctant to start a Swedish fund when the tax system is unpredictable and unfavourable as compared to the tax system in other EU countries. Further, this may also affect their ability to attract international investors, since the investors are keen on having a functioning and stable incentive-based system in place during the lifetime of the funds.
2. **Swedish tax conditions and regulations related to investors:** The function of the PE sector also implies that taxes on international investors should be seen in an international context. Here it is important to have a tax system within the EU with no risk of double taxation for international investors. International

investors aim to maximise their return and minimise their risk and, hence, for most investors there can be no “extra” regulatory or tax-related costs and risks when investing in Swedish PE funds. The risk of unfavourable tax in comparison to other EU countries is the reason why most large Swedish funds are currently domiciled in Luxemburg, Jersey or London.

Current circumstances, especially the capital market union (CMU) and Brexit, have led many EU-member states to step up their strategies and promotional activities in order to attract capital and the finance industry to their countries. For example, Luxemburg, Ireland, Italy, France have implemented measurements (tax and regulation) to attract private equity funds. In this highly competitive surrounding, Sweden needs to step up as well. If no remedies are taken, there is a risk that Sweden will start to lag behind and could potentially lose its position as one of the leading private equity markets in Europe.

Box 4.1 The 3:12 rules

The 3:12 rules

The aim of the rules is to prevent labour income to be transformed into capital income, which is taxed very differently. Tax on capital income is 20-30% flat (depending on salaries etc. in the specific companies) whereas tax on labour income is taxed progressively with a maximum of 57 per cent of the income. The 3:12 rules force taxpayers to tax a part of their income as income from employment in a situation when it could be taxed as income from capital.

Change of the legislation

The aim of the new bill is to increase tax revenue and to ensure that the possibility to convert labour income to capital gains income is limited.

After heavy criticism, the government proposed changes to the bill in late March of this year and sent it out for public consultation. In the end, the new bill would still raise tax revenue and toughen the conditions for how much income can be distributed as dividends. The law is proposed to enter into force on 1 January 2018.

Tax verdict

In end of April, the Swedish tax authority won a case against several of the Swedish PE houses, concerning tax on dividends from PE funds. The core of the issue is whether the 85 people affected fall within the legal requirements of being “active to a significant extent” within the covered companies and if the covered companies are to be considered so called closed companies which is a requirement for the 3:12 rules to apply – rendering income to be taxed based on services rather than capital gains. The people affected by the ruling may have to pay several SEK 100 million in additional taxes. Some PE houses also received rulings stating that the income is to be considered as income from employment.

Source: Copenhagen Economics

4.3 Cross-European market regulation

For Swedish PE to maintain and increase access to funds from international investors and to invest globally, it is important that key EU directives and international financial regulation with third countries be focused on reducing barriers to all cross-border PE investments

– both within and outside of the EU. Within the EU, the Alternative Investment Fund Manager Directive (AIFMD) aims to reduce the barriers for institutional investors to invest in PE funds across the EU. However, the stronger internal market should not come at the cost of weakening integration with non-EU markets. This is especially important for the large Swedish PE firms, since they are, to a large extent, funded by large US investors (as we saw in last chapter).

A large part of the AIFMD is also aimed at having better market oversight for regulatory authorities and limiting risk in the PE industry. In terms of compliance, it is also important to make sure that the increasing EU regulation does not become too much of a burden for EU investment funds, meaning that they would not be able to compete with PE funds in other markets.

Furthermore, it is important that prudential regulation does not provide unwarranted barriers to institutional investors. For example, Solvency II, which put limits on insurance companies' ability to investment in PE. These investors have increasingly been a source of finance for investment as they have recognised the ability of the PE industry to deliver relatively stable, high returns compared to other investments over a longer period.

References

- Acharya V. V., O. F. Gottschalg, M. Hahn, C. Kehoe (2013), Corporate Governance and Value Creation: Evidence from Private Equity, *Oxford Academic Review of Financial Studies* (2013) 26 (2): 368-402.
- Belloc, Filippo and Laurenza, Eleonora and Rossi, Maria Alessandra (2014), Corporate Governance Effects on Innovation When Both Agency Costs and Asset Specificity Matter (January 24, 2014).
- Belloc, Laurenza, and Rossi (2016), Corporate Governance Effects on Innovation when both Agency Costs and Asset Specificity Matter.
- Bergström C., M. Grubb and S. Jonsson (2007), The Operating Impact of Buyouts in Sweden: A Study of Value Creation, *The Journal of Private Equity*, Vol. 11, No. 1 (Winter 2007), pp. 22-3.
- Bernstein S., J. Lerner, M. Sørensen, P. Strömberg (2014), Private Equity and Industry Performance (June 30, 2014). Netspar Discussion Paper No. 06/2014-023.
- Bhagat S., B. Bolton (2008), Corporate governance and firm performance, *Journal of Corporate Finance*, 2008, vol. 14, issue 3, p. 257-273.
- Bloom, N., Sadun, R. and Van Reenen, J. (2009) Do Private Equity-Owned Firms Have Better Management Practices?
- Boucly, Quentin, David Sraer, and David Thesmar (2008), Do Leveraged Buyouts Appropriate Worker Rents? Evidence from French Data. Working Paper, HEC Paris (Groupe HEC).
- Copenhagen Economics (2017): Active Ownership: A Crucial Role for Institutional Investors, see <https://www.copenhageneconomics.com/publications/publication/active-ownership-a-crucial-role-for-institutional-investors>.

- Copenhagen Economics (2016): Gevinster for Danmark ved Reduktion i Barriere for Børsnoteringer og Øvrig Risikovillig Kapital, see <https://www.copenhageneconomics.com/publications/publication/gevinster-for-danmark-ved-reduktion-i-barrierer-for-boersnoteringer-og-oevrig-risikovillig-kapital>.
- Davis S. J., J. C. Haltiwanger, R. S. Jarmin, J. Lerner, J. Miranda (2011), Private Equity and Employment, NBER Working Paper 17399.
- Davis S. J., J. Haltiwanger, K. Handley, R. Jarmin, J. Lerner, and J. Miranda (2014), Private Equity, Jobs, and Productivity, *American Economic Review*, 104(12): 3956-90.
- Gugler, Klaus and Weigand, Jurgen, (2003), Is ownership really endogenous? *Applied Economics Letters*, 10, issue 8, p.483-486.
- Guo L., R. W. Masulis (2015), Board Structure and Monitoring: New Evidence from CEO Turnovers, *Oxford Academic, The Review of Financial Studies*, October 2015, Vol. 28.
- Harris, Richard, Donald Siegel, and Mike Wright. (2005), Assessing the Impact of Management Buyouts on Economic Efficiency: Plantlevel Evidence from the United Kingdom. *The Review of Economics and Statistics*, 87(1) p.148–53.
- Kaplan S. N (1989), Management Buyouts: Evidence on Taxes as a Source of Value. *Journal of Finance*, 44(3) p.611–32.
- Kaplan, S. N., P. Strömberg (2008), Leveraged Buyouts and Private Equity (June 2008). Available at SSRN: <https://ssrn.com/abstract=1194962>
- Knyazeva A., D. Knyazeva, R. W. Masulis (2013), The Supply of Corporate Directors and Board Independence, *Oxford Academic Review of Financial Studies* (2013) 26 (6).
- L. Guo, R. W. Masulis (2013), Board Structure and Monitoring: New Evidence from CEO Turnovers, *Oxford Academic Review of Financial Studies* (2015) 28 (10): 2770-2811.
- Lehmann E, J. Weigand (2000), Does the Governed Corporation Perform Better? Governance Structures and Corporate Performance in Germany,

- Oxford Academic Review of Finance (2000) 4 (2)
p.157-195.
- Lerner J., M. Sorensen, P. Strömberg (2011), Private
Equity and Long-Run Investment: The Case of In-
novation. *The Journal of Finance*, 66, p.445–477.
- Lerner J., M. Sorensen, P. Stromberg (2013), Private
Equity and Investment in Innovation: Evidence
from Patents. *Journal of Applied Corporate Fi-
nance*, 25, p.95–102.
- Olsson M., J. Tåg (2012), Private Equity and Employ-
ees, IFN Working Paper No. 906, 2012.
- Samila S., O. Sorenson (2011), Venture Capital, Entre-
preneurship, and Economic Growth, *Review of
Economics and Statistics* 93(1), February 2011,
p.338-349
- Smith A. (1990), Capital Ownership Structure and
Performance: The Case of Management Buyouts,
Journal of Financial Economics, 27(1), p.143–64.
- Wang, K., & Shailer, G. (2015), Ownership concentra-
tion and firm performance in emerging markets:
A meta-analysis. *Journal of Economic Surveys*,
29(2), p.199–229.
- Weisbach M. S. (1988), Outside directors and CEO
turnover, *Journal of Financial Economics* 20,
p.432-460.

Appendix A

Literature review

Literature review of active ownership in general

Much of the literature on the issues related to the lack of active ownership in institutional investor ownership in large companies is summarised in Copenhagen Economics (2017). Other literature on active ownership finds the following:

- In many research papers it is found that shareholder rights and compensation, an outside director on the board, CEO-chairperson separation and stock ownership by board members all have positive effects on operating performance, see Bhagat and Bolton (2008) and Knyazeva et al. (2013).
- The same factors are also found to increase the chance of CEO turnover in the event of poor company performance, which may explain some of the performance increases, see also Guo & Masulis (2015).
- The effect of ownership consecration on performance is typically found to be positive, but in some cases it is also found to be negative, see, e.g., Lehmann & Weigand (2000) and Gugler & Weigand (2003).
- Belloc et al. (2016) find evidence that ownership concentration increase innovations in certain cases (for younger low-tech companies).

Literature review on effect of PE ownership

Previous literature has focused on how PE affects companies in different ways, see an overview in Kaplan and Strömberg (2008). One area focuses on general performance:

- In early US and European literature, it is found that PE ownership increases the operating income to sales ratio by around 20 per cent relative to comparable companies and capital expenditures decline. See Kaplan (1989) and Smith (1990), Harris et al. (2005), Boucly et al. (2008).
- Research from later periods finds more varied and modest effects. This could suggest that later PE investments often made more radical changes to the businesses, kicking in on performance only after several years and/or that timing is very important.
- For Sweden most researchers find positive effects on profitability (EBITDA margins), see Bergström et al. (2007).

Other parts of the literature focus on how PE affect company innovations:

- The literature on innovations in PE owned companies indicates little or negative effects on actual R&D spending, but positive effects on innovations, typically measured by the number of citations, see Lerner et al. (2011, 2013).
- In relation to corporate governance, the literature also indicates that PE ownership improves the focus on management related to innovations, see Bloom et al. (2009) and Acharya et al. (2013).

A final part focuses on job creation in portfolio companies:

- In the US, UK and Swedish literature, researchers tend to find a slightly negative relative effect of PE ownership on job creation (a bit over 1 per cent per year of PE ownership). See Davis et al (2011) and Olsson and Tåg (2012).
- The effect is larger in the older studies, indicating that modern PE ownership has smaller negative effects on job creation.
- The effects seem to involve fewer new hires, and does not increase the risk of lay-offs.
- Typically, researchers find a significant positive effect on wages

Appendix B

Interview study

In order to come to an understanding of the incentives driving the different actors in the PE market, we conducted interviews with a range of stakeholders working in Stockholm. These are described in section A.1 below.

All interviews were conducted on the basis of an interview guide, which was sent to the interviewees in advance. The aim was understand both the actual work of the PE funds (micro effects) and facilitate a broader understanding of the PE infrastructure in Stockholm as well as its impact on the Swedish economy. Naturally, some actors had a better insight into certain aspects of the PE sector. Thus, participants with different angles were chosen in order to get as broad a picture as possible of the Swedish PE sector.

The results are presented in the form of general conclusions in relation to the different questions and hypotheses, for each section. These are not to be interpreted as explicit quotes, but rather as the main conclusions of our general impression and understanding from all the interviews.

B.1 Interviewed actors

We divide the interviewed actors into three different categories:

1. PE advisory firms to funds, responsible for the setting up and management of the funds;
2. Portfolio companies which the PE funds have invested; and
3. Other actors including auditors, lawyers, investment banks and academia.

Physical interviews were conducted over a number of days early on in the analysis phase of the project. This allowed CE to get a deeper understanding before going into the quantitative part of the study. The interviewed actors can be found below in Table B.1.

Table B.1 Interviewed actors

PE firms	Portfolio companies	Other actors
EQT	Anticimex	Baker & McKenzie
Nordic Capital	AniCura	Carnegie
Scope Capital	Happy Socks	EY
		Per Strömberg

Note: Per Strömberg is a professor of Finance and Private Equity at the Stockholm School of Economics.

Source: Copenhagen Economics

B.2 Results from the interview analysis

The interview analysis is divided into the following four parts:

1. The importance of economic growth and value creation;
2. Importance of Stockholm as a financial centre; and
3. An international and historical success;
4. The future perspective.

1. The importance of economic growth and value creation

From this part, we got the general answers:

The investment cases:

- *PE funds typically focus on sectors that are less cyclical and show structural growth (avoid market risk). This minimises the risk factors beyond the control of the PE funds. One underlying reason for growth in these sectors is innovation. (Several PE firms and other actors)*
- *A central part of the business of PE firms is finding and considering good investment cases and business strategies. Furthermore, the PE firms search for the right people to execute the given business strategy as managers of the given portfolio company. (PE firm)*
- *PE funds spread out their investments and risk. They are highly dependent on past performance, and therefore a PE fund cannot afford too many failures. In essence, every failure – i.e. default of a portfolio company – is big and the fund has to be more careful than many other actors. (PE firm)*
- *PE investments are attracted to companies with a strong market position in a niche market. A reason for this is that if a company is present in a highly competitive market, it must already be very productive to survive. (Other actor)*

Local sector knowledge:

- *The core PE business does not focus on stripping down companies. Instead, PE funds want to buy companies with potential and make them even better. The underlying feature is that a PE fund needs to be able to create value through transformation. A*

PE fund provides capital, but also has to offer something else – namely the ability to create a long-term profitable company. (Several PE firms)

- *To achieve a desired return for the investors, PE funds cannot buy into companies that are only experiencing management or operational problems. (PE firm)*
- *Before investing, a detailed valuation plan is developed. The plan outlines how the company can be refocused and grow organically as well as through acquisitions. Since investments are made at market price, the PE firm must have a clear idea of what tools should be used in order to develop the business model. (Several PE firms)*

Active ownership:

- *PE firms' governance and ownership model is superior to other ownership structures during a certain phases of most companies' life cycle. (PE firm)*
- *Taking the portfolio company in a new direction often warrants changes to both the management (CEO, CFO) and the board. This enables the PE firm to steer the portfolio company in a desired direction. The frequent contacts between the PE advisory partner, chairperson of the board and sometimes directly with the CEO implies a closer relationship and following-up of strategies than in many listed companies (Several PE firms and portfolio companies)*

General firm developments value creation:

- *Although the lifetime of a PE fund is typically around 10-12 years, the funds on average exit after approximately five years. The main driver for exiting is that the fund can receive a good return in combination with the recognition that the management has executed on the strategies outlined by the PE firm.*
- *In many cases, it is likely that the companies would have reduced employment without outside investment and involvement. Hence, in all cases – especially cases with without employment growth – the performance of the PE portfolio companies should be evaluated against a counterfactual scenario, often involving employment losses in the long term. (PE firm)*
- *The PE portfolio companies often show a j-curve in their development after the PE firm steps in. This is because PE firms often employ a business plan involving large restructuring, new investments and sometimes even falling earnings before they become profitable. (PE firm and Portfolio company)*
- *Because of a clear ownership idea and structure, access to additional capital is easier for many portfolio companies. This enhances their ability to follow through on investment plans and expansions. (Portfolio company and Other actor)*
- *The PE governance model creates a lot of value from a societal perspective. In a sense, it does not matter from the public side how returns within the industry are divided since the increased productivity in the firms is good for society. (Other actor)*

Management and incentives:

- *PE firms utilise their networks to hire talent that may otherwise not have been interested in working for the specific portfolio company. (Several PE firms and portfolio companies)*
- *An important reason for the success of PE firms is the alignment of the visions and incentives of investors, fund managers and portfolio company management. CEOs*

and board members are (almost) always required to personally invest in the company. Investors are also tied to the mast during the entire lifetime of the fund. (Several PE firms)

- *Since the outcome is how a PE firm earns its money, they are very active in putting the right people on board. (Portfolio company and other actor)*

2. Importance of Stockholm as a financial centre

The general answers and comments received during the interviews were:

Supporting actors:

- *The PE sector demands a lot of supporting financial services from both auditors, lawyers, investment banks management consultants and industrial advisors. The core business of a PE firm is to analyse the investment opportunities in companies and then improving the efficiency and performance of their portfolio companies. Other parts of the work can be outsourced to other actors (PE firms and other actors)*
- *The supporting services are present during all phases of a PE funds investment; From legal and commercial due diligence during the acquisition phase, to audits, standardised reporting implementation, compliance work and evaluations during the holding period and finally brokering, due diligence etc. during the exit phase – not the least when the company is preparing for an IPO. (Several other actors)*
- *The PE funds almost never work exclusively with certain actors and instead try to foster competition between different service providers. (Other actor)*
- *The bank lending to the portfolio companies is also part of a larger financing mechanism where loans and bonds are sold off to external investors. This creates a dynamic structure around the PE funds as well as portfolio companies. (Other actor)*

Exiting markets (after PE):

- *Although many PE funds lately have exited their investments as IPOs, many also sell their equity in companies to other sponsors (PE funds etc.) or in trade sales to other industry firms. (PE firms and other actor)*
- *There is a mutual understanding of how the IPO and capital market is working. This also relates to buyouts from the stock market (i.e. public to private). A good exit environment helps the PE firms. (PE firm and other actor)*

PE as an investment object:

- *Instead of a situation where institutional investors have to directly invest in businesses outside of the stock market, PE firms take care of due diligence, fund supervision etc. and act as a mediator. In turn, institutional investors enable access to “high-network individuals” as well as international investors. (PE firm)*
- *A local presence is needed in order to know the business and develop the needed expertise. The PE industry is thus a global as well as local business, and you need to be the champion in your own city (PE firms and other actors)*

Entry markets of where to find PE cases (before PE):

- *A growth company’s development can be supported by funding from different types of actors. During the start-up phase, an entrepreneur is often backed up by their*

own money and a business angel or venture capitalist (VC) fund. The company may then grow up to a point where it needs PE funding to continue to expand. The first PE fund may be followed by a second and even third fund, before the company is hopefully ready for an IPO. (PE firms and other actors)

- Besides the typical growth story for a PE funded company, the stock market is an important source of companies for PE funds to invest in. Thus, there is a continuous flow of companies, between public and private ownership models. (PE firms and other actors)
- Sweden has a delicate ecosystem of entrepreneurs, VC, PE, the public stock market etc. in combination with a strong banking system and highly developed financial services. The whole ecosystem lets PE funds tap into talent pools and develop further. (PE firm)
- Potential portfolio companies either approach the PE firms themselves, are endorsed by investment banks or contacted directly by the PE firms. (PE firms and other actors)

3. An international and historical success

Here, the general answers were:

General reasons to the Swedish historic success in PE:

- In general, the success of the Swedish PE industry can be described as a combination of three factors: capital adequacy, the right flow of deals (interesting investment cases) and the presence of the right competences (people). (PE firm)
- After the financial crisis in Sweden (early '90s) as well as in the years following the great recession in 2008, PE funds benefited from the fact that value creation in the portfolio companies was helped by the underlying macroeconomic development. (Several PE firms and other actors)
- In the early '90s, the PE sector saw a missing link in the ownership structure of companies, and thus came in with capital and a willingness to change the business. (Other actor)
- The combination of a good industry structure with innovative, tech-driven companies, a corporate governance model where employees take responsibility and healthy banks that could provide financing provided a good foundation for the PE sector to develop. (Other actor)

The Nordic region:

- The Swedish PE sector has benefited from a stable economic development, both on a country-level and in the Nordic region as a whole. (several PE firms and other actors)
- Many international investors are interested in having exposure towards the Nordic region, and local PE firms and other actors are seen as core experts in the local market. (PE firms and other actors)

Financial infrastructure and entrepreneurial spirit:

- *A close relationship with cornerstone investors was important during the early phase of the PE sector, and continues to be of great importance today. Access to pension capital via the AP funds helped the PE firms to find cornerstone investors. (Several PE firms and other actors)*
- *From a longer-term perspective, the development of larger Swedish industrial companies such as ABB, Ericsson, Alfa Laval, Sandvik etc. set the scene for buyouts in the '80s and onwards. This also facilitated the development of the Swedish stock market, which is an important complement in the Swedish financial infrastructure due to IPO and M&A opportunities etc. (PE firm and other actor)*
- *There is an entrepreneurial spirit in Sweden, both from young entrepreneurs and from people engaged in spin-offs from larger Swedish companies. (PE firm)*
- *Sweden also benefited from entrepreneurs within the financial industry, who established Swedish PE funds during the late '80s and early '90s. After the Swedish financial crisis, the timing was good for investments which could create a virtuous cycle. (Several other actors)*
- *The financial services market is sophisticated and well developed in Sweden, as indicated by the presence of international banks and other actors. (PE firm)*

Where we are today and going forward:

- *The early start of many Swedish PE firms means that the sector is mature today. The price for investing has gone up, but this also implies that PE firms must continue to improve on how they chose their investments, and that growth firms become increasingly professional early on in their life cycle. (PE firm)*

Investment success:

- *A general explanation to the growth of the Swedish PE sector is from the historical performance of the funds. Returning clients (investors) are important and the PE firms must therefore take their fiduciary responsibility. (PE firm and other actors)*
- *The international interest from investors is facilitated by the many interesting companies that have developed in Sweden, e.g. unicorns such as Spotify and Klarna. (Several PE firms and other actors)*

Political factors:

- *A trust in the institutions and judicial system means that it is relatively easy to do business in Sweden. A fair tax treatment for international investors also made it more appealing for outside investors to invest in Swedish funds. (PE firm and other actor)*
- *The Swedish model and consensus thinking between labour unions and business associations meant that PE firms were greeted more positively in Sweden when they started operating. (Other actor)*

4. The future perspective

The general answers and comments received during the interviews were:

Further business cases for PE:

- *Going forward, the value creation in the portfolio companies will need to come from operational improvements, and not simply from lower interest rates and other macroeconomic factors. Strategies must therefore be refined further in order to facilitate organic growth e.g. via the digitalisation and disruption processes in certain industries. (Several PE firms)*
- *Competition has increased dramatically and finding new businesses to invest in is more challenging compared to fundraising. (PE firm)*
- *Competition is likely to increase from other actors such as large international pension funds who increasingly prefer to set up in-house funds and structures. (Other actor)*

Expectations of future funding to the PE market:

- *There is a lot of demand for investing in the new funds. This demand is likely to remain high during the coming years. (PE firms and other actors)*
- *Although the PE firms currently do not have general problems with raising funds, an alternative source of concern is the Swedish banks. Due to increased regulation and risk averseness, a cyclical downturn could mean that bank funding would freeze up and particularly affect smaller growth firms as well as companies with higher leverage. (Portfolio company and several other actors)*

Expectations of future PE investments:

- *Swedish PE firms and funds are likely to expand into new sectors and increase their international presence in order to continue to find good investment opportunities. (PE firm and other actor)*

Political importance:

- *Overall, Sweden has had a stable political backdrop with a clear regulatory environment. Uncertainty is bad for the industry and since the political environment can change during the life-time of the fund, a stable tax regime etc. is important for the investors, especially the international ones. (Several PE funds, portfolio companies and other actors)*
- *Tax increases, e.g. from the proposed changes to the 3:12 rules, can influence the business model and incentives structure within the PE industry. (Several PE firms)*
- *Increasing the amount of money that pension funds can allocate to alternative investments would support the PE sector even more going forward. (PE firm)*

Smaller PE funds and VC:

- *For smaller PE firms, the funding side is more difficult than finding growth firms. Looking forward, the boundary is thus finding money and cornerstone investors. (PE firm)*
- *The VC sector has started to function better over the last years, with companies maturing beyond the first funding support. Going forward, there is thus increased potential in the VC sector as well as for VC and PE firms/funds to partner up. (PE firm and other actor)*

- *With many PE and VC funds becoming bigger and bigger, there may be an empty space for smaller (seed capital) funding, since the larger funds cannot divide investments into too small packages. A way to fund companies that only need SEK 5-10 million may therefore need to be developed further. (Other actor)*

Appendix C

Case analysis of portfolio companies

In this appendix, we explain our case analyses of three portfolio companies in further detail.

Happy Socks – PE funded growth to exceeding one-billion-kronor revenues

Background

Happy Socks was founded in 2008 with the idea of making socks a fashion accessory and market it with all contemporary digital tools available combining the right mix of quality, creativity and craftsmanship. The company's motto is "get it done". Happy Socks grew rapidly from the start, averaging around 70 per cent per annum, and the PE firm Scope Capital (Scope) entered as a majority shareholder in early 2015. Scope exited its investment early in 2017 when it sold its equity to another international PE firm, and was thus an owner for around two years.

For 2016, Happy Socks were sold at a retail value exceeding SEK 1.4 billion with the company recording revenues of SEK 305 million (up from SEK 204 million in 2015), with an EBITDA of around 15 per cent. The company is represented in over 90 countries and hopes to exceed SEK 1 billion in revenues by 2019.

Happy Socks can be described as a typical entrepreneurial growth company, applying contemporary ideas and company culture to a traditional market, enabling the company to carve out a new position on a traditional market. The growth of the company has been organic.

Corporate governance

Scope is a smaller growth PE firm, which specialises in partnering with entrepreneurs that need both funding and coaching to establish a scalable corporate and management structure. As such, Scope has no sector specific knowledge relating to the actual business of Happy Socks, but rather a general knowledge and a network of people with experience of building businesses in this phase of development.

The investment strategy focused on building a platform to support the continuation of the rapid growth and development of the company, introducing processes and methodology allowing Happy Socks to behave and report as a much larger company without undue strain. Scope developed a close relationship with the CEO and the transition was made in close partnership.

Operational management

The initial focus was to establish a management team including three new managers; a CFO, a CMO and a sales manager. Prior to Scope's investment, the board of directors had not worked as a proper board generally in place at larger companies and Scope appointed

its industrial advisor as a new chairperson of the board to strengthen the strategic and operating alignment. Although the board members invested in the company, it was not required by the new management recruits, who instead were offered stock options.

A central part of the investment strategy under Scope's ownership was to establish proper financial reporting standards. Scope was therefore involved in the recruitment of the new CFO. Once the new management team was in place Scope assisted the team in setting up appropriate processes and routines.

Scope puts emphasis on establishing appropriate corporate governance with clear responsibilities and accountability and actively assists management in finding their way forward, but with no ambiguity on responsibilities. As described above, the initial focus was to establish management team and second to get the business model correctly balanced to scale profitably. Scope's involvement made Happy Socks more attractive to key hires providing institutional stability to a high growth opportunity.

”

The external owner had expertise within different areas, and was someone we could take advantage of without paying consulting fees

Source: CFO

Conclusions

The involvement of Scope was focused on building management team to establish processes and routines solid enough to support the growth as well as refining the business model balancing on-line and off-line channels. The investment case was built on the contribution of growth competence to support the market opportunity created by the entrepreneurs.

AniCura – PE funded advanced veterinary care for companion animals

Background

AniCura is one of Europe's leading providers of high-quality veterinary care for companion animals. At present time, the company operates more than 150 animal hospitals and clinics throughout Europe with a focus on advanced diagnostics and surgery.

AniCura was established in 2011 through the merger of four well-known animal hospitals in Sweden. This was the first merger of animal hospitals in the Nordic region. Prior to AniCura's market entry, the market for veterinary care in Sweden was highly fragmented and comprised of individually managed animal hospitals and clinics. One main driver of clinic interest in the AniCura concept has been the opportunity to learn from each other in order to speed up quality development and improvement.

Between 2012 and 2016, AniCura expanded its operations from Sweden to six additional countries; Norway, Denmark, Germany, Austria, Switzerland and the Netherlands.

AniCura is owned jointly by a large number of employees, the Animal Hospital Foundation of Greater Stockholm and the investment companies Fidelio Capital and Nordic Capital (NC). NC has been the majority shareholder since 2014.

AniCura is a company in high growth. Whilst AniCura as a company has been around since 2011, its clinics are local champions that on average have been established for more than 20 years. A large part of AniCura's growth comes from acquisitions.

Corporate governance

NC is one of the largest PE healthcare investors in Europe. The firm saw the potential to build a European leader within the fragmented veterinary care market and identified AniCura as the best platform to build upon. NC approached the former majority owner of AniCura and after a rapid bidding process Nordic Capital bought a majority stake in the business in 2014.

NC's investment thesis was to support the European expansion of AniCura with the ambition of creating a clear European leader in the veterinary care market. Under NC's ownership the number of veterinary clinics in the group has more than doubled and the annual revenue growth has continued at around 40%. At the time of NC's investment in AniCura the company had only existed for three years and was thus one of the more immature companies that the PE firm has invested in. During NC's ownership significant investments have been made in the company to create a stable platform poised for continued growth during the years to come. The advantages of a larger veterinary care group include knowledge and best practice sharing, more resources to lift quality of care as well as improving efficiency of administrative functions and thereby freeing up resources to focus on clinical care.

Operational management

The CEO of AniCura joined the company shortly after it was created and has since then built a full management team capable of handling a very high growth rate. When NC entered as a majority shareholder they appointed a new board and was also involved in the hiring of a new CFO.

Having previously been chairperson of Unilabs and CEO of Capio, the chairperson of the board has a thorough background within the healthcare industry and has also worked as a senior advisor to the Nordic Capital Funds. In addition, Nordic Capital has three appointees on the board, including the CEO of Attendo (a healthcare company), a managing partner from NC Advisory and a principal of NC Advisory with a background from the pharma industry. AniCura's board of directors also includes representatives from the Animal Hospital Foundation in Greater Stockholm as well as employee representatives. As part of alignment, NC has backed the incumbent management team as well as the strategy and vision of the company.

The management of AniCura report to NC on a monthly basis, and meetings are held quarterly. The dialogue between the board meetings can be described as continuous, with regular discussions on strategic developments. The active ownership can thus be described as

bringing clarity to the direction of the company and does not imply operational engagement.

”

The current governance structure makes the company fast and agile

Source: Björn Larsson, CFO AniCura

Financial

AniCura's expansion has mainly been achieved via debt financing, whereas NC's involvement has helped the company obtain bank lending. The active ownership means that NC will stay close to the company to allow for swift decision making allowing management to be agile and move fast rather than waiting for approval from its owners. While rapid growth through acquisitions comes with certain risks these have to date successfully been mitigated by a capable management team supported by a knowledgeable board.

Conclusions

Nordic Capital has brought both knowledge and capital to AniCura, and assisted the company in the continuous growth journey. The sector knowledge, as well as experience within how to best support rapidly growing businesses with an increased international presence ensures that NC as an owner understands the phase that the company is in. The active ownership can thus be described as enabling the potential identified within the sector as well as for the company.

Anticimex – re-defining pest control of the future

Background

Anticimex is a leading global specialist in preventive pest control, offering a broad range of solutions of mission-critical services including inspections and treatments against pest to commercial customers and private homeowners. The company was founded in 1934 and was acquired by PE firm EQT in 2012..

The company is present in 17 countries and operating revenue has increased from around SEK 2 bn to SEK 6 bn under EQT's ownership. From being an almost purely Nordic business, Anticimex has transformed its geographical presence; the Swedish market today represents 35 per cent (vs 75 per cent when EQT acquired the business).

Prior to EQT's buyout, Anticimex was growing steadily but slower with sporadic small bolt-on acquisitions. Following EQT's acquisition, the management team was strengthened and substantial investments were made in order for Anticimex to expand across Europe, Asia-Pacific and the US. In addition, several other operational initiatives have been executed upon in order for Anticimex to reach its full potential.

Corporate governance

Although EQT had limited sector knowledge of the pest control business, the PE firm identified a service conglomerate in a highly fragmented international market with many family owned businesses, which made it attractive for PE capital.

The screening process by EQT identified a potential business strategy focused on internationalisation and digitalisation. Anticimex had high costs from manual inspections and introducing digital pest control through cameras and sensors made the business model scalable. Due to the fragmented international market, an important part of the new strategy has been acquisitions, with more than 100 add-on acquisitions.

Operational management

After EQT acquired the business, several changes were made to the Board and on the managerial level in Anticimex. A new CEO was brought in, with the clear instruction to re-focus the company. After another three years, a new CEO was hired from a larger listed international company. The changes were driven by EQT, with the purpose to continue a momentum during the development phase of the company's business.

The new board was set up with people who had different sector knowledge. This included a chairman with knowledge of consumer and subscription business (from the telecoms sector) as well as board members with varying backgrounds from insurance, media (experience of digitalisation) and the pest sector. Board recruitments were initiated by the EQT partner together with the chairman and everyone, including the CEOs, were required to invest in the company.

EQT's corporate governance model includes the troika, an informal forum with weekly briefings between the CEO, the chairman and the responsible EQT partner. This ensures a continued dialogue and evaluation between the board meetings, and enables the company to execute decisions more swiftly. The aim is that a formal governance will still be in place through the board, but that the troika can act as a transparency enhancer and reference point for strategic discussions.



The troika is a brilliant concept. It ensures formal governance while also providing direct access to the partner and chairman

Source: Jarl Dahlfors, CEO of Anticimex

A core idea of EQT's business strategy has been the digitalisation in combination with an international expansion. In the view of the CEO, the private ownership has enabled the company to move faster ahead and execute on the outlined plan. The vision has also been facilitated through EQT's network and knowledge sharing.

Financial

Anticimex' international expansion has been helped by access to bank lending and the fact that the bank loans are treated as senior debt. During the investment phase, leverage in the company has been high compared to public companies. This will ensure a sustainable development of the company and a strengthened IRR.

Conclusions

Anticimex provides a good example of a somewhat sleepy traditional company, which was bought out with a clear idea of how to re-define the business and increase revenue.