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Privest: A Small Firm Investment Framework

A guide to how private equity investors should manage investments in small firms.

Master of Science Thesis in the Master Degree Programme Management and Economics of Innovation

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Abstract

The aging owners of small businesses in Sweden are predicted to give rise to a large amount of business closedowns within the foreseeable future. While some of these firms, where the business itself is contingent upon the owner, will naturally seize to exist as the owner steps back, a significant portion of viable and healthy firms might not survive due to a lack of suitable successors or new owners. This thesis addresses this upcoming challenge by proposing and applying an investment framework for financial acquisitions of small businesses in Sweden. More specifically, the first part of this thesis develops the investment framework by synthesizing literature on private equity, venture capital and private equity investments in family firms as well as interviewing investment professionals in Sweden. The framework is based on three blocks that each deal with critical aspects of an acquisition: the identification of targets, the management of transactions and the value enhancement of an acquired firm. A fourth constituent is introduced that integrates these three distinctive sub-frameworks and extends the analysis to provide an exhaustive investment framework for small business acquisitions. In the second part of the thesis, the investment framework is applied to small businesses in the broader Gothenburg region. The results of applying the framework are manifested in the finding of two investment opportunities that are analyzed following the investment framework, revealing both strengths and inherent weaknesses. The thesis provides first and foremost a generic guideline for investors interested in targeting the small business segment. Moreover, this thesis provides some orientation for small business owners regarding common issues when preparing for and executing a sale. Albeit the practical focus of this thesis, it also gives a valuable contribution to the academic discipline of financial investments. First, the thesis ties together several different academic research streams in the construction of the investment framework. Finally, through deploying the investment framework in practice, insights that point out new research avenues materializes. Such avenues encompass how small firms' dependence on owners inhibit transactions in small firms and how financial arbitrage stemming from emotional expressed by small firm owners can be anticipated.

Key words: Private equity, Small firms, Family firms, Transactions, Value enhancement, Investments.

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We started out to research direct investments in small firms in early 2012, equipped with only a faint idea of what was to become our MSc dissertation. Looking back from where we are today, we can best summarize the past months as an unparalleled learning experience. Although the base for this learning experience subsist in the deep dive into previous academic research that we undertook, the major source of our learning can be found in the many meetings we have had with small business owners, investment professionals and M&A specialists. Therefore, we like to thank all our interview respondents for sharing their experiences with us.

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Tomislav Andric & Viktor Häggander
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Table of Contents

List of figures

List of tables

1 Introduction

This chapter presents the purpose of this thesis and provides a background to the studied problem that supports the thesis' rationale. Furthermore, the practical prerequisites that delimit the research are highlighted and finally, the structure of the thesis is outlined and explained.

1.1 Background

The oldest business owners in Europe are found in Sweden. One reason to that is the fact that Sweden's population was relatively unaffected by the world war that laid Europe almost entirely in ruins, leading to relatively high number of newborns in the 1940-50's in comparison to other European countries. Another reason is the low rate at which new businesses get started, a measure where Sweden end up close to the bottom compared to other European countries. The latter reason is often attributed to a poor business climate, where the individual business owners' situation is superseded in the debate by criticism directed at profits and risk-taking (Företagarna, 2011).

The fact that Sweden has an on average old group of business owners and a low rejuvenation of this group has a few implications. One very notable implication is that a lot of Swedish businesses will need to shift owners in the next years, as the baby boomers will head for retirement. This transfer of business ownership to the next generation will surely not be easy to overcome and there is a chance that the overall Swedish economy might suffer from it. This plausible effect is lifted forward by the Swedish business owners' interest organization Företagarna in the 2011 report *Hur klarar företagen generationsväxlingen?* in which a survey of 4 150 small businesses is presented.

The survey presented in the report states that 23 per cent of the owners want to step back from their business in 1-5 years and that another 15 per cent want to step back in 5-10 years. Since 9 out of 10 new jobs in Sweden are currently generated by small businesses (Företagarna, 2011), this generation may hamper job growth and thereby affect the overall economic situation in Sweden. Replacing as many as possible of the owners that like to step back will be necessary to avoid closing down too many businesses and finding new owners to pass on businesses to will be a key challenge to limit the economic downside for society, as eluded to by the Swedish Labour Minister Hillevi Engström in a recent interview (Von Essen, 2012).

The challenge to bring up new entrepreneurs and owners to take responsibility of Sweden's small businesses will not be matched by a single measure. Many opportunities will surface for the entrepreneurial community as well as industrial investors looking to buy strategic assets, but the present actors on the market are not likely to fully absorb the higher numbers of firms that will be up for sale in the years to come. The excess supply of firms implies an opportunity for a new kind of small business owner to make an entry.

A conceivable group of owners can be investment organizations specializing in transactions in privately owned firms and the stewardship of firms that are part of their investment portfolio, so called *private equity* organizations. However, private equity firms do not generally invest in small businesses since their business models require a certain scale of investments to be profitable. Therefore, there is an unoccupied niche that is waiting for investment firms to find it and adapt to it. If investment firms succeed to do so would not only provide a new source of financing and ownership for small businesses, it would also mean the pioneering of a new market for capital investments.

1.2 Purpose

Having outlined the existing investment opportunity in small firms, the two-folded purpose of this thesis can be expressed as follows:

First, the thesis is to propose a framework for direct investments in small private firms. The investment framework will both help identify companies suitable for transactions and provide insights in how the transactions and subsequent development of the companies should be managed.

The second part of the purpose is to deploy the investment framework in order to find a few investment alternatives, along with recommendations for the transaction process and priorities for active ownership derived using the framework.

In the explicit definition of the purpose above, *small private firms* refer to privately owned firms with a turnover of approximately 10-100 MSEK.

1.3 The Privest Concept

In this thesis the investment organization designated to address the identified investment opportunity in small privately owned firms is embodied in a firm called Privest. Although many of the properties required by Privest are yet to be explored in the coming chapters of this thesis, the following limitations will be treated as given throughout the thesis.

The originators of the investment idea that Privest pursues have emphasized that the concept that Privest build upon should incorporate a long investment horizon, at least a decennia. Instead of transferring value to the investors through regular divestments, the Privest concept rather advocates dividend streams. Furthermore, since Privest will start its investment activities from scratch, considerations must also include a small sized portfolio initially. In fact, Privest will start out by investing in only one firm and then focus entirely on developing that investment before adding another investment to the portfolio.

The firms targeted by Privest should be cash flow positive and rather mature, showing at least ten years of sustained operations. Debt financing is not excluded from the possibility set in the Privest concept but should not either be regarded as a frequently recurring strategy. Lastly, since Privest do not have any obvious access point to the deal flow it is assumed that Privest initially must search for investment in a large sample of firms. This search should focus geographically on an area reachable within one hour of travelling by car from Gothenburg.

1.4 The Structure of the Thesis

To effectively address this purpose the thesis is divided into two parts. The first part addresses the development of the investment framework and hence corresponds to the initial part of the purpose presented above. The framework will be developed in a step-by-step approach, starting with a literature review. Then, a conceptual model of the investment framework is developed using the findings brought forward in the literature review. Once a conceptual model that ties all aspects of the investment framework together on an aggregated level is established, each subpart of the investment framework will be fleshed out by adding empirical findings to the theoretic foundation provided by the conceptual model.

Part two of this thesis addresses the second part of the purpose and starts when all the properties of the investment framework have been defined. The objective of this part of the thesis, which is more practically oriented, is to deploy the framework to find relevant investment opportunities for Privest. Part two ends with a discussion of the results obtained when using the framework in practice.

2 Literature Review

The purpose of this chapter is to review relevant literature on acquisitions of privately owned firms. This review will be based on three interrelated academic areas: private equity, venture capital, and private equity investments in family owned businesses. Furthermore, the literature review will serve as a foundation for the creation of the conceptual model presented in chapter three.

In this thesis relevant literature should specifically address investments in which a substantial stake of the firm's equity is acquired. The focus will primarily be on the perspective of financial investors while less attention is given to industrial investors. This focus is motivated since Privest as an investment firm shares several characteristics with a financial investor. Three areas that are in line with these conditions and raise relevant topics for this research's scope can be discerned in the literature: private equity, venture capital, and private equity investments in family owned businesses. This chapter will highlight how the above-mentioned literature strands deal with investment selection, transaction management and value enhancement initiatives when investing in firms, as these areas answers directly to the purpose of this thesis.

Although separated in this chapter the three literature strands are interrelated and frequently, both the literature and investment professionals make no clear distinction between them. Further, it is hard to define clear boundaries of private equity and venture capital firms as these investment organizations have evolved to embrace a spectrum of different investment methods and strategies (Kukla, 2010). Hence, before submersing into previous research done in each literature stream it is necessary to briefly sort out different definitions, concepts and their relations and explain how they will be treated in this thesis.

There is no uniform and universally accepted definition of private equity but as the name suggests, it represents an asset class of equity securities in companies that are not quoted on a stock market (cf. Cumming, 2012). Private equity firms are typically organized as partnerships where the general partners are investment professionals managing investments in the unquoted portfolio companies, while the limited partners only provide funding. From this simple presentation private equity and venture capital do not differ. However, the rational for splitting these two concepts apart and treat them separately lies in their differences in investment characteristics such as target size, risk profile, and objectives. While private equity firms address investee firms in the later stages of the industry life cycle, usually mature firms, venture capitalists are oriented towards investments in young ventures in early development phases (Cressy et al., 2007). In this thesis private equity and venture capital will follow this distinction. However, it is worth to note that venture capital is commonly also considered being a subspace of private equity.

Private equity investments span a wide variety of target firms and investment structures. These investments can be classified according to who the seller is: a corporate, public or independent firm. Corporate and public sellers are associated with spin-offs, divestment of units and turnarounds. The independent seller, on the other hand, is typically interested in a transaction of the entire firm and the motivation is commonly an entrepreneurial exit, a family business succession, a turnaround or a delisting of a publicly quoted firm (Schmohl, 2009). The focus of this thesis is centred on the latter type of seller and more specifically, cases where the seller is an entrepreneur willing to make an exit or where a family business succession is pending. Therefore, this literature review will include a section particularly addressing private equity investments in family owned businesses. While general literature on private equity will set the frame for such organizations' behaviour when it comes to selecting targets, managing transactions and enhancing portfolio firm value, the literature on private equity investments in family businesses will raise specific issues related to family businesses.

Even though the literature reviewed in the following subchapters cover a great part of the theoretic base required by this study, some additional areas will be regarded as general knowledge for any person interested in the business development undertaken in this thesis. The first additional area of interest is financial theory and specifically theory within the field of corporate finance (cf. Vernimmen et. al, 2010; Damodaran, 2009). The second and third areas are strategic management (cf. Grant, 2010) and general theory on operations management (cf. Slack et al., 2010). Finally, the thesis will also in some parts rely on theory concerning business models (cf. Zott et al., 2010; Osterwalder & Pigneur, 2010). This literature represents an established theoretic base that permeates all investment undertakings and therefore it will not be specifically reviewed in this thesis.

In summary, the literature review will cover theory on financial investment firms from three different perspectives. These areas will be specifically reviewed concerning how investments are selected, how transactions are managed and how value enhancement activities are pursued. Their direct relation to the purpose of this thesis motivates these specific areas to be reviewed.

2.1 Private Equity Investments

The rapid growth of private equity activity in the last couple of decades has motivated scholars to increasingly investigate the role of private equity in several dimensions (Kukla, 2010). However, the aim of this section is to specifically extract topics related to investment selection, transaction management and portfolio firm value enhancement as treated by private equity organizations. Furthermore, this section will focus on private equity backed buyouts of established firms that either have a strong growth potential or are perceived to be sub-optimally managed under the current ownership structure. The reason for this focus is two-sided; on one hand the literature is skewed towards this area and on the other hand it is well aligned with the properties of the Privest concept. Before examining the topics related to the purpose of this thesis, basic characteristics of private equity buyouts will be discussed. This presentation will help explain the main properties of private equity activity as well as highlight what features might be applicable to investments of Privest's character.

A private equity acquisition is often financed with a substantial amount of leverage – hence referred to as a leveraged buyout (LBO)– where typically up to 70-80 per cent is debt financed (Froud & Williams, 2007). This financial mechanism was early pointed out as the foundation for the success of private equity investments as it is suggested to resolve the principal-agent problem present in many large firms (cf. Jensen, 1986). Through concentration of ownership and strong financial incentives implied by high debt levels, sub-optimal management investment decisions are avoided. Such decisions are suggested to arise when a firm's cash flow exceeds the investment opportunities and management decide to invest in negative net present value projects or waste the funds through organizational inefficiencies rather than distributing the excess funds to shareholders (Klier, 2009). Although Privest might not use an extensive amount of debt in financing acquisitions, the general properties of an LBO transaction is still relevant to discuss. First of all, the desired end is unchanged and that is to focus on cash flow generating activities while cutting down on unprofitable ones. Secondly, even with a small portion of debt target firms have to meet specific economic conditions to be suitable for a financially leveraged acquisition. These economic conditions will be elaborated further upon in the subsequent section on investment selection.

While classic LBO transactions typically aim to reduce the downside risk of investments through enhancing the target firm's efficiency, another literature stream focuses more on the entrepreneurial aspect of buyouts. More than being just an efficiency-enhancing tool, Wright et al. (2001) argue that private equity buyouts can help foster growth through entrepreneurial initiatives. It is suggested that established firms might be stuck in old routines and strategies, which prevent strategic innovations and agile response to new opportunities. As expected, a buyout strategy oriented towards entrepreneurial activities is associated with higher returns and consequently also higher risks. It is necessary to highlight this aspect, as it might become a priority for Privest's active ownership. Furthermore, the literature streams covering efficiency and entrepreneurial approaches respectively are not mutually exclusive but might well work in parallel. Kukla (2010, p.41) summarizes this by stating: "…the mission of the private equity firm as a corporate catalyst, is to actively seek and rejuvenate undermanaged businesses being in lack of strategic focus, efficient corporate governance, effective fiscal policy, and overall being in need of intensive care for a certain period".

Kukla's reference to a *certain period* is a reminder that private equity buyouts are limited in time. The implied divestment of portfolio firms has not been dealt with yet although it is vital in order to understand the buyout activity. Private equity organizations realize the greatest part of the investment profit when exiting an investment (Froud & Williams, 2007). Hence, buyout targets will be evaluated on the possibility to sell the firm within a foreseeable future, rarely exceeding ten years (Klier, 2009). Furthermore, this limited holding period is argued to positively influence the value enhancement in firms as it prevents short-term focus on financial targets while urgent business transformation is prioritized (Rogers et al., 2002). Although Privest might not apply the same exit approach as conventional private equity firms do, the topic cannot be avoided when reviewing this literature area.

Two literature strands help explain the rationale behind private equity investments, one focusing on efficiency buyouts and one on entrepreneurial buyouts. Both of these strands need to be reviewed since each of them provide contrasting views on private equity activity, of which the implications are relevant to the direction of Privest.

2.1.1 Investment Rationale in Private Equity

When evaluating buyout targets private equity firms make an overall assessment of criteria related to the target's market, strategic position, organization, products and financial health (Le Nadant & Perdreau, 2006). Although each potential target is evaluated individually there are some generic criteria that apply, not at least for LBO transactions where the risk of failing to meet debt obligations is of major importance. Due to the high financing costs the most basic criteria for investments is a proven, as well as predicted, strong and steady cash flow stream (Klier, 2009). Hence, private equity firms are mainly concerned with investing in established firms showing historical ability to sustain positive cash flows. This notion is reflected in Acharya et al.'s (2009) finding that buyout targets are frequently found in sectors with relatively high EBITDA[1] levels. Moreover, Le Nadant & Perdreau (2006) have found that target firms are neither too profitable (EBITDA margin[2]) nor unprofitable at the time of acquisition, yet they have a profitability that is superior compared to the industry average. Although Privest may not use a distinctive LBO model, its treatment of business risk is still applicable in the investments sought. With a longer investment horizon focusing on dividend yields, instead of realizing the investment through an exit, it makes sense for Privest to consider the profitability criteria used by LBO investors.

The LBO approach calls for a sufficient amount of unused borrowing capacity in the target firm to enable the leveraged deal (Klier, 2009). Hence, financial solidity is a measure taken into account when evaluating potential targets and as Acharya et al. (2009) found, the LBO targets do not typically have a debt coverage ratio below the industry average prior to the transaction. A firm constrained to take on more debt finance will have limited opportunities for financing new business initiatives. Moreover, high debt levels expose the firm to the risk of not being able to meet debt obligations, which can make the firm vulnerable to unexpected macro economic fluctuations. It is further found that a buyout target with a substantial amount of tangible assets is positively related to the attractiveness of the deal, as it can be used as collateral when seeking new debt financing.

Typically, private equity organizations focusing on the LBO model target businesses with limited investment needs (Klier, 2009). The rational for doing so is to reduce the need for equity contributions and to keep up the leverage of the LBO. This has several implications when choosing investment targets. First, private equity firms are deterred from investing in high technology industries, as the investment needs are substantial. Secondly, investment targets are preferred to show positive growth but not too high in order to keep the requirement of investments and working capital limited (Le Nadant & Perdreau, 2006). Finally, private equity firms premium modern production equipment when evaluating buyout targets and hence an assessment of their status is usually done pre-buyout.

Albeit the main focus of LBO oriented private equity firms is to acquire mature firms with limited investment needs and moderate growth, the interest in targets with strong growth opportunities has gained greater attention (Klier, 2009). Usually, the first

[1] EBITDA: Earnings before interest tax depreciation and amortization

[2] EBITDA/Revenue

years of the holding period is entirely devoted to use the free cash flow to pay interest costs and pay back debt. Thereafter, private equity organizations either use the cash flow to pay out dividends to investors or to invest in future growth (ibid.). Hence, as Acharya et al. (2009) interprets, private equity firms are taking the upside potential of the firm into account when making a target assessment. Furthermore, some scholars have recognized the opportunity for private equity organizations to target buyouts based on strategic innovation that fosters entrepreneurial growth opportunities (Mueleman et al., 2008). The literature provides little evidence on how such buyout targets are evaluated, but some frequently cited opportunities are high-end technology firms and misfit corporate divisions. Bruining & Wright (2002) stress that a pre-investment decision for growth-oriented buyout has to embrace knowledge of sector specific factors such as technology and industry dynamism. From Privest's perspective it is relevant to discuss both a buyout where the realization of profits primarily lies in efficiency enhancing tools minimizing the downside risk of the investment and a buyout that is more oriented towards entrepreneurial activities, taking advantage of the upside potential present. These two approaches will clearly have different risk-return characteristics that should be taken into account with respect to Privest's objectives. Furthermore, the efficiency and entrepreneurial approach are not mutually exclusive but should rather be seen as complements to each other. For these reasons, it is important to understand how private equity organizations evaluate both types of buyout targets.

Loos (2005) studies strategic considerations with regard to market and industry position of the target firm prior to the buyout. First of all, he finds that a strong market position is not necessarily a determinant for successful buyouts. In contrary, targets with a small market share are able to generate high economic returns. This might be explained by the fact that these firms have found successful niche strategies. In fact, his second finding reveals that niche strategy buyouts outperform low cost and premium strategies on a return basis, although a niche strategy is associated with a higher risk. One plausible explanation to that is that niche buyouts offer potential for strong organic growth. When studying the product characteristics of buyout targets Loos (2005) finds that increased product diversity is adversely correlated to performance although beneficial from a risk perspective. Another interesting conclusion is that buyout targets with one or a few customers perform better than firms with a diversified customer base, which is in contradiction to commonplace strategic theory. Finally it is found that buyout targets with one distribution channel outperform those with multiple channels, which is explained by the high expenditures related to dealing with many distributors. It is therefore suggested that a marketing strategy emphasizing growth should focus on exploiting opportunities in existing distribution channels rather than introducing new ones.

Private equity firms' investment evaluation is an extensive undertaking with no best practices available. As presented, though, some strict criteria have to apply for a LBO deal to even be considered. Similar criteria might well be adaptable to the Privest case since targets have to prove strong financial viability. Buyout targets aiming to provide economic returns through strong growth call for a great knowledge in the specific sector and technology. The scarce literature on growth-oriented LBOs might be explained by the idiosyncratic nature of such investments and hence, evaluation of such firms differ from case to case. In this regard, potential target firms for Privest have to be carefully evaluated based on what initiatives might foster growth without taking on hazardous risk. Later in this theoretical review, and more thoroughly in the conceptual model of the investment framework, value-enhancing activities will be discussed and integrated in the evaluation of buyout targets. Independent of the focus of the buyout investment, market and product specific characteristics are vital parts to assess prior to a transaction. Although an overall judgement has to be made on these aspects of a potential target, Loos' (2005) findings can be indicative when doing analysis of markets and particular firm characteristics. Another vital aspect included in the investment decision but not emphasized yet, is the exit opportunity. Due to its importance for value realization, the exit is a major part of the overall buyout target assessment (Klier, 2009). Since Privest's aim is not to adapt a typical fund structure with a limited holding period, this topic is a bit of the mark. Nevertheless, the option of exiting an investment should still be considered. As Barber & Goold (2007) suggests, when corporate parenting no longer adds value an exit might be a fruitful alternative.

This section has mainly treated private equity practices and criteria applied when assessing a potential buyout target. A brief discussion on the applicability of these practices to the Privest case was also presented. The bulk of the information presented in this section will be used to influence the conceptual model for target screening presented later in section 3.1. Some ideas will also be channelled to other parts of the conceptual model, predominantly to the part covering value enhancement in portfolio firms.

2.1.2 Transaction Management in Private Equity

A first theme regarding transactions in private equity is the access to investment opportunities. The degree of exclusivity is argued to affect the transaction process and its outcome. To have an exclusive right to initiate and negotiate a transaction is favorable from a competition perspective as well as it allows for maximizing the fit between the investee firm and the private equity investor as information sharing and personal contact is enhanced (Schmohl, 2009). However, exclusivity is hard to achieve and hence private equity investors address their network of professionals in order to stay exposed to exclusive investment opportunities (Fenn et al., 1997).

The greatest attention in the literature on private equity transactions is devoted to asymmetries in information between owners, management and buyers. The implications of the information asymmetry will be different depending on what type of buyout is considered, a management buyout (MBO) or a management buyin (MBI). In the first case, where the incumbent management purchases the firm backed by a private equity organization, agency theory suggests that information asymmetry arises due to the separation of management and ownership. Here, the firm's management has an informational advantage, being equipped with proprietary information and thereby better positioned to evaluate the firm and its performance (Howorth et al., 2004). The MBO obviously has an advantage in reducing the information gap and providing a private equity firm with greater details concerning the firm's risks and opportunities. However, the information asymmetry that exists between the owners and the incumbent managers is also suggested to give rise to negotiation difficulties since the perceptions of the firm's value will most likely differ (ibid.). Prior to financing this type of buyout an extensive managerial due diligence needs to be conducted (Yates & Hitschliffe, 2010).

In an MBI, where a private equity organization acquires a firm together with external managers, the information asymmetry will instead arise between the owners or incumbent managers of the firm and the private equity organization (Wright et al., 2001). Jones & Search (2009) suggest that it is impossible to entirely close the information gap arising in a MBI prior to the completion of the transaction. However, in their study of power relationship between the private equity firm and the target firm some suggestions on how to reduce this gap were presented. First, private equity firms try to reduce the information gap by frequent face-to-face interaction with the investee's owners and employees. The key attribute is to demonstrate an entrepreneurial attitude, a vision and a focus on business growth. Furthermore and of equally importance is to get to know the business culture of the target through physical proximity. A study including working practices, values and the gathering of in-depth knowledge of the target firm's employees is required to understand the business culture.

As presented in this section there are several obstacles faced by private equity firms in the transaction phase. It is further suggested that the magnitude of these obstacles will differ depending on the buyout type. The literature in this section raises central ideas of any transaction and is therefore suitable for assisting the transaction management framework presented in section 3.2.

2.1.3 Value Enhancement in Private Equity

Practically all private equity backed investments involve a clear plan of how to enhance the target's value within the holding period. Such a plan is according to Rogers (2002) a simple statement of the fundamental changes required to transform the firm and based on that statement, it guides the portfolio firm's actions. The literature on value creation in private equity buyouts divide different value enhancement approaches into direct and indirect value drivers (cf. Berg & Gottschalg, 2005; Loos, 2005). The direct value drivers have a real value creation effect that increases the buyout firm's cash flow through cutting expenses or more efficient use of capital, increasing revenues or through financial engineering. On the other hand, the indirect value drivers also have an effect on the firm performance but only through amplifying the effect of the direct value drivers. Such indirect effects stems from changes in the organizational, corporate governance and ownership structure. Furthermore, the literature makes a distinction between value creating opportunities pre- and post acquisition. This section will sort out the various value drivers as discussed by the literature. The full set of value drivers maps all possible ways to enhance value in businesses and can therefore be used by Privest as guidance.

Regarding the direct value drivers more emphasis will be devoted to cost reductions, improved asset utilization and growth generation since these constituents might directly apply to Privest. Financial engineering on the other hand is of less interest to Privest's case as its effect is largely dependent on a high level of debt. In short, financial engineering relates to the utilization of the private equity firm's reputation and contact network to negotiate superior borrowing terms, both to finance the buyout but also to provide subsequent financing to the portfolio firm (Loos, 2005).

The most common value driver utilized by private equity firms is cost reductions following improvements in the buyout firm's operation and investment decisions.

Operational improvement is an effect of the increased incentives for managers to focus on cash-flow generating activities (Berg & Gottschalg, 2005). A major source of cost reduction is cutting the overhead costs by improving control systems, building better systems for coordination and communication and enhancing the speed of decision making (Loos, 2005). However, all operational efficiency initiatives might not help the firm to compete in its industry; focusing too much on operational efficiency might have the opposite effect. A related, but still distinct value driver is the improved utilization of the firm's assets. Private equity firms focus on crafting an optimal amount of working capital through a more aggressive policy on accounts receivable, reducing the inventory level and extending the payment period to suppliers (Loos, 2005).

Finally, value enhancement in private equity investments is not only reached through operational improvements but is also fostered by focusing on revenue growth. The role played by private equity organizations in this situation is to reinforce the strategic focus of the portfolio firm, typically by increasing the product value and innovation. Common measures include changes in pricing, product quality, customer service, and customer mix as well as reorganization of distribution channels. Further strategic considerations include either the divestment of non-core businesses or add-on acquisitions to expand into areas where the firm enjoys strong competitive advantages (Loos, 2005).

The indirect value drivers, as stated in the beginning of this section, contribute to value enhancement or cash flow generation only through their influence on the direct value drivers. Berg & Gottschalg (2005) find that the most obvious indirect value driver is the reduction of agency cost in buyout targets. The amplitude of the positive effect stemming from the reduction of agency cost will vary from case to case depending on the prevalence of agency cost in the buyout target. Moreover, reducing agency cost is also contingent upon the means applied by the private equity firm to mitigate it, such as inducing high levels of debt.

The reduction of agency cost can be further broken down into three distinct categories. First of all, by arranging a management and employee incentive program the private equity firm is able to provide a carrot and stick mechanism to reduce the agency cost (Loos, 2005). The incentive program is structured in a way that the management has a substantial stake in the firm's equity and is thereby motivated to seek for efficiency gains and strategic efforts. Secondly, the increased incentives of the management lead to an improvement in corporate governance. Private equity firms also apply closer monitoring activities to evaluate management's performance and to make sure that the portfolio firm meets its objectives. Finally, the use of a great amount of leverage is considered to be an indirect value driver as it reduces the available free cash flow by focusing management on servicing debt payments rather than investing it inefficiently. Another indirect value driver discussed that do not relate to the agency cost regards the revival of entrepreneurial spirit in the buyout firm, leading to more innovative ideas and processes. Such effects are mostly seen in large firms with a bureaucratic and centralized organizational structure (Loos, 2005).

While the discussion on value enhancement opportunities available for private equity firms so far have focused on post-acquisition initiatives, the literature also suggest some pre-acquisition opportunities. According to Loos (2005) value can also be captured during the acquisition and negotiation phase of the investment. The first opportunity to capture value prior to the acquisition regards the information asymmetry that arises when an MBO is considered. Incumbent managers possess insider information that can be exploited when negotiating a deal. Secondly, the literature highlights that private equity organizations are skilled in negotiating. By identifying important issues that are central in the context of the deal, private equity firms can position themselves favorably in negotiating price and other terms.

This part of the literature review has presented the main value enhancement approaches deployed by private equity firms. It was found that value can be created both through applying direct measures but also by resolving issues that indirectly affect the business' value. The two extensive academic works that constitute the bulk of this part will serve as the foundation for the value enhancement framework built up in section 3.3 of this thesis.

2.2 Venture Capital Investments

Venture capital refers to equity investments made to launch, develop and expand new businesses (EVCA, 2011). This definition emphasizes that Venture Capital is related to entrepreneurial undertakings rather than investments made in mature businesses. Therefore most problems and solutions discussed in the literature on venture capital do not have a clear cut fit into the investments sought by Privest. There are however a few topics in the venture capital literature that are of interest for Privest and these will be discussed in the following text.

According to Lerner & Gompers (2004) there are three themes that echo in the research stream on venture capital. First, venture capital investments can be seen as a cycle in which all parts are highly interrelated. The interrelation between the parts; the raising of capital, the investment phase and the exiting of venture capital investments must be understood as a whole to understand the venture capital industry. However, such deep-probing analysis of the venture capital research field is out of Privest's scope and consequently this literature review will omit considerations related to fund raising and exiting of venture capital investments. Second, it is argued that the venture capital industry is adjusting slowly to changes in supply of capital and entrepreneurs' demand for financing. This topic also shows a weak alignment with the purpose of this thesis and will therefore not be discussed further.

Lastly, Gompers & Lerner (2004) argue that there are significant incentives and information problems for venture capital investors to overcome. The problem of choosing and managing investments with a high degree of uncertainty has parallels in Privest's case, which motivates this literature review to henceforward focus on the incentives and information problems present in the venture capital field. The following text will briefly describe these problems and what solutions the industry typically apply to solve them. Whenever found, implications that are useful for Privest are highlighted and presented in sections referring to the various aspects of the purpose of this thesis.

A venture capital investment is coupled with high uncertainty. The uncertainty stems from both the principle agent problem (cf. Jensen, 1989) that describe the cost of having a misaligned incentive structure and the information asymmetries that are present in all private transactions where the seller typically has more accurate information than the buyer (cf. Myers & Majluf, 1984; Stiglitz & Weiss, 1981). All across the venture capital field – from early phase seed investment to the contribution of expansion capital in mature firms – staging of investments and a varying duration of capital contribution is commonly applied to mitigate such risks.

Staging refers to the practice of dividing investment into stages, where the continuation of capital contribution in the next stage is contingent of the investee's performance in the current stage. In this way, staging of investment provides investors with a safety vault through which to escape if the incentive structure proves to be unfavorable or if the information evaluated before the acquisition do not correspond to reality. Staging is not directly transferable to Privest's case since its concept stipulates a one-time acquisition of a controlling share of the investee firm.

Varying duration of investments is another way of mitigating uncertainties present in venture capital investments and it simply corresponds to how long the investors need to stay committed with their contribution of capital. Gompers & Lerner (2004) argue that the duration of investment is related to the nature of the investee firm's assets in a way that a high ratio of tangible to total assets is awarded with longer investment durations, whereas balance sheets dominated by intangible assets like R&D projects make investors' patience run short. Considering Privest's long investment horizon it might be wise to not invest in firms with too much intangible assets, although the reasoning explained above mostly concerns investments in young and unproven firms.

Risk-mitigating mechanisms used in venture capital transaction, such as conditional payments and syndication, are highly relevant to consider in this thesis. The transaction management framework presented in section 3.3 will therefore integrate and discuss such risk-mitigating practices.

2.2.1 Investment Rationale in Venture Capital

Although academic literature on venture capital is rich in general, there seems to be few studies conducted that shed light on how venture capitalists screen potential investments for attractive features. Kaplan & Strömberg (2000) claim to be first to study this topic and their findings are therefore of interest for this thesis. Their study of how venture capitalists choose investments conclude that venture capitalists do not rely on any predetermined variables that aim to lift forward attractive opportunities. Rather, venture capitalists try to assess the overall investment opportunity, i.e. the market conditions and timing, the firm's products, technologies and past performance and the quality of management. Furthermore, Kaplan & Strömberg (2000) show that venture capitalists frequently underpin investment rationales by constructing investment theses. Such theses are generally closely related to the overall opportunity for investment, with assumptions relating to market size and growth being the most frequently cited theses.

Kaplan & Strömberg's (2000) results constitute important puzzle pieces in constructing a framework for investments in small firms due to primarily two reasons. First, they highlight the industry practice of assessing the overall investment opportunity. Evaluating the overall opportunity versus the potential risks is a necessity to make sound investment decisions in an environment characterized by high uncertainty. Therefore, the screening framework that will be constructed for Privest must incorporate an overall perspective. Second, they describe the use of investment theses that can be used not only to categorize and prioritize potential targets, but also set an agenda for active ownership post-investment. The use of investment theses as a way of structuring the analysis of potential candidate firms can possibly facilitate the practical implementation of the investment framework.

The emphasis on overall assessment suggested by Kaplan & Strömberg (2000) is also in line with a comparative study of venture capitalists in various countries performed by Manigart et al. (2000). They show that there is no one way of assessing an investment opportunity, but that practices varies with geographical location and perhaps more importantly, with the competencies inherent in the human capital of various venture capital firms. Manigart et al. (2000) also highlight that the assessment of investments shift focus depending on the age of the investee firm. Generally in the field of venture capital, sources of uncertainty lie in the entrepreneurial character of the investment, in which the track record of the entrepreneur and the quality of the management team in the investee firm are taken under scrutiny to assess the risk of the investment. Investments in start-ups or other young firms are however not in line with the investment strategy outlined for Privest, which is pointed at small but mature firms. In such late stage investments, analysis focus is transferred from the entrepreneur and the quality of management to financial analysis (Manigart et al., 2000).

The main conclusions from this part of the literature review, which are relevant to transfer to the theoretical framework, are the importance of overall investment assessment and the practical convenience of using investment theses.

2.2.2 Transaction Management in Venture Capital

Information asymmetries and incentive problems associated with venture capital investments can at least be partly mitigated by incorporating a few mechanisms in the transaction. These mechanisms are not directly applicable to Privest's situation, but provide some guidance for how transactions in small firms can be managed. In the following sections common risk mitigation methods are discussed through the lens of Privest.

On an aggregated level, venture capitalists mitigate investment risk by diversifying the investment portfolio (cf. Norton & Tenenbaum, 1993) and staging investments as described in the section above (Gompers & Lerner, 2004). Since Privest's prerequisites rule out a well-diversified portfolio and staged investments, none of these methods are applicable for Privest. On the other hand, staging the investment is not the only way to control risk through the deal terms. The use of covenants and conditional payment are additional mechanisms used by venture capitalists relating to the transaction phase (Gaggini, 2011).

Another way to reduce risk associated to information asymmetries that is commonly practiced in venture capital is to syndicate investments. Doing so not only implies greater diversification, it also means that the investment rationale is verified through the existence of more than one bidder. Gompers & Lerner (2004) show that this reasoning is more common in early stage investments, where the uncertainty is higher, and that investors seek greater exclusivity in later stage investments where uncertainty generally is lower. This finding implies an opportunity to trade-off the advantage of being the sole bidder against the reduction of information asymmetries that results from having a contester in the acquisition process, if uncertainties are high.

Risk-mitigating mechanisms used in venture capital transactions, such as conditional payments and syndication, are highly relevant to consider in this thesis. The transaction management framework presented in section 3.2 will therefore integrate and discuss such risk-mitigating practices.

2.2.3 Value Enhancement in Venture Capital

The literature on venture capital that address value enhancement activities in portfolio companies are predominantly concerned with changes in the senior management of portfolio companies, which ought to be thought of as an indirect reference to value creation. Kaplan & Strömberg (2000) found that most venture capitalists influence the composition of the management team before the investment or expect to do so afterwards. Similar results are obtained by Gompers and Lerner (2004) that emphasize that venture capitalists are more concerned to be involved in the shaping of the management team or active on the board when the investee firm go through turbulent periods, exemplified through a change of CEO.

These results do not have any direct implications for Privest, apart from reminding that new owners in a firm have a responsibility to maintain stability in portfolio companies by establishing and supporting a strong management team. On the other hand, one should be observant that such activities are more critical in young firms where solid management can be critical to short and mid-term survival, as opposed to the investments in mature firms sought by Privest.

2.3 Private Equity Investments in Family Owned Firms

The third and final research field included in this literature review covers research on family businesses. The literature in this field has historically to a large degree been occupied with the transformation of ownership from one generation to the next (Granata & Gazzola, 2010). Therefore it can be expected that family business related research might contribute with important puzzle pieces to understand investments in small firms from a transaction perspective. Studies in the field of family businesses have in recent years also begun to address other topics than succession. One such topic that is of outermost interest for this thesis is Dawson's (2008; 2011) studies of decision criteria for private equity firms that seek investment in family owned businesses.

The research performed in the field of family businesses is generally qualitative in character. Such an orientation is understood considering the research's focus on relations within the owners and non-economic values that normally never surfaces in negotiations regarding acquisitions in larger or publicly owned businesses. The literature covered in the following sections are therefore of highest interest given the purpose of this thesis. The rest of this literature review will first review what contributions research on family businesses has left to understand how investors evaluate family businesses. A section discussing the characteristics of transactions in family owned firms follows and finally, the last section of this chapter will examine value enhancement activities in the context of investments in family owned firms.

2.3.1 Investment Rationale in Private Equity Investments in Family Owned Firms

Investments in privately owned family firms share all the general uncertainties of private equity and venture capital investments already discussed, with the asymmetry of information being perhaps the most important hinder to come across (Scholes et al., 2007). Besides the general considerations that precede acquisitions, investments in family firms require the investor to evaluate if the fact that the target is a family firm will affect the investment in any way. If so, the attractiveness of the investment opportunity is contingent on the possibility to mitigate this risk in a satisfying way, as explored in the following sections.

A first interesting topic to bring up is if private equity professionals have a different approach to family firms, compared to when they evaluate other privately owned firms. This topic has been addressed by Granata & Gazzola (2010), who found that about half of the private equity firms included in their study reported that they flag family firms as extra risky. This risk allegedly relate to the firms' dependence on key employees, differences in the acquisition process and deal structure, and also the emotional values that are commonly expressed in negotiations considering transactions in family firms. Granata & Gazzola's (2010) respondents also point out that some of these risks are not specifically related to family firms but to small firms in general, which increase the transferability of the reasoning above to Privest's situation as Privest is not expected to only consider investments in family firms.

As already mentioned in the introduction to this review on literature relating to family businesses, Dawson (2008; 2011) has made an important contribution with her studies on investment decision criteria applied by private equity firms that address family businesses. Following the same argument presented by Granata & Gazzola (2010), that family firms are in many ways similar to small firms in general, allows Dawson's results to also apply for small firms. That increases the value of her studies from Privest's perspective since Privest seek investments in private, but necessarily not family-owned businesses.

Dawson's 2008 study reveal that the two factors that are most commonly associated with investment decisions among private equity professionals are the profitability of the firm and the industry growth. As good as all respondents acknowledge the importance of these factors, which do not relate to family firms specifically. The most influential decision criteria that specifically relates to family firms is the professionalism of management. This matter is looked into by 56% of the respondents, which plausibly reflect Granata & Gazzola's findings that about half of private equity professionals treat family firms differently than other firms.

Private equity professionals also associate investment decisions in family owned firms with the presence of experienced family members and non-family management (Dawson, 2011). Experienced family members that stay in the firm after acquisition is attractive since competitive advantage and tacit knowledge can reside in them. The presence of non-family management is an indicator that the firm is professionalized, an attractive feature held forward by respondents also in Dawson's 2008 study. To sum up, private equity professionals investing in family businesses are attracted to opportunities were the intangible resources of the firm do no reside in family members and will be inaccessible post-acquisition. Privest therefore ought to consider how transactions can be structured in a way that minimizes the risk that human capital will be lost.

This section dealt with investment considerations in family firms both from a general perspective but also with regard to private equity backed investments. Besides the findings on important decision factors governing the investment, family firms are commonly seen as riskier investments than firms with other ownership structures. Ideas from this section will serve as input to several parts of the conceptual framework presented in chapter three.

2.3.2 Transactions of Family Owned Firms

This section is focused on transaction related issues regarding buyouts of family owned firms. For the purpose of this thesis, it is relevant to review the academic discussions on this area as it is expected that many of Privest's potential targets will be family owned. Moreover, family firms differ in several dimensions compared to non-family firms, not at least when it comes to the transaction phase (Niedermeyer et al., 2010). To better understand private equity investments in family firms a more specific literature on family firm transactions will be integrated in this section.

In order to understand the various issues related to a family business transaction it is necessary to review the transaction from many aspects. The owners of family businesses often have an emotional component attached to the business, a non-financial value that the owners take into account when considering an exit (Astrachan & Jaskiewicz, 2008). The emotional value can be expressed in several ways, such as a will to maintain the firm's culture and identity, guarantee the safety of employees and sustaining a good reputation (Niedermeyer et al., 2010).

Two obvious implications that directly affect the transaction arise due to the emotional aspect present in family owned businesses. First of all, the valuation of the firm has to account for this non-financial value. Schmohl (2009) finds that valuation discrepancies are commonly present in family business transactions as owners often has a certain value of the firm in mind that cannot be substantiated by computation while investors rely on models based on cash flows and earnings. Secondly, the presence of a non-financial component is expected to affect the transaction process in the context of negotiation, since the fit between the owner and the investors as individuals is of particular importance in a family business sale (ibid.).

The relationship between the family business owner and the investors is particularly stressed by the literature (cf. Scholes et al., 2008). A successful deal is contingent upon a close relationship in which both parts cooperate to find a fair and bilaterally attractive solution. External managers seeking to acquire a family firm (MBI) are therefore at disadvantage since it is unlikely that they have developed any relations of trust with family business owners prior to the transaction (Schmohl, 2009). With reference to all deal structures, the approach to owners during the transaction phase is of significant importance to manage the transaction successfully. At the extreme end, a deal might not even be reached due to a mismatch of the owner's and investors' demands. Moreover, it is found that a stiff relation prohibit effective information sharing, which is of great interest to the investor in order to obtain a realistic and extensive view of the firm and its performance (Schmohl, 2009).

Another characteristic of the family firm is that the family members often have a significant role in the business, usually as management. Howorth et al. (2004) suggest that such key individuals possess tacit knowledge about the business, which can be hard to transfer to the new management team upon a transaction. This asymmetric information problem requires a considerable amount of time to resolve. In particular, this problem arises as the family firm owner-managers fail to plan for a succession. On the other hand, if the family firm owner-managers have prepared the incumbent personnel to take over, by sharing knowledge and information, the loss of key knowledge and competence about the business will be reduced.

Several suggestions are presented on how to prevent the issues discussed above. First of all, family business owners seek acquiring parties with an interest to retain a long-term sustainability of the firm (Schmohl, 2009). Secondly, family business owners usually embrace the idea to continue being a part of the future direction of the firm (Niedermeyer et al., 2010). Proposing a continuing role in the firm to the family business owner both sends signals of trust to the owner and decreases the risk of loosing tacit knowledge. Finally, Seet et al. (2010) argues that the involvement of a professional sell-side advisor might help to close potential gaps in knowledge and in the relationship between small or medium sized family firms and private equity investors. The purpose of the advisor is to assist the owners when the transaction process becomes increasingly complex.

This section highlights the most cited issue regarding family firm investments: the transaction. It is in this thesis critical to assess what factors that influences the transaction in the kind of firms that Privest target in order to respond appropriately. Therefore, findings from this section will be central to the transaction management framework presented in section 3.2.

2.3.3 Value Enhancement in Family Owned Firms

Since the literature on private equity activity in family firms assumes that a buyout transaction takes place, it is natural to lie down that value enhancement in family firms is similar to value enhancement in general buyout transactions. Therefore, a reference to Loos (2005) and Berg & Gottschalg's (2005) work presented earlier in this chapter is adequate. In addition, the literature on family firms lifts forward a few things about value enhancement that is of interest to know. Loos (2005) establishes that transactions in family firms yield lower return compared to transactions in other private equity transactions. This is thought to result from already relatively efficient governance and incentive structures, or that family firms may involve cumbersome factors such as non-professional relations in management.

Le Nadant & Perdreau (2006) hold forward that the principal-agent problem in family firms typically is less significant, leaving less potential for efficiency gains by reducing the agency cost. Scholes et al. (2010) establishes that fewer possibilities for efficiency gains exist when managers with equity stakes are employed pre-buyout. Interestingly, Scholes et al. (2010) also found that the potential for efficiency gains is higher in situations were the founder is present at the time of buyout and when management and the private equity investor were both involved in the succession planning.

Value enhancement in smaller family firms is more likely to stem from operational improvements than an alignment of incentive structures. This statement is supported by Jennings & Beaver (1997) who report that poor managerial competence is more common in small businesses, which can perhaps be explained by a relatively lower level of training (Loan-Clark et al., 1999). Furthermore, Watkins (1983) found that small firms do not acknowledge the need to implement even basic management principles, which possibly can give rise to opportunities for private equity firms to realize significant improvements by addressing relatively simple problems.

In this section it is established that value enhancement activities utilized by private equity organizations in family firms do not significantly differ from other private equity investments. However, some deviations are present and these are acknowledged as input to the conceptual model presented in section 3.3.

2.4 Summary and Conclusions

The following list of bullet points presents a concise summary of the literature review and highlights important conclusions.

- The literature review rests on three interrelated theoretical areas.
  - → Private equity literature is considered as the Privest concept shares fundamental characteristics with such investment firms.
  - → Literature regarding venture capital is surveyed for relevant topics mostly because of the similarity in size of investment targets.
  - → The acquisition of small and family owned businesses, which are the targets of Privest, have particularly been addressed by reviewing theory on family firms and available literature on private equity investment in family firms.

- The three literature areas are linked to the purpose of this thesis by specifically highlighting topics related to investment criteria, transaction management and value enhancement approaches.

- Literature on private equity presents the following main findings:
  - → *Investment criteria:* A wide array of information needed to perform an acquisition evaluation is presented and has to be weighted to reach an investment decision. Although some common criteria apply for LBOs, the assessment of a business will be contingent upon the buyout approach.
  - → *Transaction management:* Issues concerning information asymmetry is by far the most cited one. Implications are contrasted depending on whether an MBO or MBI is considered and general solutions to the problem are presented.
  - → *Value enhancement:* An extensive and generic discussion on value enhancement approaches considered by private equity firms is found in the literature. Value creation is suggested to be possible both pre- and post-acquisition and reached through direct and indirect approaches.

- Literature on venture capital presents the following main findings:
  - → *Investment criteria:* It is stressed that an evaluation has to be based on the overall performance of the firm, and not on single variables. Further, an assessment of the management is crucial to support the investment decision.
  - → *Transaction management:* Topics regarding information asymmetries and incentive structures are raised. Suggestions on resolving those are presented by introducing various risk-mitigating mechanisms.

→ *Value enhancement:* Opportunities for value enhancement are mostly discussed with regard to improved managerial routines as new owners provide knowledge and competence to the business.

- Literature on family firm investments presents the following main findings:
  → *Investment criteria:* Private equity investment evaluation of family firms follows largely the same routine as for other buyout targets. The literature though, acknowledges specific risks related to firm dependency on key persons.
  → *Transaction management:* It is stressed that the transaction of a family firm differs substantially from other transactions. Thus, critical factors Privest needs to assess and deal with are inferred from the literature on family firm investments.
  → *Value enhancement:* Approaches to enhance value in family firms is not treated distinctively in the literature, but is suggested be in line with other buyouts. Some specific value creation approaches related to family firms are presented.

- The three literature areas reviewed aim all to contribute to the creation of the conceptual model in chapter three. Each of the areas provides complementary findings that will assist in the designing of a screening framework of investment targets, raising critical transaction management topics, and suggesting suitable value enhancement approaches.

3 A Conceptual Model of the Investment Framework

This chapter presents a generic theoretic model for investments in small firms that build on the reviewed literature. The purpose of presenting such a model is to provide a theoretical platform that can guide the empirical research presented in part I of this thesis. The founding blocks of the conceptual model relate directly to the purpose of this thesis and encompass *a screening framework*, *a framework for transactions in small firms* and a *framework for value enhancement* in portfolio firms. A fourth constituent of the model named *the investment case* is devoted to describe the assessment of the overall investment opportunity, integrating the entire investment framework.

3.1 Layout of the Conceptual Model

The practical goal reflecting the purpose of this thesis is to present a set of investment cases, all of which describe attractive investment opportunities for Privest. To successfully reach such a goal requires data to be processed and analyzed in each of the parts of the conceptual framework before it is aggregately presented as an investment case. As visualized in figure 3.1 the investment case can therefore naturally be placed at the center of the conceptual model, as it is most contingent on other parts of the investment framework.

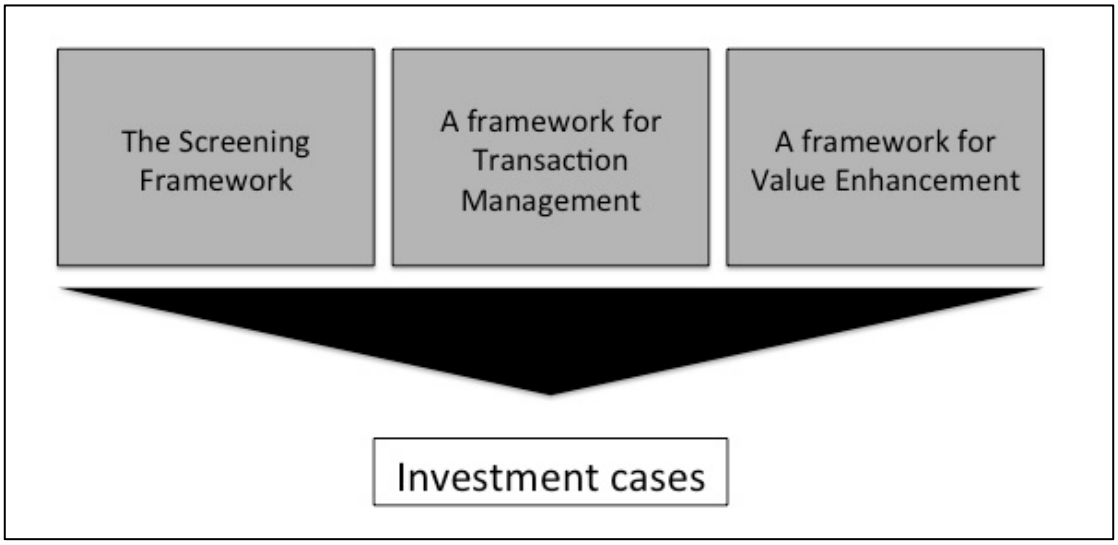

Figure 3.1: The constituents of the investment framework

The satellite parts surrounding the investment case are the cornerstones of the investment framework. The screening procedure decides what firms that qualify to be presented as an investment case. Important issues concerning transactions in small firms can be analyzed using the part of the framework that focuses on transaction management. Lastly, ideas regarding how value can be enhanced in the buyout candidates can be generated and compared using the part of the framework referring to value enhancement.

Due to the interrelatedness of the model constituents, it is hard to effectively explain the issues that characterize each of them and at the same time capture the full complexity of the investment framework. The following sections covering each part of the investment framework will therefore involve the risk that all interdependencies between the constituents will not be described. In the end, however, the strength of this model is that the investment case will sustain much of the complexity, since it stipulates an overall assessment of the investment opportunity.

3.2 Screening for Attractive Investments

This section will lie out the foundation of the screening procedure that supports the selection of investment candidates. As the later stages of the screening process require considerations regarding transactions management to be made, section 3.3 plays an important supportive role to this section, exemplifying some of the interdependencies present in the investment framework.

3.2.1 Structure of the Screening Framework

The literature review presents many findings that can contribute as content in a screening framework (see sections 2.1.1, 2.2.1 and 2.3.1). However, no direct references can be found that aid the construction of a screening framework from a structural perspective. This is probably due to that private equity firms generally do not rely on the kind of screening framework that will be developed during this study; they rather leverage their extensive network to find appropriate investment opportunities. Furthermore, private equity organizations apply an overall assessment of the investment opportunity, including an evaluation of both quantitative and qualitative aspects. The incorporation of such an analysis in the screening procedure is one of the key challenges faced in this thesis. Figure 3.2 visualizes the parts of the screening framework and how these relate to the other areas covered in the conceptual model of the investment framework.

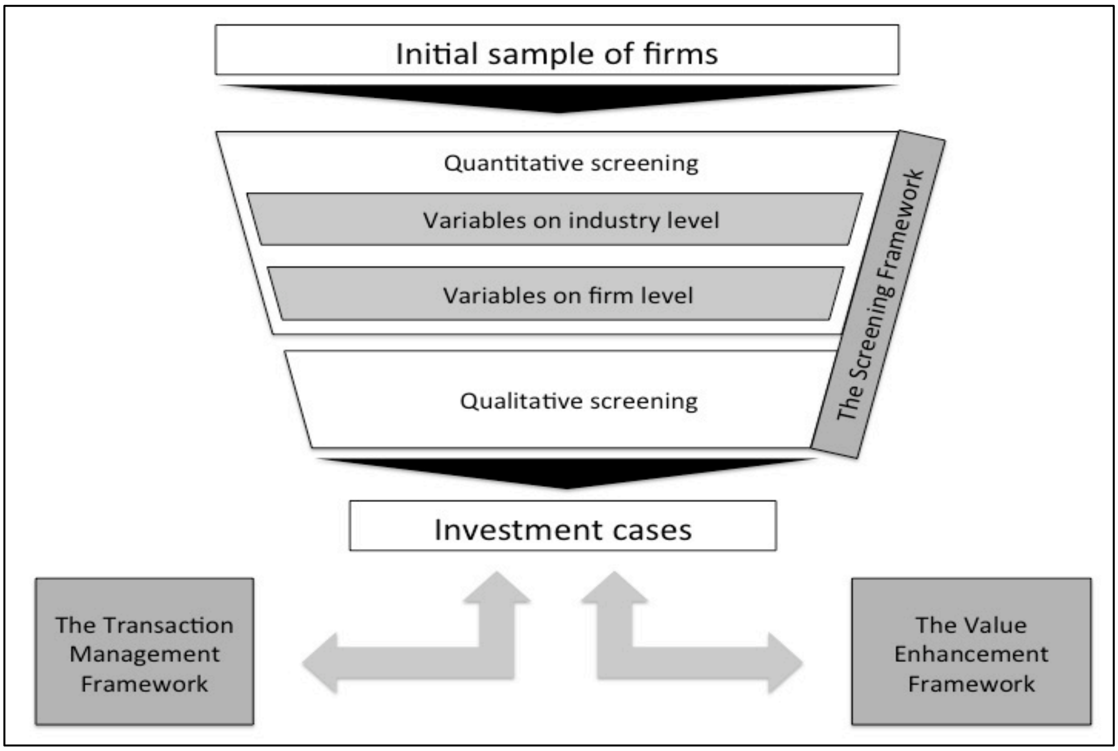

Figure 3.2: The structure of the screening framework and its relations to other parts of the investment framework.

Due to the large sample of firms that anticipatively will be evaluated in this thesis, it is practically impossible to perform the extensive evaluation practiced by private equity firms. Therefore, the screening framework has to be designed to continuously assess comparable characteristics of the target firms. The first set of characteristics analyzed will be of quantitative, or more specifically financial nature, since it allows for a factual comparison of a large sample of firms. Moreover, the screening framework has to incorporate an evaluation of firms that goes beyond pure financial measures, and it is therefore necessary to include a qualitative assessment of the target firms. The outcome of the combined quantitative and qualitative screening is a few qualified investment alternatives.

3.2.2 Quantitative Screening

The idea of employing a quantitative screening is to arrive at a sample of firms that is of a size that allows qualitative screening of each firm. In order to make a fair comparison of the target firms, the quantitative screening has to focus on characteristics that are not troubled with ambiguity. From the literature review, several financial measures can be extracted that supports this comparison of firms (cf. section 2.1.1). These measures can be divided between firm specific and industry specific variables. It is also found that family firms, who are argued to share similar characteristics with small firms, are treated in the same way as other private equity investments with regard to two critical parameters: firm profitability and market growth (cf. section 2.3.1).

The possibility to generalize and quantify measures of firm and market performance used by private equity organizations makes it suitable to base the quantitative part of the screening framework along these two performance dimensions. Relying on this overall structure, the next consideration for the screening framework relates to what measures to use and what boundaries to apply. Suggestions from the literature on these measures are mostly related to the LBO strategy, which are in line with Privest's investment direction (cf. section 2.1.1 and 1.3). However, the quantitative part of the screening framework also has to account for the growth-oriented approach highlighted by the literature, since Privest might consider targeting small mature firms with strong growth potential. The last consideration for the quantitative framework regards the assessment of the overall investment opportunity, stressed by both the private equity and venture capital literature (cf. 2.3.1). Hence the framework has to be designed to support such an overall assessment to as great extent as possible. Before turning to the firm and industry variables respectively, the essence of this discussion is outlined below:

(1) The quantitative screening will include variables related to the firm's and its industry's performance to allow a comparability between a large set of firms.
(2) The quantitative screening has to be designed in a way that accounts for differences in firm characteristics depending on buyout approach.
(3) The quantitative screening has to support an overall assessment of target firms.

The design of a quantitative screening framework has to make allowances for some practical implications induced by the conclusions above. One way to organize the screening framework would be to simply exclude firms continuously as each variable is assessed. However, that would oppose against point two and three above since it would prohibit an overall assessment. This in turn prohibits finding nuanced alternatives of interesting firms for Privest. Therefore, a potent way of constructing the quantitative screening framework is to introduce a point awarding system. The systems will premium attractive features instead of eliminating firms based on single performance variables, allowing an overall assessment of the firms. As a consequence, it will also allow different buyout types to be discerned based on firm and industry performance variables.

3.2.3 Variables Relating to Industry Attractiveness

Attributes of a firm's industry is according to private equity literature integral in the evaluation of the overall investment opportunity. The contribution to quantitative measures can be found in the literature on LBO transactions (cf. 2.1.1) and private equity investments in family firms (cf. 2.3.1). The former one observes the state of the industry's profitability upon the acquisition and the latter one points out the attractiveness of industry growth. Although far from exhaustive in suggesting how to assess the industry attractiveness quantitatively, the literature review clearly points out the need to relate the firm's performance with its industry's. The screening framework focusing on quantitative analysis therefore requires measures of industry performance to be identified, appropriately defined and applied to allow comparisons between buyout targets.

3.2.4 Variables Relating to Firm Attractiveness

Most variables for screening that can be traced in the related literature are focused on the level of the firm. Although private equity organizations make an overall assessment, several financial measures particularly related to LBOs can be extracted to influence the construction of the quantitative screening framework. As discussed earlier, the generic criteria that apply for LBO transactions should be supportive when targeting small businesses as well, since Privest aim to acquire mature and cash flow positive firms. Nevertheless, to assess the applicability of these criteria requires further investigation.

Among the variables mentioned in the literature regarding LBOs are profit levels, financial solidity, and investment needs. Literature strands on venture capital and family firm investments also highlight firm growth as an attractive aspect (cf. 2.2.1 and 2.3.1). However, the findings provide little detail on the definition of these variables and obviously, no references are found of how to deploy them in a screening framework. Moreover, the intended design of the screening framework will be subject to a trade-off between thoroughness and quality of the quantitative comparison.

3.2.5 Qualitative Screening

The qualitative part of the screening framework aims to capture necessary evaluation criteria that would have been interesting to apply already at a quantitative level, but that are not available in such forms. Building on the results from the quantitative screening and using information that is not available through quantitative sources, the purpose of the qualitative screening is to arrive at a few buyout candidates that will be further investigated as investment cases. The information needed in this part of the screening has to reveal whether a firm is transferable or not within Privest's intended investment horizon. Due to its practical relevance and the obviousness that a firm has to be transferable to be considered as an investment opportunity, very little can be tracked in the literature review that is suitable for this part of the screening.

A firm's transferable state might be investigated from two perspectives. The first determinant is associated with the owner's willingness to sell the business. A brief literature discussion (cf. section two) states that there might be several reasons for considering sale of a business. When it comes to small businesses, the most prominent reasons for a sale are related to entrepreneurs willing to exit and a family business succession. All ways to identify such situations might increase the likelihood of finding owners that are ready to divest their businesses. The second determinant concerns the firm itself and whether a change of ownership is inoperable due to the business' dependence on certain persons. In the literature on family firm transactions this issue is depicted as a major concern as the owner's or other key persons' knowledge and competence is critical for the sustainability of the firm. Taking these two perspectives together, the qualitative screening has to reveal whether the business is for sale at all and if there is a large risk that the business will fail to operate in the absence of the owner or other key persons that leave the firm upon a transaction.

The theory developed in this section outlines the structure and function of a screening framework that can be used to find attractive investment opportunities in small firms. This theory will be used as a basis for the empirical research presented in chapter 5, which aims to fulfill the purpose of providing a screening procedure applicable to finding attractive investments. Having covered the first constituent of the conceptual model presented in figure 3.1, this chapter now continuous with a section devoted to transaction management in small firms.

3.3 Transactions in Small Firms

This section lays out the theoretical base for how transactions in small firms can be analyzed and managed. A successful transaction is in many ways paramount to the overall investment activity, in the sense that the areas covered in the following section relate strongly to the other parts of the investment framework; a correct analysis of owner dependence is crucial to the screening process and the relation that forms between the seller and buyer determines the prerequisites for value enhancement prior to and post acquisition. The theoretic base of this part of the framework mainly resides in the literature stream on information asymmetries and the research in the field of family businesses presented in the literature review (see section 2.1.2, 2.2.2 and 2.3.2).

From an investor's perspective acquisitions are often viewed as linear processes that start with a preliminary assessment of the investment, move through various due diligence and negotiation processes, and finally end when the post-acquisition integration process has begun. Such a representation is adequate to provide an overview and describe the different activities that are performed during a transaction. On the other hand, it fails to capture the complex interdependencies present between the transaction phase and the activities that reside in the other parts of the investment framework. Therefore, the reasoning presented in this section does not attempt to describe what steps a transaction in small firms theoretically should include. It rather aims to raise the level of abstraction to a point where issues that are crucial for transactional success can be discussed in a context that clearly shows how those issues fit into the big picture.

3.3.1 Important Aspects in Small Firm Transactions

There are two main issues that govern the success of transactions in small firms: information asymmetry and owner desires. The information asymmetry prevents the investor to make an exhaustive and realistic assessment of the firm prior to the acquisition, putting him at risk. On the other hand, the family business owner has particular interests in the post-acquisition future of the firm. A mechanism that can help balance the buyer's need to close the information gap and the seller's individual desires concerning the object of transaction is therefore required. As inferred in the literature review (cf. section 2.3.2), the relation that forms between buyer and seller in small firm transactions often take on this balancing function, as shown in the figure below.

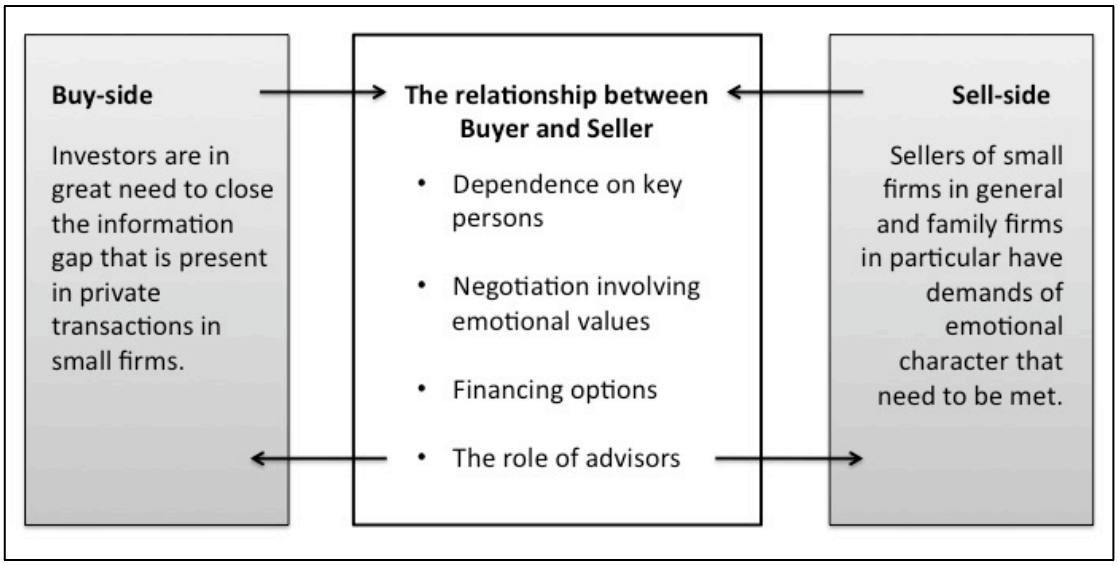

Figure 3.3: The relation between buyer and seller as a balancing mechanism in small firm transactions.

The following text brings up four areas that will have an effect on the success of transactions in small firms, even though the relative importance of each area will most likely vary from case to case. The unifying property between these areas is that they can all be analyzed within the frame of the relationship formed between the buy– and sell-side of the deal. As in all relationships, the level of trust between the parts determine how much of the imbalance that can be equalized. The prerequisite of a successful transaction, viewed from either side, is thus contingent on the will to meet the other side's needs.

Dependence on Owners or Key Persons
When discussing the dependence on owners or key persons an analogy is expected to exist between small firms and family firms, concerning its prevalence. The literature suggests that owners who are also managers in a family firm have developed specific knowledge of the firm that is often tacit in nature and therefore hard to transfer. A business that is highly dependent on such key persons is obviously an issue calling for attention during a transaction, meaning that it is necessary to determine the extent of the small firm's dependency and how, if at all, it might be reduced prior to a transaction.

A well-evolved relation between the buyer and seller lowers the risk of owner dependence as the information gap experienced by the buyer decreases. In a situation were both parts trust each other, steps toward a solution of the information asymmetry problem is also more likely to be taken. Therefore, this study has to examine what factors that govern how such relationship can be established. Another solution that effectively solves issues related to owner dependence requires certain mechanisms to be present in the financing structure of the deal; a topic that is further explored in the paragraph *Financing options* below.

Negotiation Involving Emotional Values
The engagement in a small business transaction requires and understanding of the seller's motives or values, as there is often an emotional or private value attached to the firm. It is observed that family business owners put considerably weight to such values when stepping into a transaction process. This notion makes transactions in

small firms rather different from larger transactions, in which negotiation in a greater extent is based on pure economic values. As inferred in the literature review (cf. section 2.3.2), there is an opportunity present in smaller transactions since a sensitive buyer can receive a discount by obliging the seller's demands in negotiation. In fact, the fulfillment of the entire deal might be contingent on the investor's ability to acknowledge the non-financial values expressed by the seller.

The negotiation process in small firm transactions thus is directly related to the value enhancement of the overall investment. As explained more thoroughly in the part of this conceptual model that covers value enhancement, financial effects can contribute to the overall value creation at the time of acquisition. The existence of such a financial arbitrage implies that the overall negotiating strategy employed by investors seeking to buy small firms should strive to optimize this effect. Therefore, and as already mentioned in the previous section, it is of importance to this study to present guidelines for how to approach and interact with the owner of a small business.

Financing Options

Just as the literature review recalls, there are a multitude of different financing arrangements at dispose for an investor seeking to acquire a firm (cf. section 2.1.2). A careful discussion of the structure of the deal is important when considering a transaction, since certain financing arrangements can help control risk. One example of such a situation, primarily stressed by the literature on private equity (cf. section 2.1.2), is to apply an MBO to mitigate the risk of owner dependence. The choice of financing arrangement is thus based on the investors' need to reduce risk in the transaction, but it must also acknowledge the seller's needs. Ultimately, the transaction structure should provide solutions to problems expressed on both sides of the transaction.

The primary function of the financing agreement thus becomes equal to the relationship between buyer and seller; it is a mechanism that equalizes imbalances between the transactional parts. Finding a mutually beneficial financing structure can just as a sound relationship contribute to the success of the transaction. This study therefore needs to investigate how the financing arrangement of the acquisition affects the likelihood of a successful transaction.

In summary, a transaction process involving small firms is mainly about resolving two critical parts. On the one hand, the buyer has to close the information gap to get access to reliable and accurate information about the firm and its performance. Moreover, small businesses are troubled with a dependency on key persons, which is seminal to overcome for a transaction to be successful. On the other hand, the owner of the business has certain interests in a transaction that goes beyond pure financial compensation. It is suggested that a close relationship between the two parties involved works in the direction to resolve the parties' uncertainties. Finally, the transaction process is also about finding convenient ways of structuring the deal and financing the buyout. Hence, for these matters alternatives will be presented to Privest.

The Role of Advisors

The literature review suggests that the involvement of an advisor on the sell-side improves the chances of a smooth transaction (cf. section 2.3.2). In fact, the benefits of involving an advisor to support the seller of a small firm are generally acknowledged to exceed the extra cost it impairs for the buyer. This effect can be understood considering that smaller firms typically need help to reach a transferable state, typically by reducing the dependence of key persons prior to selling.

A similar discussion can be applied to the issue of exclusivity in a transaction. The exclusivity of a transaction reflects how many buyers that are active in the bidding process. Many potential buyers typically means that the price is pushed up higher, whereas a sole bidder has a better chance to close the deal with a lower price. Generally, exclusivity is attractive for investors but due to the uncertainties regarding information in private transactions there is a trade of between exclusivity and uncertainty. A group of interested buyers can be interpreted as a verification of the information shared among investors. Thus, partaking in bidding will likely lead to more expensive deals, which yet are safer from an information perspective. Achieving exclusivity in a deal is naturally dependent on the relation between buy and sell-side, suggesting that buyers that are perceptive to the sellers desires have a better chance to succeed.

The text above has narrowed down the wide variety of topics related to transaction management that can be found in the literature review into four areas that are vital to transactions in small firms. Doing so provides a theoretical platform to continuously build on through the empirical research presented in chapter 6. Having established a theoretic base for transaction management, this chapter now proceeds with a section addressing how value enhancement can be pursued.

3.4 Value Enhancement in Portfolio Companies

This part of the investment framework provides an analytical lens through which value enhancing activities in target firms can be identified and motivated. The theory developed in this section thus provides a base for the empirical investigation presented in chapter 7. Considering the practical utility of the intended analytical lens it needs to have two sides. First, a framework is needed to aid the generation of ideas on how value can be enhanced in small firms. Such a framework needs to be exhaustive in the sense that it covers all approaches to value generation that is theoretically applicable in small firms. Furthermore, the analytical lens must also incorporate a way of quantitatively measure and compare the economic effect of various value enhancing activities. Such measurement is not only needed for a correct representation of potential upside in the investment cases, but is also of great importance considering the comparability across investment cases when evaluating investment decisions.

3.4.1 Approaches to Value Creation in Small Firms

This section presents a framework that covers all theoretically viable approaches to value generation that is mentioned in the literature review (cf. section 2.1, 2.1.3, 2.2.3 and 2.3.3). The reviewed approaches are complemented with a business model oriented perspective and presented in a structure that visualizes the properties and interdependencies of the model constituents (see figure 3.3).

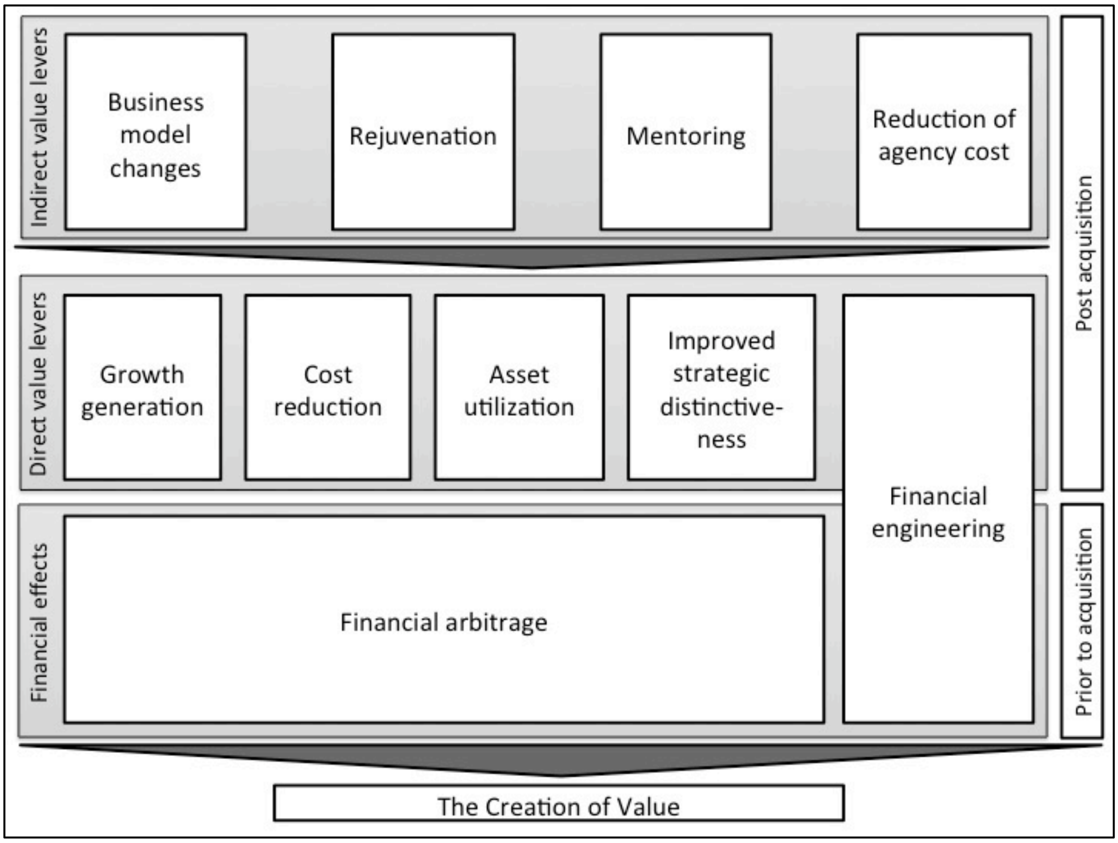

Figure 3.4: A brake-down of value enhancement approaches in private equity transactions.

As recalled from the literature review, academics have discerned different categories of value enhancing activities (cf. section 2.1.1). On an aggregated level, a distinction can be made between direct value levers, indirect value levers and financial effects that help to generate value. The direct value levers share the property that they have a direct impact on the firm's cash flow generating ability. Indirect value levers do not have such an impact; they rather act as support to the direct value levers. Finally, financial arbitrage makes a contribution to value creation that is independent of physical improvements and corresponds to the capturing of financial effects.

On another note, academics studying the approaches utilized by private equity professionals also acknowledge that activities can be categorized according to when they occur. Most of the approaches that can be used to enhance value typically take place ex-post the acquisition. Yet, as the figure above shows, some alternatives to value enhancement requires commitment also before the acquisition takes place. Even though this representation of value enhancing approaches is exhaustive, it should also be noted that the different areas covered are not mutually exclusive. The causality of the economic effects following value-enhancing activities derived using this model can therefore be hard to assess.

Before looking into the different approaches to value generation more closely, it is worth to point out that the purpose of the following descriptions not is to explain how an investor can utilize them to enhance value. The breakdown and categorization of different approaches rather aims to provide a road map to be used when seeking ideas on how value can be created.

Financial Arbitrage

Financial arbitrage is intimately related to the occurrence of transactions, but since Privest aims for long-term ownership the likelihood of capturing any financial effects at divestment is not to be expected. Such arbitrage typically stems from the re-valuation of the investee firm that occur in connection to the divestment, in which the altered size and profitability of the firm induces a higher valuation multiple.

On the other hand, Privest has the opportunity to meet the specific needs of the seller and receive a discount on the acquisition, as discussed in section 3.2. This corresponds to a capturing of financial effects at the time of acquisition and will have a positive effect on the return of the investment.

Direct Value Levers

The direct value drivers share the property that they have a direct effect on the cash flow generating ability of a firm.

<u>Growth Generation</u>

Going through the income statement of a firm, the first opportunity to create value that present itself is to increase the revenues accounted for on the top line of the statement. A rational approach to increase the revenues of a firm is to ask what can be done with the resources that are already in place. Such an analysis can render if the assets allocated to the selling function is optimally utilized, or if changes can be implemented in sales routines to improve performance.

A second approach that might need more commitment is to assess the income generation of the firm for a strategic perspective. Such an analysis can help determine if the firm is targeting the right customers or offering the right product to them. Generally, the kind of changes that might be proposed in such a discussion will be harder to implement since it is stipulates changes that go further than changing the day-to-day routines and might possibly also imply allocation of further assets to the sales function.

A third alternative approach is to analyze the pricing of the firm's products and services. The effect of price changes may leave various contributions to revenue increases depending on the volumes transferred to customers, which need to be considered as part of the analysis. Furthermore, it is also important to note that price changes might have unwanted effects on revenues if careful considerations are not made regarding customers sensitivity to price changes, and their possible reactions to such.

Cost Reduction

Addressing the operational efficiency and its related costs in small firms is an appealing approach to value creation from a theoretical standpoint. As mentioned in the literature review (cf. section 2.1.3), the lion part of the value generated in buyout transactions could be traced back to operational improvements in the target firms. At the same time, the literature reviewed in the field of family businesses (cf. section 2.3.3) reveal that small firms are more likely to be inefficient and lack even basic management systems. Taken together, these two findings suggest that the theoretical prerequisites for value enhancement through operational improvements when investing in small firms are benign.

In the income statement, operational improvements will take effect through lowering the firm's costs, i.e. all expenses needed to run its operations. Depending on the character of the firm's operations, the possible paths to improve the efficiency are countless. Instead of listing viable alternatives here, it is more meaningful encourage an all-encompassing approach to operational improvements that can find support in the literature on operations management briefly introduced in the first section of the literature review (cf. section 2.)

Improved Strategic Distinctiveness

As identified in the literature review on buyout transactions, new owners can often bring a new vision and strategic intent to a firm (cf. section 2.1.3). Depending on the situation in which the acquisition occurs, such changes can be motivated differently. In some cases, a change of strategic direction is necessary to ensure the long-term survival of a firm that is heading down the wrong path. On the other hand, strategic changes can also unlock new potential in already healthy firms by entering new markets, focusing on a specific group of customers and products, or rebuilding the supply chain. Again, overlooking the entire set of possible ways for a firm to improve its strategic distinctiveness requires extensive knowledge within the field of strategic management, also introduced in the first section of chapter two.

Asset Utilization

To run its operations, all firms need a set of appropriate assets. Since firms that enjoy superior returns typically have a streamlined set of assets that are used in an efficient way it is rational to examine the asset structure for possible improvements. As most firms need a diverse set of assets there is no single approach to be applied for such an analysis. Most of the assets, like buildings and machines, can often be analyzed from a strategic standpoint using the competencies referred to in the paragraph *improved strategic distinctiveness* above. The key issue here is to find out if there is a less costly way to access the utility of the asset, or if the asset's importance in the firm's operations is of too great importance to accept such a trade-off.

A firm's assets can also be analyzed from a financial perspective. The purpose of such an analysis is to determine what levels of capital the firm requires to run its day-to-day operations, the so called working capital, and how the excess capital in the firm should be optimally used. If there is a need for new capital investments to finance expansion or other prioritized projects, the capital released from the optimization of the asset structure can be employed to fund these projects. Otherwise, since the Privest concept stipulates a focus on dividends rather than proceeds from divestments, the term *optimally* can be interpreted such that excess capital is distributed to shareholders.

Financial Engineering

A distinguishing strength of private equity firms is their ability to negotiate beneficial borrowing terms and craft a financing arrangement that minimizes the after tax cost of debt. This job is predominantly done ex-ante the acquisition, although the financial engineering activities might extend into the ownership period in order to build an efficient capital structure. Since this ability is based on having a good track record and access to an extensive network of creditors, financial engineering activities are not likely to give a large contribution to value creation in Privest's investments. Moreover, Privest is not likely to use an extensive portion of debt in acquisitions, rendering that financial engineering becomes of less importance.

Indirect Value Drivers

Even though the following issues brought up in the following paragraphs do not directly affect the cash flow in a firm; they still have an effect on the value creation process through their support of the direct value levers.

The Firm's Business Model

Introducing the business model as a unit of analysis provides an overview of the business logic applied by the firm. With the benefit of such an overview, activities that directly affect a firm's value can more easily be identified and prioritized. The business model perspective is foremost of help in a discussion of the strategic distinctiveness of a firm but can also provide a structure to the analysis of growth- and cost reducing approaches to value creation. The theoretic basis for an analysis of business models is briefly introduced in the first chapter of the literature review (cf. section 2.).

Mentoring

The purpose of mentoring activities is to reinforce the senior management of the investee firm. In this context, the wording *reinforce* refers to providing complementary expert competencies that can be used by management as a sounding board for their own thoughts and ideas. Typically, mentoring activities are implemented through representation on the board, although other more operational alterations are possible. As pointed out in the literature review (cf. section 2.2.3), activities that aim to support management can be extra important when the firm experience turbulent times. However, to include the help of experts is expected to help implementation of almost any conceivable value-enhancing activity.

Rejuvenation

Firms that have lost their pace and fallen into routines can benefit from activities that aim to restore the entrepreneurial spirit in the firm, leading to more innovative processes and ideas. This effect, albeit hard to measure, have been observed in post-buyout firms although it is not clear whether any such effect can be expected within the scope of Privest's investments. Given the small size of the firms Privest seeks to invest in, they can be expected to already be entrepreneurial in their character; an essential up-side of small firm's high dependence on key persons.

Reduced Agency Cost

The large returns that private equity firms have enjoyed from reductions of agency costs are not expected to surface in small transactions, leaving this topic of lesser interest for Privest. However, in some respects the principal-agent problem might have some implications for Privest. It has been observed that having debt payments that need to be served help focus management's attention on generating cash flows and minimizes the risk of inefficient reinvestment of cash flows in alternative projects. To conclude, mechanisms that better align the incentive structure between owners and managers in the investee firm contribute to value creation by preventing a suboptimal asset structure.

3.4.2 Measuring the Effect of Value Enhancing Activities

Just as depicted earlier in this chapter, the analytical lens does not only need to support all possible approaches to value creation, it must also present a viable way to measure how much value that potentially can be created. In this thesis, value refers to equity value of the firm. To be able to measure the degree of value that is created trough various activities, a definition of equity value is therefore needed. Following basic accounting math, the value of equity can for this purpose be expressed as:

$$\boldsymbol{Equity\ value = Valuation\ multiple \times Revenues \times Margin - Net\ Debt}$$

This representation is adequate since it allows for all possible value enhancing approaches to be represented through one of the variables above. Since net debt is subtracted to arrive at the equity value, it follows that the product of the valuation multiple, revenues and margin corresponds to the enterprise value (EV). Therefore, the valuation multiple used should be based on EV, although any level of profit can be used as long as it is aligned with the margin measure. In addition, the valuation multiple is in this model also thought to contain the theoretic discount that can arise from financial arbitrage (see the paragraph *financial arbitrage* above).

To enable a comparison between investment cases the increase or decrease of equity value can be quantified by the internal rate of return (IRR). To do so requires a time period to be defined over which the rate will be measured. Starting at time zero, the IRR over an investment period of N years then represents the annual return made from the investment.

$$\boldsymbol{IRR = \sqrt[N-1]{\frac{Valuation\ multiple_N \times Revenues_N \times Margin_N - Net\ Debt_N}{Valuation\ multiple_0 \times Revenues_0 \times Margin_0 - Net\ Debt_0}} - 1}$$

Using this theoretic representation of value creation it is in practice straightforward to build a model in which various value enhancement activities and combinations thereof can be evaluated. Such a model would also fulfill the requirement of enabling comparison across different investment cases. On the other hand, it should be noted that significant assumptions relating to the variables included in the model are needed to provide a quantitative input. As all models, it therefore needs to be used with care and consideration.

This section has lain out the theory needed to at one hand identify value-enhancing activities and on the other hand measure the economic effect of such activities. The theory presented make out the fundament of a framework for value enhancement in small firms that will be further built upon by the empirical investigation presented in chapter seven. The last section of this chapter will now turn to address the role of the investment case as an integrating entity that communicates the overall investment opportunity in a firm.

3.5 The Investment Case

In the investment case, critical aspects of an investment opportunity should be highlighted. This is primarily achieved by letting the investment case be an integrator of the various parts of the investment framework previously presented in separate sections of this chapter. To ensure that such presentation of the investment opportunity is robust enough to be used in practice, the empirical investigation presented in chapter 8 serves the purpose of revising the content of the investment case proposed in the following text.

3.5.1 External Analysis

Even though the screening process outlined in the previous parts of this chapter is designed to reveal risks that are typically prevalent among the firms included in the sample, it falls short of providing a detailed analysis of the firm's external environment. As findings in the literature review on private equity suggest (cf. section 2.1.1), such analysis is necessary to assess the competition a firm faces or its position in the value chain. Identifying opportunities and threats in the firm's external environment is also of importance as input to a discussion of the firm's strategic direction and what changes that can be implemented to benefit the long-term value generation of the firm.

3.5.2 Internal Analysis

As the external analysis concerns the firm's environment, the internal analysis logically addresses what strengths and weaknesses the firm has that are contingent on factors that reside inside the firm. Theoretically, both strengths and weaknesses can take a multitude of forms, spanning a range of concepts from intellectual capital to a high dependency on key employees. On a more aggregated level, such a discussion can be centered on the identification of the firm's sustainable competitive advantage, if such can be found at all.

3.5.3 The Financials of the Firm

Even though firms that have qualified for investment cases have already gone through an financial evaluation as part of the quantitative screening, a deeper analysis of the firm's financial situation will be performed as part of the investment case. An extended analysis of the firm's financials serves two purposes. First, the past financial performance of the firm reveals a lot of information on the firm that are of interest to assess the quality of the firm as an asset. Secondly, the past performance can also be used as a base for forward looking projections, which are required to build a financial investment case using the theory explained in section 3.2.2.

3.5.4 Possibility of a Successful Transaction

Transactions in small firms –and not the least in family firms– have many characteristics that require sincere consideration and set them apart from general private equity transactions. Therefore, a distinctive part of the investment framework outlined in this chapter is devoted to the management of transactions in small firms. The analysis induced in that part of the framework will be channeled into the investment case in order to enable a well-founded discussion on transaction management, which is supportive in an investment decision.

3.5.5 Value Enhancement Opportunities

One section of the investment case should also be dedicated to the improvements that can be made in the firm and what value such improvements can be expected to generate. The opportunities present for value-enhancing activities are mapped using the part of the investment framework dedicated to value enhancement in small firms (see section 3.3.). Including a discussion based on the part of the investment framework that analyzes value enhancing activities in each investment case will further increase the contrast between different investment cases. If quantified, the proposed improvements can be assessed in the financial investment case implied under the paragraph *The financials of the firm* above.

As an endnote to this section, it is important to point out that the outline of an investment case herein presented is of a general character. Consequently, the focus of various investment cases will –and should– differ depending on their prerequisites. To conclude, the structure and content of the investment case is second to its mission to provide an overall assessment of the investment opportunity by integrating the various parts of the investment framework. The topics raised up for discussion in this section form a basis on which the empirical investigation in chapter 8 will add supplemental findings concerning how the investment case should work as an integrating entity in the investment framework.

To summarize, this chapter presents a conceptual model of the investment framework that embrace four constituents; a screening framework that aid the selection of attractive investment opportunities, a framework that highlights important topics in transaction management, a framework that enables the analysis of value enhancing activities and finally, a section covering how the entire investment framework can be integrated in investment cases. All taken together, these sections constitute a fundament that will be further built upon by adding the empirical findings presented in part I of this thesis.

4 Method

This chapter explains the research methodologies that have been applied to fulfill the purpose of this thesis. As the purpose is two-sided, and these sides differ in their character, it is rational that also this chapter is divided into two sub chapters; each addressing its respective part of the thesis' purpose.

4.1 Research Methodology for Part I

This section describes the research methods applied in order to fulfill the purpose of constructing the Investment Framework. The rationale behind the chosen methodologies is presented and their inherent strengths and weaknesses are discussed.

4.1.1 Research Strategy

The construction of the Investment Framework will constitute this thesis' major contribution to the academic research on direct investments in small firms. For that reason, the research methodology addressing part I of the thesis is of greater importance –and foremost interest– from an academic perspective. The purpose of the first part of the thesis can be recapitulated as:

… to propose a framework for small-scale private equity investments in Sweden. The investment framework will both help identify companies suitable for transactions and provide insights in how the transactions and subsequent development of the companies should be managed.

Predominantly, the research strategy employed to fulfill this purpose will be of a qualitative character. A qualitative focus is suitable considering the wide scope of the purpose and the expected interdependencies between the research areas implied in the literature review. Viewed from an opposing perspective, an out-and-out quantitative approach is ruled out since there is neither any quantitative methods that would leave a stronger result than qualitative research, nor is there any easily accessible quantitative data to be used in such research.

4.1.2 Research Design and Methods

After deciding that the overall research strategy is to apply qualitative research methods to fulfill the purpose of the thesis, the next step is to make some tactical decisions on how the research should be set up. According to Bryman and Bell (2011), there are multiple research designs that are available to support qualitative research, but given the many theoretic areas needed to be integrated into this thesis not all of them can be applied. Of the various research designs that Bryman and Bell (2011) propose, the one most likely to be suitable for this study is a case study. Such design is associated with the in-depth analysis of one particular situation, in this thesis the construction of an investment framework that addresses small private firms.

Although case studies can be performed in many various situations and with different objects of analysis, there seem to be a rather distinctive sub set of case studies that this study can be sorted under. The prerequisites for this thesis matches a category called *representative cases* rather well, which are cases that seek to exemplify and explain a typical situation or form of organization (Bryman and Bell, 2011). The research similarities with the case study design has implications for the performance metrics under which business research is evaluated, as is more thoroughly discussed under section 4.6 below.

As a preparation for the study a review of literature areas associated to direct investments in small firms is conducted. Based on this review, a conceptual model of the investment framework has been constructed. This model acts as a theoretical framework as it on an abstract level ties together the various parts of the framework and outlines its borders in a theoretically satisfying way. The conceptual model also guides the data collection in this thesis by highlighting critical areas of the investment process.

To match the various situations and stages of this thesis a combination of research methods will be applied. In early stages, open interviews will be held with small firm owners and transaction specialists. The open interview is suitable for orientation in a new field and also carries the advantage of generating topics that can be re-checked with other interviewees as well as serves as a source of snowball sampling. For the main data collection that is based on the conceptual model, semi-structured interviews are used. This interview method has the advantage of allowing in-depth inquiries into a limited research area. Depending on the interviewee's competence, the conceptual model will provide the base for the structured interviews that will be performed.

4.1.3 Sample Selection

As the aim of the research conducted in this thesis is to explore how an investment organization targeting small firms should operate rather than provide a statistically correct investigation of such investments, a set of non-probability sampling methods have been deployed. Any of the chosen interviewees have been selected using *purposive sampling, convenience sampling,* or *snowball sampling.*

Purposive Sampling
This sampling method depicts that interviewees are selected based on their ability to contribute with data that are useful in order to fulfill the purpose of this thesis. In this thesis, private equity professionals are thus invited to contribute to the creation of a screening framework that can be used to find attractive investments while the chapter on transaction management rely on interviewees with an expertise within small firm mergers and acquisitions. One possible drawback of this sample method is that the data gathered from selected respondents all weigh in heavily on the findings. This is especially so when the sample size is not very large.

Convenience Sampling
This sampling method plainly implies that interviewees that are easy to access are chosen to partake in the study. This might sound unambitious at first, but given the rather small number of individuals that have the competencies needed to help construct the investment framework and how hard these individuals can be to access, it makes sense to consider this sampling method. The use of convenience sampling is thus rational given the nature of the research, although it must also be made clear that this sample method cannot be used exclusively, as it would render a too weak correlation between the chosen interviewees and the required information to be obtained in the interviews.

Snowball Sampling
Using snowball sampling basically means to follow the references given by previous interviewees. This method is used more extensively in the early part of the study in order to find individuals that can provide an overview of the research field. In the latter part of the study it is still used, albeit it is more and more replaced by purposive sampling. In the initial phase of research, when the studied problem is so far not well defined, snowball sampling is beneficial since it helps uncover new potential interviewees. However, such benefits are expected to decrease as the studied problem becomes increasingly defined and understood.

As the possible interviewees' competencies and ability to contribute to the thesis varies, this set of sampling methods together serves the purpose of this thesis well. Since the access to interviewees is somewhat limited, the quality of the respondents is expected to determine the credibility of the outcome rather than the sheer number of interviewees taking part. On a negative note, non-probability sampling methods have a negative effect on the generalizability of the results obtained, a topic which will be more elaborated in section 4.6 below.

4.1.4 Data Collection

The data collected within the scope of this thesis stem from one of the following instances. First, the literature review provides an extensive theoretical background to the area of study that serves as input to the conceptual model of the investment framework. Second, five open interviews were conducted with small firm owners and transaction experts to provide additional input to the conceptual model by helping to identify critical topics (cf. Appendix I for a list of interviews). Lastly, a total of eleven semi-structured interviews were conducted using an interview guide (cf. Appendix II) based on the conceptual model of the investment framework. The semi-structured interviews had a duration of one to one and a half hours and addressed the areas identified as part of the purpose of this thesis:

Finding Investment Opportunities

In order to research how a screening procedure should be built to find investment opportunities in a sample of small firms two groups of interviewees were addressed. First, private equity professionals were interviewed regarding their expertise in finding investment opportunities. As far as possible, the selected interviewees were well experienced in analyzing smaller investee firms, however also professionals that normally handle bigger transactions were consulted as a consequence of convenience sampling. Secondly, transaction specialists were also addressed since they typically have a far-reaching knowledge on how acquisition opportunities emerge in the market.

Managing Transactions in Small Firms

This area is almost exclusively addressed through interviews with transaction specialists and M&A experts focusing on smaller sized private transactions. Such industry experts have a non-paralleled understanding of the prerequisites and properties of transactions in small firms and their contribution is thus highly important. In addition, small firm owners have contributed with their opinion on transaction management through the initial open interviews.

Value Enhancement in Small Firms

To resolve how value ought to be created in small firms post acquisition private equity professionals were predominantly interviewed. Just as when collecting data on how investment opportunities can be identified, priority was given to respondents that typically work with small firms. Management consultants with experience from managing projects in private equity owned organizations were also addressed in order to collect relevant data for this research area.

Depending on the stage of the research in which the various interviews took place, different rules were applied to decide when to stop interviewing. When performing the initial open interviews, more interviews were booked and performed as long as each interview provided new perspectives on the problem background and brought insights that was useful to create the conceptual model. The semi-structured interviews were more limited by the access to interview respondents and the resources available to engage in travelling to the interviewees' locations. However, during the process of interviewing a satisfying saturation emerged in the answers despite the limited resources allocated.

4.1.5 Data Analysis

The data analysis performed in this study follows the grounded theory approach. Grounded theory is an iterative process in which data collection, analysis and eventual theory are intimately related and continuously refer back to each other. Thus, grounded theory is associated with the creation of theory that emanates from data (Bryman and Bell, 2011). That property is well visible in the construction of the conceptual model from data derived through the literature review and open interviews. The use of grounded theory as a basis for the data analysis can be well motivated considering the complexity of the problem this thesis addresses. According to Bryman and Bell (2011) grounded theory is suitable to use in situation when there is a need to capture complexity and at the same time retain a linkage to practice.

As part of the analysis toolbox triangulation is used to verify and control for patterns in the data. Triangulation refers to verifying an opinion or statement using additional sources, or as is typical in this thesis, additional interview respondents. This practice is applied both in isolated interview groups, such as the private equity professionals, and across different groups to discern similarities and differences between their inherent perspectives.

4.1.6 Performance Metrics in Business Research

Generally, qualitative business research is evaluated through its performance in the metrics reliability and validity (Bryman and Bell, 2011). To increase the level of detail in the evaluation these two metrics are divided into two sub metrics: internal and external. These metrics and this thesis' robustness in each of them are discussed in the following text.

Internal Reliability
This metric concerns whether the individuals in the research team experience the same thing through hearing and visual observations. As the team only consists of two individuals that will conduct the interviews together, the internal reliability of the study should be regarded as fully acceptable.

External Reliability
External reliability parallels to which extent the study can be replicated. This property is generally low in qualitative research and so is the case also in this study. The implication is that it is not likely that an independent research team can repeat the study and reach exactly the same result.

Internal Validity
The performance in this metric is generally thought to be high in qualitative research, which can be expected since the metric measures the match the researchers' observations and the theory that is subsequently developed using the observations. The high internal validity is the chief reason to why a case study is suitable for the kind of study that this thesis constitutes.

External Validity
Just as the internal validity is the key strength of the research presented in this thesis, the external validity that concerns the generalizability of the results make out a weakness. A weak external validity is generally present in all qualitative research, but it might sound more negative then what it is. From a practical perspective, the results obtained in this thesis do not have to show a high external validity to fulfill the purpose of the thesis.

4.2 Research Methodology in Part II

This section describes the methods behind deploying the investment framework to a set of firms in Sweden. Rather than referring to particular research methods within social sciences, this section will be more pragmatically oriented focusing on explaining how the investment framework has been used in practice. Pros and cons of the method used will be discussed together with a motivation why it is appropriate given this thesis' purpose.

4.2.1 Research strategy

The second part of the thesis' purpose aims to retell the practical usage of the investment framework, as recapitulated below:

… to deploy the investment framework in order to find a few investment alternatives, along with recommendations for the transaction process and priorities for active ownership derived using the framework.

Even though the methodology applied to tackle this task might be of less academic interest, experiences derived from deploying the investment framework in practice provides insights that enables a comprehensive discussion of the final results. The overall research strategy is defined by the investment framework as presented in part I of the thesis. The following text thus communicates a structure for how the investment framework can be implemented.

Deploying the investment framework presented in this thesis requires two distinct research designs, one for the screening process and one for the investment case. These two will be elaborated upon separately in the following text.

4.2.2 Method: Screening for Attractive Investments

The screening process aims through quantitative and qualitative assessment screen among a pool of firms to find attractive investment opportunities that can subsequently be evaluated more closely as investment cases. How to design such a screening processes has been discussed in part one and will be further discussed in chapter ten in this thesis. In this section the screening process used in this thesis will be discussed from a methodology perspective to discern its strengths and weaknesses.

The process of screening for investment opportunities includes the following steps:

- Designing the screening process
- Defining exact measures to use for each quantitative variable found in part one
- Defining the boundaries for each measure
- Decide the relative importance of each quantitative variable defined in part one
- Decide how to measure the qualitative variables

The sample used for measuring the quantitative variables was found in the database *Retriever*, where figures from firms' financial reports are presented digitally.

The overall design of the screening process includes a quantitative screening followed by a qualitative screening phase. In the quantitative screening the aim is to extract a manageable set of firms that can be evaluated qualitatively. Furthermore, the quantitative screening divides between well-performing firms and bad-performing ones. The qualitative screening is a necessary intermediary step that covers evaluation criteria that are seminal to investigate prior to processing the investment opportunity to the investment case phase and that the quantitative screening cannot embrace. Starting with a quantitative screening based on predefined variables that relate to Privest investment direction a pool of potential buyout candidates is created. These candidates are then evaluated based on the quantitative variables and divided into specific groups based on the industry's and firm's financial characteristics. A point-awarding system is introduced to assign a value to each variable and thereby provide a ranking of firms in each group. The Firms are then extracted from each group with the total points rewarded guiding the prioritization. The next step is the qualitative screening that complements the quantitative one and determines whether the firm proceeds to the investment case stage.

In order to apply the screening process in practice the relevant variables found in part one has to be explicitly defined to measure some observable states. That is, each variable has to be assigned a measure that can be retrieved for all firms in order to make a fair comparison. Furthermore, the measure for each variable has to be chosen in a way that it reflects what it is expected to do. This issue is mainly associated with the quantitative variables, but should not cause any substantial problems, as financial measures are explicit in the sense that there is limited unambiguity to what they actually communicate. Where a quantitative variable is used as a proxy to measure, for instance likelihood of pending generation shift, there is a risk that the actual state of the firm in this particular regard is not fairly reflected in the measure. Controlling for this problem has been done in several regards when applying the screening process. First of all, variables that could potentially face such a risk have been flagged in the screening framework so that precaution is taken when comparing firms. Secondly, some quantitative variables are evaluated in the qualitative screening as well, allowing for a closer investigation of the particular state.

Besides deciding on what exact measure to use for each variable, criteria have to be decided upon that can part good performance from poor performance. Although the screening process constructed in part one provides some general guidelines on this behalf, there are generally no exact rules that can be applied. Examples of questions that demonstrate this issue are *"What are good and poor profitability levels?"* and *"What is a good and poor growth?"*. Hence, deciding what boundaries that will be used for each variable needed a qualitative assessment and an iterative process of trials based on different values. In some cases relative measures was used where for example a good growth is discerned based on how well the firm performs on this measure relative to its industry peers.

When applying a set of quantitative variables that are assigned points based on the firm's performance, a challenge arises in the relative importance of each variable. One way to deal with this issue is to make all variables of equal importance. In the screening process designed this non-discriminating approach was chosen with a slight modification. From the findings in part one, it made sense to skew the relative importance towards the firm-specific variables and thereby give less importance to the industry-specific ones.

The qualitative variables were introduced to reveal some critical aspects of the investment candidates; the first one focuses on whether the firm is significantly dependent on key persons focuses and the second one on if the owners have an exit in sight. The first variable is assessed by gathering information on the firm through Internet searches and visiting the firm’s webpage. Ideally, indications that a firm’s owner dependency is manageable can be derived from the existence of an organizational chart or similar representation that communicates that responsibilities are delegated throughout the organization. However, such information can only be regarded as indications and must be followed up through interviews. The other variable is evaluated through a phone interview.

Finding attractive investment opportunities can be done in a variety of ways. A screening framework is a systematic way to handle a large amount of firms and when in place, relatively fast evaluate and compare important characteristics of a firm. This ability that the screening process possess is also its main drawback, as it is impossible to internalize all characteristics relevant for a complete investment evaluation. Hence, there is a risk that some attractive investment candidates are not processed further and that some unattractive investment candidates actually make it to the next stage.

At the opposite end of ways to find attractive investment opportunities one can start by identifying firms that are for sale, e.g. through a M&A advisory, and evaluate each firm in much more detail. The main advantage here is that the owners have already planned for an exit and started to prepare the firm for a transaction. In the screening process used in this thesis the willingness to sell a firm is revealed through the qualitative screening, which occurs after the firm is identified as attractive. On the other side, the benefit of the screening process in this regard is exclusivity and thereby mitigation of potential competition that could increase the price of the firm during negotiations.

Despite that the screening process used in this thesis has weaknesses it is impossible to account for all possible aspects related to investment evaluation. The screening framework constructed is useful with regard to the purpose of this thesis, to identify attractive investment opportunities in the Gothenburg region. Being a powerful tool for evaluating and comparing different firms with their peers, the screening framework’s applicability stretches beyond this particular study.

4.2.3 Method: The Investment Cases

The investment cases aim to make a deeper evaluation of the firms found as attractive in the screening framework. Such an evaluation covers areas that complement the screening framework and are fundamental to recommend the firm as an attractive investment opportunity. The investment cases evaluate a firm’s situation based on past, current and future prospects of the firm. Hence, the appropriate research method to use is the case study.

Sample selection

Since the investment cases aim to answer very specific questions and detail the owners' view on a potential sale, purposive sampling of the owners is the only viable sample selection method that can be applied in this part of the research. The data required to be collected is specifically related to the firms investigated and their immediate environment. Relevant respondents to include here are the owners of the firms, personnel at other firms that are related to the focal firm such as competitors, distributors and suppliers, as well as other respondents with knowledge of the industry of interest.

Data collection

The investment cases require both primary and secondary data to be gathered. For the former one, interviews are held with individuals mentioned in the most immediate section above. In this process, one deep interview was performed with the owner of each firm subject to the investment cases, and each interview was subsequently also followed up with a phone interview. Secondary data that is collected consists of financial statements, industry reports and relevant information found on web pages.

Data analysis

The data analysis carried out in the investment cases is to a high degree determined by the structure and content of the investment framework. Essentially, the analysis follows a hypothetically driven path (cf. figure 9.1) through the investment framework along which data can be continuously gathered and assessed in accordance with the findings that make up the content of the investment framework.

PART I: Developing a Framework for Investments in Small Privately Owned Firms

With a generic takeoff point in the conceptual model presented in chapter three, the following five chapters present empirical investigations that aim to render details in the investment framework.

Chapter 5 establishes how a large sample of firms can be screened for attractive investment opportunities. Chapter 6 provides guidance in how transactions in small firms ought to be managed. Chapter 7 investigates what value enhancing activities that should be prioritized in small firms. Chapter 8 addresses the integrating role of the investment case. Finally, chapter 9 presents a summary of the empirically enriched investment framework, along with recommendations for how it should be used.

5 Empirical Revision of the Screening Framework

In this section, empirical findings derived from interviews will be presented on how to structure a screening framework and what variables are suitable to include. These findings aim to build on the theoretical foundation presented in section 3.2 and provide additional insights in designing the screening framework. The section is organized as follows. First, the overall structure of the screening framework will be discussed based on the interviews. Then, suitable quantitative variables to include will be presented followed by a discussion on what qualitative variables that are needed to be deployed.

5.1 Empirical Findings

This section presents empirical findings relating to the screening framework in small firms. The presented findings are based on interviews with private equity professionals, M&A specialists and management consultants (cf. Appendix I).

5.1.1 Overall Structure of the Quantitative Screening

The findings from the interviews conducted with private equity firms reveal that the deployment of a structured screening procedure is rather unusual in practice. Two respondents were however able to share experiences of using a screening influenced approach to find buyout targets. The first one, a private equity investment manager, acknowledges that the firm he represents occasionally works proactively to find a buyout target. Commonly, a macroeconomic feature is then set to narrow down suitable industries upon which cold calls to potential targets are conducted. A similar approach is presented by an M&A advisor who performs searches in databases based on product identification numbers. The respondent adds that this is a common practice when the objective of the acquisition is to complement or supplement an already existing business.

The consensus among the respondents is that an evaluation of an investment target has to include a fundamental analysis based on several dimensions. One obvious constituent is the financial analysis, although one private equity professional advises that caution should be taken to not overly rely on the figures. Another professional supports this idea and provides additional insight into the analysis of a firm's performance based on financial figures. He suggests that the assessment of a firm's performance should relate to the average industry performance and to the objectives of the private equity firm. For example, firms that do well in stable markets differ as analysis objects from firms in markets with high expected growth. The former types of firms provide more opportunities for working with managerial issues, which is a field where the private equity firm he represents has strong competence. Finally, one private equity professional stresses that the private equity firm should avoid betting on both the firm and the industry performance. Hence, a firm must be attractive from at least one of those perspectives if the investment opportunity should be rationally pursued.

5.1.2 Quantitative Variables

In the interviews with private equity professionals financial variables were predominantly discussed but also variables that might be quantified, despise not being purely financial. The very first consideration for the private equity firm is to make a brief analysis of whether the target firm is within the scope of the investment firm's direction. The most frequent variables that govern such an initial screening include turnover, firm value, geographic location, and type of industry. For the industry variable, one respondent said that the private equity firm he is representing is not specialized in any industry but targets industries with low risks. A target firm meeting these basic requirements qualifies for a closer evaluation. The next findings will present the discussion on quantitative measures used to evaluate an investment target.

A necessary element to be included in the evaluation of the firm performance, and as pointed out earlier, is the industry in which the firm is competing. According to one private equity professional, defining the industry is not a straightforward task although it is highly important to establish a sense of it. Commonly, the private equity firms evaluate the size of the market and its growth. One private equity investor suggests that the growth can be measured both regarding the revenue and the profit of the industry. While the former one gives an indication of the overall growth of the market the second one suggests whether the overall profits increase. Another measure that can be deployed to assess the attractiveness of an industry is to observe the change in entrants and bankruptcies over a period. According to one private equity investor an interchangeable measure that also indicates whether an industry is over or under established is the change in profit margin over time. Usually, this calculation is based on earnings before interest, taxes, depreciation, and amortization (EBITDA) since it is a good proxy for the firms' cash flow. A compounded annual growth rate (CAGR) is recommended to use when attempting to discern trends. Finally, the private equity firm respondents acknowledge that a time period of the last five years is enough to use when performing the calculations. Different approaches are suggested to choose attractive industries to look for firms in. One private equity investor suggests that comparing the different industries and extracting the best performing ones might be considered, or alternatively exclude the ones with negative growth. Another industry professional states that the private equity firm he represents generally set a financial goal in terms of revenue or EBITDA growth. If the industry is not in line with these targets, he argues that there is no idea to pursue the investment. Finally, a handful of the investment professionals acknowledge the macroeconomic risks present in certain industries and that has to be accounted for when assessing the attractiveness of an industry. Most common risks are associated with political decisions and technological changes, suggesting that caution should be taken with industries such as education, healthcare and information technology.

The financial measures related to industry attractiveness are in analogy relevant for assessing the particular investment target. As already touched upon, comparing the firm performance to the industry average is a way to identify more or less attractive firms. One management consultant with experience from private equity owned organizations suggests that a firm should be rewarded based on its ability to continuously perform better than its peers based on revenue growth and profitability[1]. Moreover, stability in financials over time should also be premiered. Also, from the interviews it can be inferred that the perception of a firm's performance is contingent upon what type of investments the private equity firm targets. One private equity organization focuses on investing in firms with a proven concept but that lacks knowledge or capital to scale the business. Hence, the organization targets firm with a positive cash flow but not necessarily a high profitability. Another private equity firm investor, with a greater focus on mature businesses, supports this idea by stating that the target firm has to demonstrate opportunities for improvements. The profitability is suggested to be correlated to the business risk; the larger the profitability the lower the risk for business failure. For example, a small business with low profit margins and exposed to currency effects might not survive for long if the currency adversely affects the business' financials for a long time period.

The financial solidity of the firm might be of interest to assess according to the respondents, as it reflects both the riskiness of a firm from a financial perspective and the opportunity to finance future projects with new debt. Several investment professionals suggest that a financial solidity of 25 % is used as a minimum level to avoid the riskiest of investments. In addition, one private equity investor suggests that the financial solidity of a firm can be compared to the industry average in order to further prioritize firms according to their attractiveness. One investor complements the previous finding by stating that this measure might as well reflect the business itself. He suggests that firms with high financial solidity are typically conservative-minded, stable and associated with low risk. A final topic discussed with the respondents regards the assessment of a business' dependency on the owner or other key persons. A plausible way of revealing this risk is to assess the number of employees, board members and whether the firm itself owns a subsidiary. The investor argues that the professionalism of the firm increases as the board has two or more members and hence the dependency on key persons becomes less critical. In the same sense, owning a subsidiary might also indicate that a firm has taken a step towards a professionalized organizational structure.

5.1.3 Qualitative Variables

Although it is suggested that a firm's dependency can be studied quantitatively, other findings reveal that the issue might be somewhat more cumbersome and needs an extensive qualitative assessment. M&A advisors particularly addressing small firms suggest that the dependency cannot be assessed in its entirety prior to the acquisition. However, one advisors points out that a starting point can be to look at the organizational chart and sort out whether the firm has a structure where critical functions are supported by individuals others than the owner.

[1] EBIT over operating capital employed

5.2 Analysis and Implications for Privest

Section 3.2 highlighted several theoretical considerations related to the construction of a screening framework and how such a framework can be applied to evaluate the attractiveness of an investment opportunity. The empirical section 5.1 further contributed to the creation of the screening framework by suggesting applicable variables to use and how these should be implemented. The subsequent text will integrate the theoretical foundation with the empirical findings to flesh out the screening framework in its entirety.

5.2.1 The Overall Structure of the Screening Framework

The overall structure of the screening framework is divided into a quantitative and a qualitative screening phase, as suggested in the theoretical framework. While the quantitative part will include comparable metrics of the performance of and risk with an investment target, the qualitative part of the screening phase will deal with issues necessary to assess before constructing an investment case. Prior to these two screening phases predefined variables based on Privest's overall objectives will be defined and deployed, as suggested by the practice of private equity firms. The variable structure presented in the figure below is influenced by the theoretical and empirical findings and represents the overall form of the screening framework.

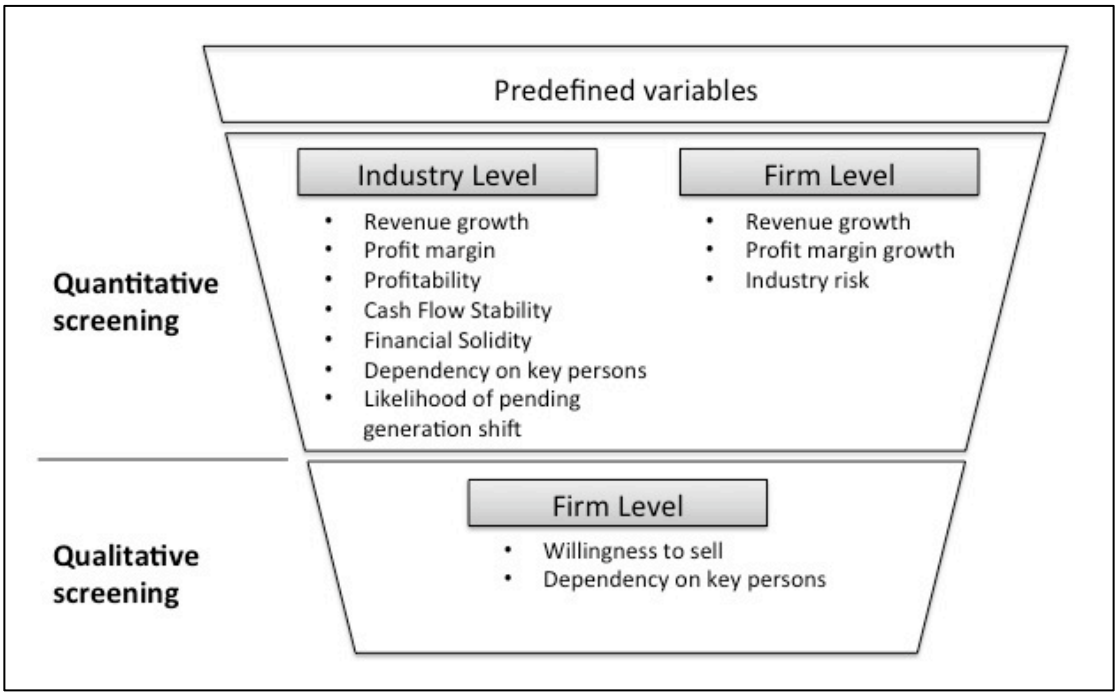

Figure 5.1: Overview of the screening variables.

As can be discerned in the figure, the bulk of the variables are directed to analyze the financial performance of an investment target and its industry. The quantitative variables included are not intended to provide a basis for an exhaustive financial analysis of an investment target, but rather to allow for comparing firms on critical parameters so that investment opportunities can be prioritized. Moreover, as the previous findings suggest, a fundamental analysis is often required to assess the overall opportunity and hence a decision to invest cannot solely rely on financial data. However, the practical orientation of this thesis requires an initial screening to be made.

5.2.2 Quantitative Screening

After mapping the overall framework structure, the next step is to come up with a layout for conducting the quantitative screening. One requirement on the screening framework stated in the theoretical part of this thesis was that it has to allow for differentiation between investment opportunities based on the buyout approach. The empirical findings suggest that there is no particular best-case investment; rather a given investment opportunity is more or less attractive given the preferences of the investment firm. Since this thesis is not bounded by any specific direction regarding the buyout approach, the quantitative screening will be designed to account for several types of approaches. The table below illustrates how a division of investment opportunities will be conducted based on each firm's financial and industry characteristics.

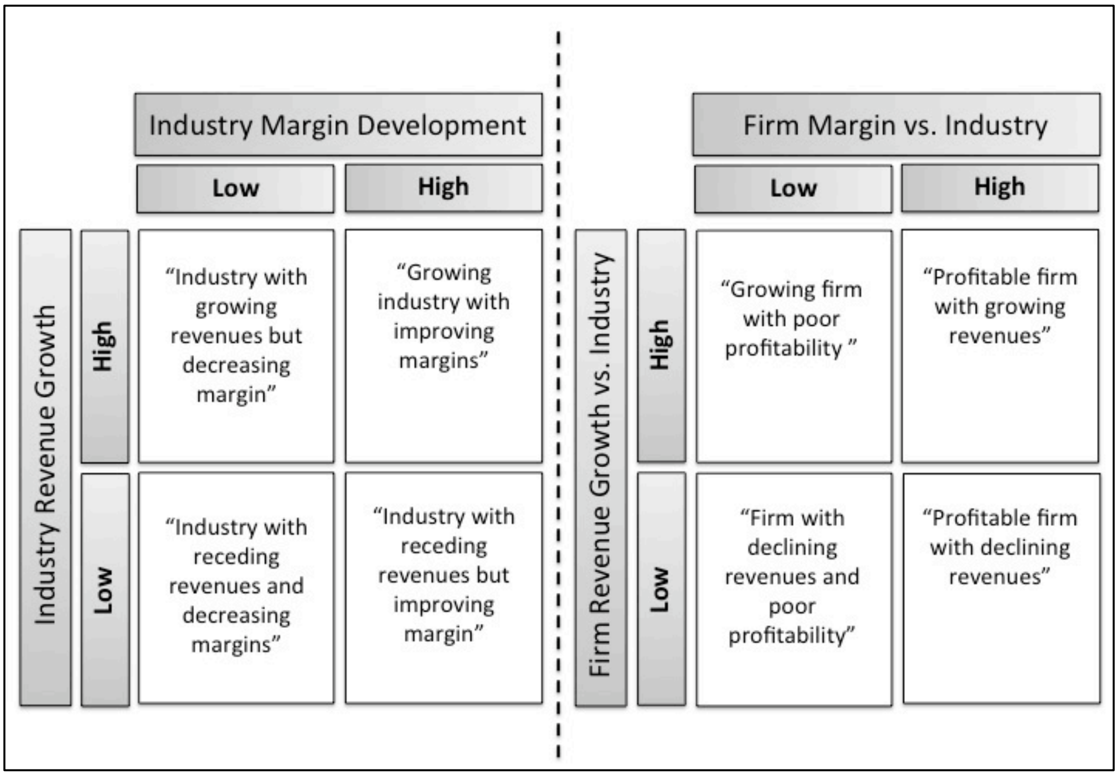

Figure 5.2 Overview of industry and firm cases

As suggested in the conceptual model of the investment framework and visualized in the figure above, two variables at industry and firm level can be used to create sixteen categories. While the value of the industry variables is determined based on a positive or negative CAGR, the firm level variables' value is based on whether the firm performs better or worse compared to the industry. This rationale is suggested by the empirical findings, where a firm's attractiveness is often related to its peers' performance. The variables will be more closely analyzed in the subchapters below. Categorizing the investment targets as proposed enables extraction of attractive firms with disparate sets of characteristics, while it at the same time enables the exclusion of overall unattractive firms.

Variables Relating to Industry Attractiveness

The size and growth of an industry was empirically found to be important factors to estimate when assessing an investment target. These measures are directly linked to the underlying market's demand for the industry's products and services. In the quantitative screening framework, the industry growth will therefore be used as one parameter to reveal the attractiveness of an industry. It is defined as the historical revenue growth of the aggregated firms in a particular industry. For the purpose of differentiating between various industries' growth, a variable needs to be assigned one out of two possible values; growing or declining revenue size. The absolute market size is on the other hand cumbersome to analyze as it is hard to relate to something meaningful and it will thus not be included in the framework.

Furthermore, both the conceptual model and the empirical findings stressed that the industry's profit margin is an element suitable for differentiating between attractive and less attractive industries. The development of the industry's EBITDA margin will therefore be used as the second variable to assess the industry performance, as it provides a hint of the competitive situation in the industry. The variable must be assigned a value corresponding to having a profit margin development that is either positive or non-positive.

Both the industry growth and the margin development variables will be calculated on the historical figures embracing the last five years. In summary, the following industry variables will be used to set up categories that will support the selection of an investment target:

Table 5-1: Variables at industry level.

Variable	Explanation
Revenue Growth	Measures if the industry is declining or growing in size
Margin Development	Measures how the industry's efficiency changes over time and provides insight into changes in the competitive environment

Besides these two variables, a third industry variable will be included in the quantitative screening. This variable relates to the risk embedded in a particular industry due to, as the empirical findings suggest, political uncertainties. The industry risk variable will be used to indicate whether a certain firm is operating in environments where the uncertainties might be expected to radically affect the business itself. Based on the empirical findings, industries within the education and healthcare sectors are associated with such risk and will therefore be marked as risky in the quantitative screening. The final industry variable is hence:

Table 5-2: Risk variables at industry level.

Variable	Explanation
Industry Risk	Reveals risks associated to political uncertainty

With these variables in place, the next set of quantitative data used in the screening framework will be based on firm-specific data.

Variables Relating to Firm Attractiveness

To further distinguish investment targets into specific cases, a division similar to the one above can be conducted at firm level. Combining the industry and the firm division will, as explained above, render firm cases with different characteristics that can be used to reveal various investment approaches. Contrary to the industry division, the firm level division will use variables that relate the performance of a firm to the average of its industry peers. The variables used for the firm level division are firm growth, which is calculated in the same way as for the industry growth, and firm margin expressed as the average EBITDA margin. A firm's EBITDA margin performance is related to whether the EBITDA margin is higher than the firm's industry average. Although these two variables are sufficient to span the firm level cases, further quantitative variables on firm level will be assessed to provide a more exhaustive view of the firm's performance. The table below summarizes the two variables that will be used to construct different cases on firm level. The text immediately following the table will discuss what additional firm variables will be included in the screening.

Table 5-3: Variables at firm level

Variable	Explanation
Revenue Growth vs Industry	Measures revenue growth rate relative to the industry
Margin Level vs Industry	Measures efficiency relative to the industry

There is a consensus between the literature on private equity and the empirical findings that attractive firms have proven stable and nonnegative cash flows. The framework will therefore include a variable that controls for this fact, allowing for firms with a negative cash flow to be suppressed while firms with stable and positive cash flow are premiered. This variable hence consists of two parts. First of all, it should flag firms with negative EBTIDA levels for any of the five latest years. Secondly, it will look for the volatility of each firm's EBITDA during the same period and establish whether the approximated cash flow is somewhat stable over the years. This variable will both be used as a risk variable and a variable that premiers well-performing firms associated with a stable and non-negative cash flow. A second variable that will be used in the screening framework to reveal the attractiveness of a firm is a profitability measure, which is recommended by one respondent to be calculated as EBITDA over operating capital employed if comparison is to be made across industries. Since the profitability only will be assessed relative the industry average, the profitability will therefore be assessed as the more general EBIT over operating capital. This measure will reveal how capital efficient a firm is, and by relating one firm's profitability to the industry average more attractive firms can be found. The third additional variable relates to financial risk and as highlighted in the empirical findings, a common proxy is to look at the financial solidity of a firm. A variable will be constructed that indicates if a firm has a critically low financial solidity. Consulting the empirical findings, the critical level will be set at 25 per cent and the solidity will be calculated as an average over several years.

Table 5-4: Additional quantitative variables evaluating the firm's financial performance

Variable	Explanation
Stable and positive cash flow	Reveals whether the firm has stable and non-negative cash flows
Profitability vs Industry	Discerns how capital efficient the firm is
Financial Risk	Reveals potential risks related to how the firm is financed

Two final variables will be introduced at quantitative level to provide a first indication of the firm's person dependency and the likelihood of a pending generations shift. The first of them tries to approximate the firm's owner or key person dependence. Judging by the literature background and the somewhat indecisive empirical findings relating to the identification of key person dependence, this variable must be conservatively constructed. Therefore, only the most obvious warning signals, i.e. firms that only have a handful of employees, will be marked as risky. This conservatism in the quantitative screening can be motivated by the extensive focus on owner dependence following in the qualitative screening. The second variable is constructed mainly from the insights provided in the conceptual model, section 3.2.2. Family business successions constitute a great source for finding businesses sale opportunities. Therefore, a variable that estimates the likelihood of generation shift will be applied, based on the age of persons in leading positions in the firm. Although included as a quantitative screening variable, revealing whether a business is for sale or not will be treated more closely in the qualitative screening section below. The figure below summarizes the last two quantitative variables.

Table 5-5: Quantitative variables for initial indication of owner dependency and firm sale likelihood

Variable	Explanation
Owner Dependence	Reveals the most obvious risk of high person dependence
Generation Shift Likelihood	Indicates whether there is a pending generation shift in the firm

Altogether, ten variables related to both industry and firm performance will be included in the quantitative screening framework. Before discussing the qualitative part of the screening procedure, the final layout of the quantitative screening will be presented together with a discussion on practical considerations.

The Layout of the Quantitative Screening

Having presented the overall structure of the quantitative screening and the variables that will be included, the next step is to describe how all aspects will be merged together so that a set of attractive investment objects can be identified and processed qualitatively. The figure below illustrates the structure of the quantitative screening framework.

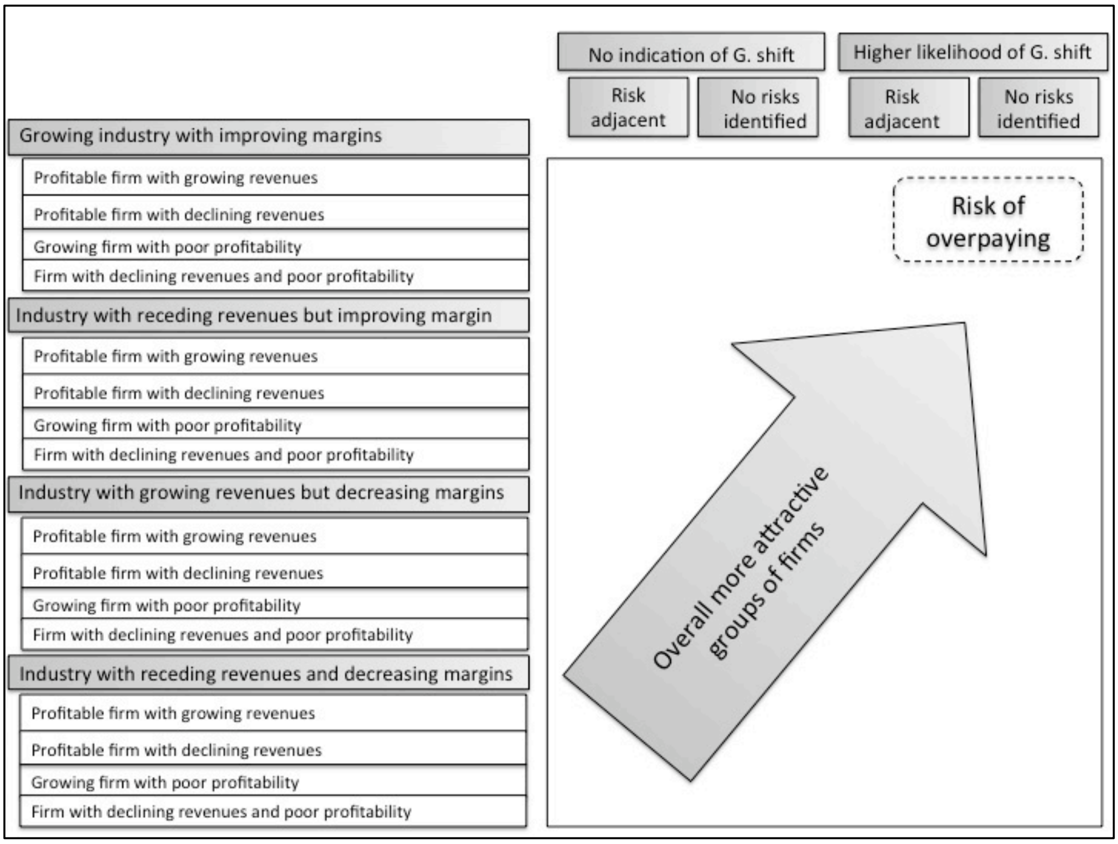

Figure 5.3: Layout of the quantitative screening.

As earlier described, two industry variables and two firm variables related to growth and profit will be used to group firms into different categories. First of all this approach is in line with the first requirement derived in section 3.2.1, as it includes both industry and firm performance considerations. Secondly, the approach meets the second requirement of the desired quantitative screening procedure presented in section 3.2.1, by allowing the attractiveness of the firm to be partly determined by the purpose of the investment. Moreover, six other variables will be integrated in the quantitative screening framework to further distinguish between attractive and less attractive investments. While the variables related to likelihood of generation shift and risk will be used to indicate whether any of these are present, the other variables will be included in a point-awarding system that assigns a numerical value reflecting the firm’s attractiveness in each variable. This setup supports the third requirement presented in section 3.2.1 by allowing for a investment opportunity to be assessed on several variables, instead of being excluded by failing to show attractiveness in one performance measure. A thorough review of the point-awarding system and what values that can be assigned to the variables will be omitted in this chapter, as it would limit the general applicability of the screening framework. Instead, an explicit definition of the assigned values will be given in part two of this thesis, which retells the practical process of finding attractive investment alternatives for Privest.

5.2.3 Qualitative Screening

After the quantitative assessment of potential target firms, two main issues must be dealt with prior to choosing which firms that are suitable to be treated as investment cases. These issues were treated briefly in the quantitative screening section above, but require a closer evaluation that is only possible through a qualitative assessment. The first issue regards the firm's dependency on key persons. The empirical findings revealed that it might be hard to identify this problem, yet some qualitative means can be deployed to indicate whether a firm is too dependent on a single or a few persons. The qualitative study addressing dependency issues will attempt to assess the management and organization structure in the firm as well as how competence and practical skills are shared in the organization to reveal the degree of person dependency. The final issue to be addressed is associated to whether the owner of the business is interested in selling its business and whether the owner finds a buyer like Privest attractive. Although this topic hasn't been raised explicitly in neither the literature or during the interviews, it still has to be an integral part of the qualitative screening to allow for purposeful investment cases to be pursued. The two areas needed to be investigated in the qualitative screening are presented in the table below.

Table 5-6: The two qualitative screening variables

Areas of interest in the qualitative part of the screening framework
The risk of the firm being heavily dependent on the owner or other key persons
The present owner's willingness to sell and appreciation of Privest's offer

The qualitative screening is the last part of the screening framework that aims to identify attractive investment opportunities. However, the two variables presented will not have a significant role in determining attractive features, but are rather required to reveal whether the investment opportunity is pursuable at all.

5.3 Summary

This section has through input from the theoretical section 3.2 and empirical section 5.1 outlined a detailed screening framework that aims to extract a set of attractive investment opportunities from a large sample of firms. Thereby, this section fulfills the purpose of the thesis related to creating a framework that assists in identifying companies suitable to be acquired. The screening framework is not exhaustive in the sense that it captures all aspects of a firm evaluation but by deploying critical variables it serves to prioritize between potential investments. This priority list will constitute the input for the investment framework's investment case analyses. Finally, due to the difficulty of embracing all possibilities in a screening framework of the sort presented in this chapter, practical deployment of the screening framework will occasionally require ad-hoc practices to be used. Part two of this thesis will more thoroughly discuss such issues as they arise.

6 Empirical Enrichment of the Transaction Management Framework

The purpose of this chapter is to continuously build on the theoretic framework for transaction management defined in section 3.3. Consequently, the analysis presented in this chapter constitutes a guide to how transactions in small firms should be managed.

6.1 Empirical Findings

This section presents empirical findings relating to transaction management in small firms. The presented findings are based on interviews with M&A specialists and private equity professionals (cf. Appendix I).

6.1.1 General Findings

Before presenting findings that specifically relates to the areas indicated as interesting in the conceptual framework on transactions in small firms, some notes are needed on the general situation in which such transactions take place. M&A professionals that specifically work with small firms stress that the selling of the firm is most likely the largest affair the seller will undertake during his or her lifetime. Accordingly, M&A specialists work hard to keep a sound relation with potential sellers. One M&A professional states; ”Everything is built on confidence, the seller must rely on the advisor and the buyer when selling his life’s work” (cf. Appendix I).

Given the importance of the seller’s confidence it is relevant to ask what measures that can be taken in order increase a buyer’s trustworthiness in the eyes of the seller. The approaches taken by M&A professionals to do so vary, however some themes reverberate in the answers. First, the experience of operating and selling an own business is widely believed to strengthen the seller’s confidence in his advisor. Second, to show enthusiasm for the seller’s firm is often positively registered by the seller. Following this approach, one M&A professional states that they try to interact with the seller as a team of two to three persons to communicate that they are sincerely interested and prepared to commit resources to the transaction.

Even though there are approaches for a buyer to increase the seller’s confidence, some of the prerequisites for a balanced relation between the parts in a transaction are simply not possible to influence. One M&A advisor refers to the importance of “tryne-faktor” in small firm transactions, a Norwegian expression incorporating the chemistry between the buyer and seller as individual persons. The high influence of emotional aspects in small firm transactions entails that the prerequisites of a good relation sometimes lie beyond the parts’ control.

6.1.2 Small Firms’ Dependency on Key Persons

No matter their area of specialization, all respondents taking part in this study share the view that small firms are troubled with a high dependency on the owner or another key person. The actual dependency lies in the relations present between the owner, customers, suppliers, and the employees. The relations that a business owner has built up with various stakeholders of the firm is crucial for the firm's operations, or as a M&A advisor puts it: "it *is* the firm" (cf. Appendix I). High dependency of key persons can also arise if the knowledge required to run the firm is tacit, i.e. if routines are not documented.

According to the industry professionals consulted in this study, high person dependence is associated with the following circumstances. Most obviously, a firm with only a few employees is more likely to be dependent on the owner or a key person. Moreover, firms operating in competence intensive industries in urban regions are generally believed to be more risky than firms whose operations include physical production. Additionally, one private equity professional suggests that the number of board members in a firm can reveal owner dependence. A firm's evolution from having one to two or more board members can allegedly indicate a higher level of professionalism in the firm. However, this proposition is contradicted by another investment professional stating the small firms generally do not need a board, implying that it leads to inefficient government.

Due to its presence in small firms, investors are compelled to investigate the level of person dependence before an acquisition. A transaction specialist proposes that the firm's organization scheme can be a good starting position for such an analysis. Formally delegated areas of responsibility are a good sign that the responsibility for the firm's daily operations is shared within the organization and not contingent on an individual. Ultimately, the analysis should also aim to assess any key person's relation to the owner, since there is always a risk that key persons leave with the owner as he sells the firm.

To avoid a situation in which key persons depart the firm and leave the new owner without the required know-how to run its operations necessitates a multifaceted approach. Before a transaction, small firms need to be prepared in order to transfer responsibility of important relations and document the routines and practices needed to run the business. A substantial part of the dependency problem can be mitigated in this way according to a private equity professional. Moreover, key persons can be legally bound to counteract person dependence by mechanisms in the deal terms. According to the industry professionals consulted, the resigning seller is typically bound to stay in the firm for one to two years while the new owner establishes control. During this time, part of the payment is postponed and regulated by covenants or commissary notes. Additionally, seller reinvestments are also commonly used in practice to help align the incentive structure during and after the transaction, as stressed particularly by private equity professionals.

6.1.3 Negotiation and Emotional Values

The influence of emotional values on the success of small firm transactions should not be underestimated. First of all, transaction specialists state that it is a typical deal-breaker, meaning that a buyer that does not show any responsiveness to the seller's emotional side will not likely be able to close the deal at all. Furthermore, the emotional values expressed in the negotiation do not only require a sensitive approach from the buyer, it also entails an opportunity. Transaction specialists share a unified view that there is a tendency of small business owners to leave monetary concessions in exchange for the buyer's will to acknowledge the seller's needs in other issues covered in the negotiation.

The extent to which such an exchange is possible varies a lot and is allegedly hard to estimate before the negotiation starts. Generally, the owner's willingness to trade off monetary against emotional value depends on the intensity of the owner's relations. A firm with intense relations within the firm's employees and between the firm and its customers, suppliers and society typically means that emotional values weigh heavier in the seller's perception. The most distinct issue brought up by both M&A professionals and small business owners concern the firm's employees. Other concerns include the general future of the firm, which direction it takes after the acquisition and how brand names will be managed.

Even though the opportunity to achieve a discount at the time of acquisition is real, M&A professionals stress that it is not easy for investors to continuously gain it in negotiations. First of all, one M&A advisor declares that the emotional values must be balanced roughly equally with the industrial character of the deal as well as with the financial aspects. Another very important aspect to factor in is that a sound and unprejudiced relation between the seller and buyer is necessary to realize a reduction of the monetary constituent of the deal.

6.1.4 Financing Options

The financing arrangement of a transaction do not only solve the obvious matter of transferring the payment from buyer to the seller, it also plays a key role in mitigating transaction risk. The variety of possible financing arrangement for a transaction is extensive, however M&A specialists argue that one has to be cautious to introduce advanced financing schemes when discussing potential transactions in small firms. Allegedly, there is a prevailing opinion among small firm owners that financing arrangements including a portion of debt is not desirable or even ill mannered.

From an investor's perspective, debt is used to reach a desired level of return on the invested capital, but it can also be used to improve incentive structures. No matter if debt is included in the financing, investment professionals stress the need of seller reinvestment in any transaction. Reinvestments serves both as part of the total financing and as an important tool to mitigate risks related to the incentive structure.

Even though most industry professionals focus on the financing arrangements role in risk mitigation, it is also important to emphasize that a suitable financing can solve problems on the sell-side too. As one private equity professional points out, natural candidates that are ready to take over small firms sometimes face a financing problem. Although the candidate, typically a key employee, is well prepared to run the business he or she is not able to finance the acquisition on his or her own.

6.1.5 The Role of Advisors

Private equity investors typically use external consultants and experts for any kind of task that need to be performed during the transaction. Financial and legal due diligence is performed in all transactions and sometimes management and the firm's operations are also analyzed using external competence. In one case, an M&A advisor even reports that he was asked by a institutional private equity investor to advice the investor's targets, if the investor should choose to target small firms. Allegedly, even though the advisor would help the seller gain more from the selling, the investor valued having an advisor at the seller's side that helped explain financing arrangements and prepared the firm for the upcoming change of ownership.

Involving an M&A advisor specialized on transactions in small firms on the sell side has many advantages. First of all, they take care of and run the transaction process so that the seller can concentrate on running the business. Second, they have great expertise and experience in reducing a firm's dependence on key personnel prior to an acquisition. Moreover, an M&A expert advising the seller can help explain financing arrangements and other issues that otherwise might deter sellers of small firms from discussing the selling of the firm with an external investor.

To capture the benefits of using external experts, private equity professionals withhold that a certain degree of exclusivity must be present in the deal. Without such exclusivity there is a risk that resources are wasted in a process that might end up without any transaction taking place. According to a private equity investment manager, a viable approach to mitigate such risk is to proactively search for investment activities, e.g. through screening activities.

6.2 Analysis and Implications for Privest

Provided the theoretical prerequisites for transactions in small firms and the empirical findings presented in the text above, a complex picture of transaction management in small firms is emerging. It includes unique opportunities, like the chance to acquire a firm with a negotiated discount, or helping small firm's to close a financing gap to the next generation manager. On the other hand, the unique opportunities are also coupled with unique risks, primarily in the form of small firms' high dependency on key persons. A successful investment in a small firm –from a transaction perspective– therefore requires Privest to seize the opportunities that might be present without exposing itself to an inacceptable level of risk.

To start with the downside of direct investments in small privately owned firms, it is obvious that the investee's dependence on key persons must be dealt with. Albeit not easy, an analysis of the matter suggest that there are several viable approaches Privest can use to reduce the risk associated with owner dependency. First, an advisor assisting the seller before and during the acquisition can significantly help reduce the firm's dependence on key persons and prepare it for the transaction. Second, Privest should always make use of incentive aligning mechanisms in the financing arrangement of the transaction. Lastly, the relation between Privest and the seller must be sincere enough to allow a mutual will to reach a bilateral agreement.

Of the possible opportunities that might be present when investing in smaller firms, two themes arise as attractive from an investment perspective. First, through a well thought out offer and sensible negotiation tactics Privest has the opportunity to transform a seller's emotional values into a physical discount. Such an offer cannot be standardized, but must rather be individually designed in collaboration with the seller to ensure that Privest address the crucial issues and has time to gradually build up trustworthiness. Ultimately, the possibility to gain monetary advantages through meeting the seller’s need to secure emotional values will be contingent on Privest’s relation to the seller.

The second opportunity persists in the ability to fill financing gaps in situations where an employee is willing to become an owner in the firm, yet do not enjoy the economic situation that ordinary bank financing would require. In such a situation, Privest would not only provide the financing of the transaction, but also function as a problem solver for the firm’s owner. The term problem solver should not only be interpreted as descriptive in this case. Privest’s offer should communicate that Privest has the ability to solve financing problems for small firms; an ability that seems to be lacking in the market and thus entail investment opportunities for investors targeting small firms.

As already frequently implied, the prerequisites for both risk mitigation and the attractiveness of investment opportunities from a transaction point of view is contingent on Privest’s relation to the seller. To formally define the properties of an appropriate relation is impossible, yet Privest’s interaction with potential sellers can be designed to foster trust and a sound relation by following some basic principles. First of all, Privest should make sure its organization include people with an entrepreneurial background that have managed and sold their own business. Preferably, the team interacting with the seller should also include persons that are knowledgeable in the business of the firm at hand. Privest can furthermore signal trustworthiness and a will to achieve a bilateral transaction through insisting that the seller hire an advisor, in case the seller so far has not hired one.

Taking all characteristics of transactions in small firms together, two generic investment situations come forward as extra potent for Privest. The first situation corresponds to an ordinary buyout transaction, in which Privest has a chance of realizing a monetary discount by taking responsibility for the emotional values expressed by the seller in the negotiation. Most likely, such a transaction will involve considerable risk of key persons leaving the firm. A financing arrangement that binds the resigning owner or other key persons to the firm for a limited time is thus needed. Such financing arrangement should be designed to increase the seller’s incentives to transfer information and know-how to the firm’s remaining personnel and give the seller incentive to provide realistic estimates for future performance. To further streamline the incentive structure, remaining and possibly new management should be invited to invest along with Privest.

Table 6-1: The most potent investment situations for Privest

Key Issue	Buy-out transaction	Management Buy-Out
Owner dependence	• In a plain buyout transaction the risk of losing key persons increases. • The increased risk needs to be mitigated through financing arrangements.	• A management buyout implies that key persons and competence remain in the firm. • It is critical that Privest maintain good relations with the new management.
Possibility to achieve an arbitrage situation through negotiation	• Without any chances of negotiating a discount, a buyout situation should be avoided since it there is no upside to the risk taken.	• Arbitrage chances increase if Privest acts as a problem solver for the seller by enabling the generation shift.
Financing arrangement	• Debt financing can help align incentives structure • Seller re-investment is critical to ensure reasonable estimates and cooperation post acquisition.	• A MBO elegantly mitigates risks associated with owner dependence • Owner managers must invest along Privest, taking on an amount of debt that is significant in relation to their private economy.
The role of advisors	• The role of advisors increases in relation to the owner dependence of the target firm.	• In all circumstances useful, but not as critically as in a pure buyout transaction.

The second situation corresponds to the situation in which Privest can help a firm close a financial gap when there is an appropriate heir. In such a situation, Privest will become part owner of the firm through a MBO transaction. Considering the risks involved in small firm transactions, this transaction has clear advantages. Not only is the risk associated with person dependence greatly reduced; Privest will also have a better position in negotiating the price since the emotional concerns sellers typically express in negotiations are distinctively addressed.

6.3 Summary

Transactions in small firms are a complex matter and heavily influenced by emotional values. Due to its complex and somewhat irrational nature, the risk present in such transactions is inherently high. However, the risk can be reduced by alignment of the incentive structure and most importantly, by winning the trust of the seller. From a transaction perspective, the most attractive investment situation for Privest is to act as a financing problem solver for a firm in which there is an obvious heir that is restrained by his or her ability to finance the generation shift.

Emanating from the theoretical model of transaction management presented in section 3.2, this chapter has presented empirical findings and an analysis that revise how transactions should be managed in small firms. The aspect of this thesis' purpose that corresponds to the presentation of insights in how transactions in small firms should be managed is thus fulfilled.

7 An Empirical Perspective on Value Enhancement Activities

This chapter aims to add empirical facts to the conceptual model concerning value-enhancing activities explained in section 3.3. The chapter also presents an analysis on how Privest should pursue value generation in investee firms.

7.1 Empirical Findings

In this section, empirical findings concerning value enhancement approaches in investee firms are presented. The presented findings are based on interviews with private equity professionals, M&A specialists and management consultants (cf. Appendix I).

7.1.1 General Findings

As pointed out by all respondents, there is no right way to determine what changes should be implemented in an investee firm to maximize value creation. Successful value creation rather requires a work methodology that generates a multitude of ideas and tools to compare each idea's contribution to value enhancement relative to the required effort to implement it. Furthermore, the findings from the interviews suggest that the planned value enhancement activities are contingent upon the divestment strategy. For the larger private equity firms, these activities have to be chosen with regard to the pre-stated holding period. On the other hand, one private equity investor explains that the firm he represents rather explores the opportunities available for value enhancement, sets goals to be achieved and define necessary activities to be performed, and upon the realization of these goals exit the investment. One critical consideration for small firms is, according to same respondent, that value creation approaches are necessary for a small firm to thrive. The risk of having a passive value enhancement strategy is that the business might gradually fade away as small firms have not secured a critical amount of the market.

Another aspect of value enhancement highlighted by some of the private equity professionals relates to the implementation of the activities. The most common problem in case of an MBO is that the incumbent management is often stuck into old views and strategies, usually making them resistant to proposed changes. According to one private equity investor, this issue can partly be resolved by replacing a person in the management, most commonly the chief executive officer. In small firms however, replacing a person in a management position might sometimes be inappropriate due to the unique knowledge and competence such a person possesses. It is also stressed that no gain is achieved by continuously ignoring the management or key persons in the organization when making critical decisions. Rather, it is suggested that management and key persons should be informed why a certain activity is rational, based on e.g. benchmarks with competitors. A related finding supports this idea by suggesting that the problem is not that management or key persons lacks an understanding of certain initiatives, but rather that their focus is elsewhere such as on the day-to-day operations.

The following text will bring up ideas on value enhancement opportunities inferred from the interviews conducted with industry professionals on private equity investments. While a few recurring themes particularly address value enhancement in small firm investments, others are applicable to a broader set of firms. It should be noted that several industry experts acknowledge that the framework for value creation presented in the theoretical framework is exhaustive in the sense that it covers all possible aspects of value creation. The aim of the text below is to highlight areas of value enhancement with a focus on small business investments to complement the already presented value creation framework.

7.1.2 Capture Financial Effects by Forming a Buyer-Seller Relationship

In the interviews performed with M&A professionals specialized in small businesses, evidence is found that financial arbitrage is frequently realized in transactions where the buyer is able to meet the in individual needs of small business owners. The possibility to achieve the price reduction that results in a financial arbitrage is based on the relationship between the seller and buyer; industry experts verify that a seller must find it trustworthy that the buyer will stand by his obligations in order to leave a discount.

7.1.3 Drive Value by Focusing on Sales

Initiatives focused on enhancing the sales of a business is according to many private equity investors the most potent approach to create value in small firms. One respondent argues that small and midsize firms should have a relative advantage to grow in their industry. It is further suggested that selling is generally not a prioritized activity in small firms, and routines that facilitate efficient sales management are not present. To provide structure for the sales organization in a small business is expected to yield a high effort-adjusted reward; hence it is an issue that private equity firms often target immediately. Other means to increase the sales is to add new distributions channels or alternatively exploit opportunities within existing distribution channels, according to one private equity investor. The respondent explains that they try to sell more of a firm's product range through an already existing channel, especially when the products are complementary.

Inefficient selling can also stem from having a too wide product range, leading to unfocused efforts and misdirected offers. One experience shared by some of the private equity professionals interviewed is that firms are often troubled with an unfocused strategy. In those cases, the product range is often too wide and many of the customer accounts are not profitable. As a consequence, a common value enhancement approach used by private equity investors is to reassess their offering in order to reduce or get rid off unprofitable ones. Instead, a clear business strategy is announced that focuses business growth in profitable areas.

7.1.4 Value Creation Through Cost Reductions

A first topic addressed by the private equity professionals on cost reductions concerns deploying such practices that yield a real cost reduction effect. A *real* effect does in this context correspond to operational improvements that directly improve the profit margin and consequently results in a higher operational cash flow. However, these cost reduction initiatives was presented as general approaches and no specific reference to small firms were made.

Another topic that received greater attention among the respondents concerning the opportunities it provides in small firms is working capital management. Commonly, owners of small businesses have a conservative view on working capital requirements and due to their high risk aversion they often keep the level of working capital unnecessary high. As one private equity investment manager puts it, owners often neglect the costs associated with these high levels of capital. The rational for reducing the working capital is that the capital released can either be used to fund expansion initiatives or used as dividends to the investors. Furthermore, a reduced working capital implies less cost of capital as less amount of equity and loans are required.

Several means of reducing the working capital is suggested by the respondents. The most common procedure is to start by evaluating the inventory requirements to reveal how excess inventory might be reduced. One private equity investment manager proposes working with operational opportunities in logistics. He adds that small businesses often have ineffective procurement routines that can be overcome by introducing supply management systems, although another private equity investor discourage investments in large enterprise resource planning systems due to the risks associated with such undertakings. Another practice deployed by private equity firms is to oversee the terms with suppliers and customers; a reduction of working capital might be achieved by extending the maturity date of accounts payable or reducing the maturity period of accounts receivable. A final mechanism suggested by a private equity investor is to force the portfolio firms to work with reducing the working capital by keeping tight liquidity limits. This practice requires the portfolio firm to find ways to release working capital tied in e.g. inventory and operational accounts.

7.1.5 Value Creation by Introducing a New Agenda

Another topic discussed regarding strategic change in small businesses has to do with the current owners vision, knowledge or will to take the business to the next level. One private equity investor explains that private equity firms might find attractive opportunities in such firms, as many of them are entrepreneurial driven but with a fundamental value that can be further built on. Additionally, current owners are often stuck into old thinking and ways of doing business, which might open up for value creation opportunities. Among the mentioned actions that can introduce a strategic change in this regard is business add-ons, license production, and engagement in cooperative networks.

Moreover, private equity organizations usually apply a different view regarding the firm’s assets. By closely evaluating which assets the firm should own and which to lease or rent, opportunities to free capital can be exploited. Common assets that are subject to such an evaluation include machines and real estate.

7.2 Analysis and Implications for Privest

This section aims to analyze the various value enhancing approaches that are available for Privest.

7.2.1 General Considerations Regarding Value Creation

As inferred in the empirical findings, value enhancement is an integral part of any private equity investment. Private equity firms are increasingly forced to add value to the investee firm in order to realize attractive returns upon divestment. Although Privest is not primarily concerned with gaining profits through an exit, value enhancement initiatives should be considered for other reasons. This statement finds support in the empirical findings suggesting that small businesses risk perishing if no actions to develop the business are taken. Hence, it is suggested that a value enhancement strategy for Privest should be influenced by the private equity firms' practice that implies setting value creation goals and when reaching these goals, decide whether to exit the investment or set up new goals to follow.

Value creation approaches have various impact on the organization in which it takes place. The empirical findings highlighted that precaution is needed when suggesting initiatives that might stand in contrast to, or might be unfamiliar to the management team's believes, especially when considering an MBO. It was further suggested that support and education might be needed for managers to increase their knowledge and understanding of certain management practices, which all might be connected to the primary value drivers. Hence, mentoring seems to be a required initiative in order to stimulate value creation in small businesses. Privest must therefore ensure that the required supportive competencies are available before pursuing any projects aiming to enhance value.

7.2.2 Value Creation Approaches Suitable for Small Firms

Although the generic model on value creating approaches presented in section 3.3 has been verified as exhaustive by interview respondents, it is interesting to note that some areas are pointed out as extra potent considering investment in small firms. The activities emphasized to be particularly relevant for small firms are first and foremost associated with growth generation, improved strategic distinctiveness and asset utilization. Additionally, value-enhancing approaches related to financial arbitrage, business rejuvenation and mentoring was also found to leave a contribution to value creation, either at the time of transaction or indirect, i.e. through its support of the direct value levers. The most potent approaches to value creation in small businesses and their connection to the conceptual model are presented in figure 7.1.

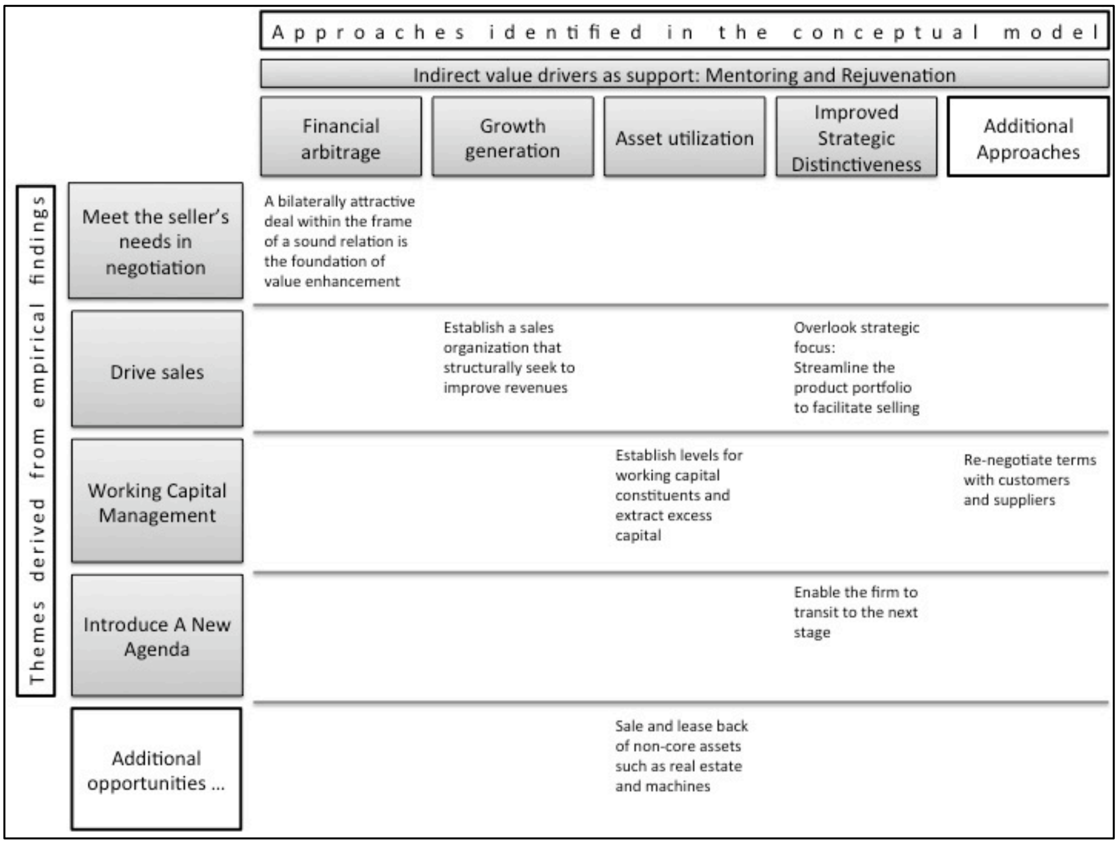

Figure 7.1: The most potent approaches to enhance value in small firms

Several means to increase the sales with a firm's current resources is presented in the empirical findings. A first step towards more efficient selling is to acknowledge the need for and subsequently establish an organized sales function in the firm. This initiative sets the foundation for working structurally to find new ways to distribute the firm's offer through existing or new channels. Additionally, growth generation through these improvements might be amplified by strategic changes particularly addressing what product or services to offer, since the empirical findings suggest that a too wide product range might increase the complexity of sales, resulting in inefficiencies. There is also a great rationale for Privest in pursuing sales since small firms need to work actively to maintain their market share and avoid perishing in the elongation.

The strategic changes to consider when acquiring a small firm are generally not associated with drastic redirections, but rather focused on streamlining the business. This is commonly achieved through reducing the product range or by divesting non-core elements of the business such as real estate. Identifying the most profitable offers in a firm and focusing all efforts to grow and gain market shares within these segments should be a prioritized strategic action. Strategic change might also come as a consequence of ownership change, where the new owners challenge the old structures with new ideas and perspectives. The empirical findings suggest that small firms often lack the ability to transit to the next level. One plausible explanation to that is the risk aversion present in older business owner's, who are satisfied with the returns of the current business situation. Consequently, opportunities should exist to scale an acquired small firm, as it seems that such opportunities are not bounded by the nature of the business but rather by the mindset of current owners.

Further on, the empirical findings suggested that several value creation opportunities might arise as a consequence of small firm's suboptimal asset utilization. Here, activities to enhance value should be primarily focused on working capital but also on deciding whether to own the business' buildings and equipment. Vast possibilities to reduce the working capital are expected to exist in small businesses where operational improvements and negotiations with customers and suppliers are to be prioritized. Through improved asset utilization capital can be released and used more profitably than tying it up in e.g. inventory or real estate. Working continuously with utilizing the firm's assets optimally might institutionalize a stance in the firm that stimulates search for cash flow generating activities while eliminating or reducing wasteful ones. However, if working capital levels are reduced to critically low levels the firm's ability to meet its obligations toward stakeholders might be compromised. The improvements in asset utilization are thus ruled by a tradeoff with the firm's operational abilities.

The theoretic indication that a financial arbitrage might be realized at the time of acquisition is supported by the empirical investigation and thus constitutes a real opportunity for Privest. It is observed that the seller in exchange of meeting his or her non-monetary needs gives a discount on the price. This in turn has a direct impact on the investment's IRR. To realize an arbitrage would be a kick-start to the value enhancement process and an important contribution to the total value that Privest might realize in an investment. Hence it can be concluded that financial arbitrage is an important part of the value creation in small firm investments and that the findings discussed in chapter 6 are crucial to understand in order to achieve it.

7.3 Summary

Although the theoretically viable approaches to enhance value in investee firms are seemingly endless, the analysis presented in this chapter show that certain approaches are extra potent in small firms. Consequently, Privest should start the assessment of various value enhancing activities by considering the chances to realize a financial arbitrage, how sales can be improved and if there is excess capital that can be extracted from the firm's working capital. For the longer term, the investee firm's value can advantageously be enhanced through a more distinct strategic focus and by enabling the firm to take the next step in its evolution, which might have been abstained by the former owner.

This chapter has added empirical observations to the conceptual model presented in section 3.3, enabling a comprehensive analysis of what value enhancing approaches that should be prioritized in small firms. The part of this thesis' purpose that is associated with the subsequent development of investee firms is thus fulfilled.

8 Empirical Revision of the Investment Case

This chapter empirically investigates how investment professionals use investment cases or similar documentation in practice. These findings add practical utility to the investment case framework presented in section 3.4.

8.1 Empirical Findings

Before going into how industry professionals use investment documentation in practice, the sufficiency of the investment case's content (cf. section 3.4) must be assessed. Allegedly, private equity professionals make use of documentation similar to the investment case, declaring that the content proposed in section 3.4 is both relevant and exhaustive. This finding and all other empirical findings presented in this section are derived from interviews with private equity professionals (cf. Appendix I).

Having acknowledged the overall structure of the investment case, private equity professionals waive that the process in which such documentation emanates from starts with the definition of a vision, or an overall goal with the investment. Starting at a strategic level, a key task is then to brake down the overall investment goal into – ultimately– actions that can be implemented in the firm post acquisition. Even though this process is quite straightforward to outline, industry professionals stress that it is a common trap to linger at a too theoretical level when proposing actionable tasks. To reinforce his opinion, one investment manager explicitly points out that one should be very careful not to underestimate the difficulty of achieving a clear and implementable vision during the acquisition; since it takes a while to get to know the investee firm, investors need to keep their plans dynamic.

After establishing a set of actions that contribute to the fulfillment of the investment goal, the actions are evaluated using a financial model. Such an evaluation serves two purposes. The first is to test the robustness of the assumptions needed for the actions to jointly fulfill the overall investment goal within a reasonable time frame. Secondly, the downside of the investment can also be assessed by analyzing how bad the implementation can turn out before the IRR becomes critically low.

8.2 Analysis and Implications for Privest

By supporting the theoretically derived investment case framework, the investment managers acknowledge its practical relevance. That is, the approach to assess the overall investment opportunity presented in section 3.4 is applicable and will therefore constitute the foundation for the presentation of investment cases. To establish an exhaustive analysis is yet only a good start. It is crucial that the investment cases lift forward the risks and most potent opportunities in order to enable a contrasting view of the different investment opportunities. Although an investment case should aim to present an overall assessment, it will be a challenge to simultaneously lift forward the key issues in an investment opportunity.

Another key challenge will be to define an overall goal with the investment and subsequently derive actions that steer the investee firm in that direction. This difficulty predominantly persists in the fact that accurate information on the investee firm will probably not be accessible when the investment case is elaborated. However, with the aid of the investment framework presented, an initial investment case can be created. Such a document can then serve as a basis for discussion with the firm's owner. According to the findings presented concerning transaction management in small firms, a transparent discussion with the seller help build the relation needed to access information and update the investment case.

The financial model that private equity professionals often include in their analysis should be an integral part of the investment case. Based on the theory explained in section 3.3.2, such a model can provide multiple benefits in to the investment case. First, various visions and actions can be tested and compared in a way that quantifies Privest's decision grounding. A second utility of a financial model is, as expressed by private equity professionals, that Privest's risk taking can be quantified in a similar way. Such analysis allows not only a comparison of the downside across various investment opportunities; it can be utilized to identify critical scenarios in which Privest must react to respond to a negative development.

8.3 Summary

This chapter has been concerned with presenting private equity firms' procedures to analyze and present the overall opportunity of an investment. These findings both support and add practical utility to the investment framework presented in chapter three. Thereby, this chapter constitutes the last puzzle piece in the construction of the investment framework and consequently, all aspects associated with the first part of thesis' purpose are satisfyingly covered.

9 Conclusions Upon Completing Part I

The purpose of this chapter is to provide a summary of the investment framework and explain how is it supposed to be used.

9.1 The Revised Investment Framework

The investment framework developed in part I of this thesis was created in three distinct steps. First, a literature review was conducted in order to provide orientation and to highlight important topics that an investment framework addressing small firms must consider. Then, a conceptual model of the investment framework was created that ties the framework together in a theoretically robust, albeit somewhat abstract structure. Finally, an empirical investigation addressing the four main constituents of the investment framework was performed, enabling an exhaustive analysis from which implications for Privest can be extracted. All in all, the resulting investment framework provides valuable guidance to investors with respect to how investment opportunities in small firms can be identified, how transactions in small firms should be managed and lastly, what value enhancing activities that should be prioritized in small firms.

Applying the screening framework presented in chapter 5 identifies potentially attractive investments. This screening procedure allows for a large sample of firms to be assessed quantitatively, simultaneously as the overall assessment stressed by both theory and industry professionals is maintained. The screening framework also provides guidance through the subsequent qualitative screening phase, in which the key risk present in small firms –owner dependency- is preliminary evaluated. In short, the screening framework brings order and structure to the fairly disperse and noisy input sample, leaving a few candidates that can be more deeply analyzed in a so-called investment case.

Although finding attractive firms is a promising start for an investor seeking to acquire a small firm, special considerations must be given to how the transaction should be managed. This topic is thoroughly analyzed in chapter 6, in which it is concluded that the success of transactions in small firms is contingent on the relation between buyer and seller. The analysis also concludes that the most attractive scenario for Privest –from a transaction perspective- is to partake in an MBO transaction, in which Privest help a firm close a financing gap between the present owner and to-be owner manager. To conclude, a successful investment is dependent on a successful transaction and the framework presented in chapter 6 therefore provides a valuable analysis tool that should be used in the development of investment cases.

Once an attractive firm is found and successfully acquired, the analysis presented in chapter 7 concludes that an agenda aiming to develop the investee is required to ensure the long-term success of the investment. The most promising approaches to enhance value in small firms are to increase sales, optimize the utilization of assets and apply a distinct strategic focus in the target firm. However, the value enhancement potential in a firm is also interdependent on the possibility of negotiating a discount resulting in an arbitrage situation at the time of acquisition.

Given these three pillars of the investment framework, the investment case described in chapter 8 plays the role of integrating them into an operationally potent document. To recall, the second-to-none function of the investment case is to provide a clear overall assessment of the investment opportunity given the information that is at hand. In the arrival at such representation of a complex investment opportunity lies the very essence of the investment framework and consequently, the first part of this thesis's purpose is thus fulfilled.

9.2 How to Use the Framework

For the practical purpose that is addressed in part II of this thesis, the investment framework will be deployed in its entirety. The logical order of actions then follows the summary of the investments described in section 9.1 above. However, even though interdependencies exist between the different parts of the investment framework, each part can be independently consulted. Financial and industrial investors alike can thus utilize the investment framework according to their specific needs, irrespective of which phase of investments they might be in. To enable effective implementation of the investment framework, the investment framework can be thought of as a guide that assist investors in applying a hypothesis driven approach to investments in small firms. The hypothesis stated for each firm that is assessed is "Firm X is an attractive investment opportunity", which can be broken down into sub conditions that the various parts of the investment framework help to address (see figure 9.1 below).

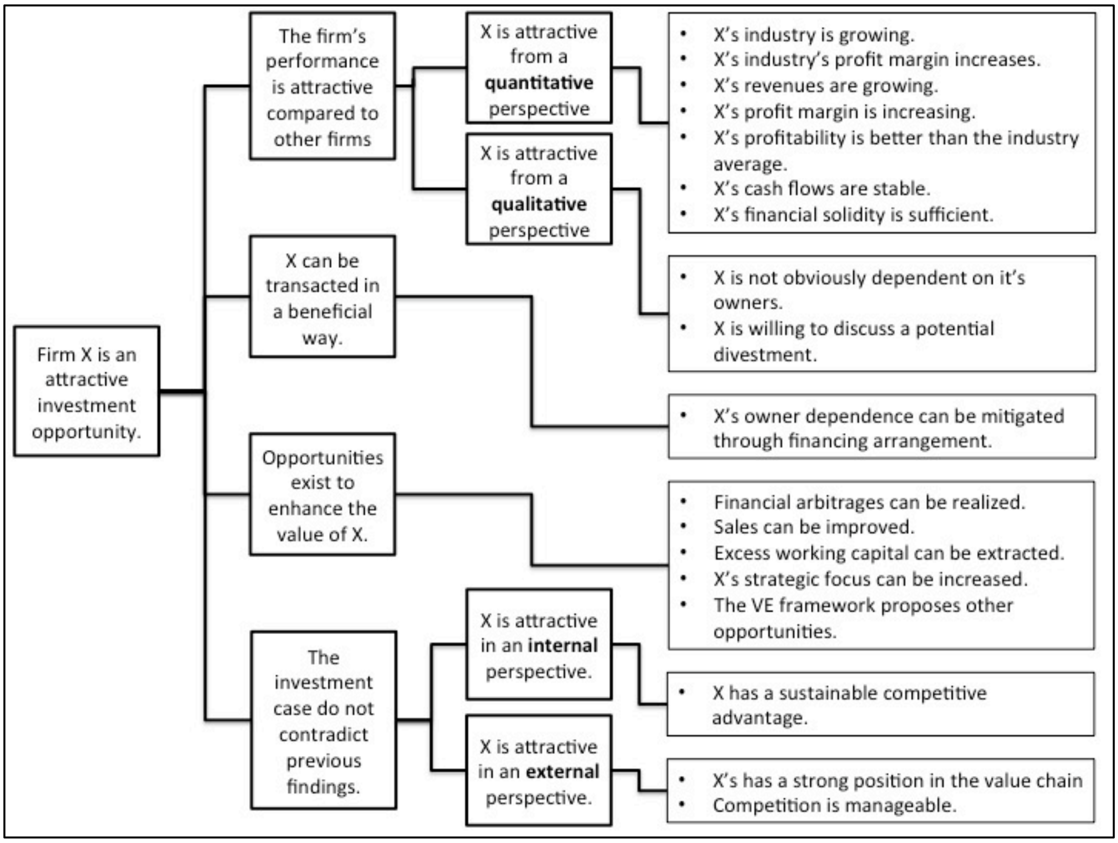

Figure 9.1: The practical implementation of the investment framework follows a hypothesis driven approach.

Depending on the nature of the topics covered in the different parts of the investment framework, the level of abstraction in descriptions and explanations varies. In some areas, like the quantitative screening framework, the investment framework provides substantial guidance by defining suitable variables. In other parts, especially in the framework for transaction management, the conclusions are harder to grasp in a practically oriented setting. In the end, it is up to the investment framework's users to decide how much of their actions that should be determined by the framework and to what extent their individual competencies and previous experiences will be allowed to influence decisions. All in all, the primary value of using the investment framework lies not in the practical aid it provides, but in the mental guidance it provides to investors seeking to invest directly in small firms.

This chapter, in which the empirically revised investment framework is summarized, marks the completion of part I of this thesis. The first part of this thesis' purpose is therefore fulfilled and the remaining part of the thesis will accordingly address the practical deployment of the investment framework (see part II).

PART II: Deploying the Framework to Find and Assess Investment Opportunities

This part of the thesis addresses the second part of this thesis' purpose: to practically implement the framework in order to find and assess investment opportunities. This process is, naturally, supported by the findings presented in part I of the thesis.

Chapter 10 describes how the investment framework was implemented. Then, chapter 11 provides a brief summary of the implementation process and discusses critical issues concerning the practical use of the investment framework.

10 Implementing the Investment Framework

This chapter describes the practical work of deploying the investment framework in order to find attractive investment opportunities in the Gothenburg area.

10.1 Screening for Investments in the Gothenburg Area

This section presents how the screening framework was practically implemented to find attractive investment opportunities in the Gothenburg area.

10.1.1 Progress of the Quantitative Screening

This section describes how the quantitative screening framework was implemented with the aim to select candidates that could be assessed in the qualitative screening. The practical work to do so required two things. First, the study needs a data source that can deliver all the variables needed in the screening framework. Second, a computer program is needed to store the data and enable data manipulation. In this study, these two requirements were met by using the database Retriever[1] and Microsoft Excel for the data storage and manipulations.

Preparing the Firm Sample for the Quantitative Screening

Before initiating the quantitative screening phase, a number of steps were taken to shape the sample of firms so that they match the variables that are implicitly defined by the Privest concept (see section 1.3). First of all, a gross sample was extracted from the Retriever database using the available preferences in Retreiver's user interface. The attributes of the firms included in the gross sample are presented in table 10-1 below.

[1] www.retriever.se

Table 10-1: The attributes of the gross sample of firms

Attribute	Value
Company form	Aktiebolag
Revenue	0 – MSEK 499
Number of employees	1 - 99
Geographical location	Västra götalands län and Hallands län
Excluded industries	Hotell & Restauranger, Hår & Skönhetsvård, Offentlig förvaltning & Samhälle, Detaljhandel, Reparation & Installation, Ambassader & Internationella Organisationer, Bransch-, arbetsgivar- och yrkesorganisationer
# Number of firms found:	**34 176**

After the gross sample was downloaded a first quality check of the data was performed, in which firms that entirely missed data was deleted. Plausibly, the existence of such firm's in the sample is due to their late registration[1]. Checking the gross sample for firms that entirely lacked data led to the deletion of 2 181 firms, leaving 31 991 in the sample.

Having established a more satisfying data quality in the sample by deleting firms for which all data but the firm name was missing, one more preparatory step is needed before the predefined variables presented in section 1.3 can be applied. This step is to categorize all firms according to their ownership structure and make sure all firms are represented by their main holding company. This step is rather tricky to implement practically, since all revenue and profit data must also be aggregated under each main holding firm without being double accounted. In short, the approach taken to overcome this obstacle was to divide the firms into three separate groups. *Simple firms* are not part of any group and consequently no data alterations are needed to show a true representation of their financials. *Main parent companies* are at the top of an own company group. Therefore, all their subsidiaries data need to be added to the main holding company of the group, whereupon the daughter companies are deleted from the sample. The last group, *other main parent companies,* consist of firms that are part of a company group whose main holding company is either too large to be included in the gross sample or lies outside the geographical scope. Table 10-2 summarizes the results of this analysis.

[1] Firms registrated 2011 or 2012 are registred in the database but has not reported any data yet

Table 10-2: Three different types of ownership structures

Type of firm	Number of firms
Simple firms	23 055
Main parent companies	2 699
Other main parent companies	5 431
# Number of remaining firms	**31 185**

The next step applied to shape the sample of firms was to delete firms whose revenue span do not match the investment sizes sought by Privest. Accordingly, firms with a three-year average revenue smaller than MSEK 10 and larger than MSEK 100 were deleted from the sample. This led to the deletion of 24 002 that were too small and 821 firms that were too large. Also, the analysis revealed 46 firms that lacked revenue data for the last years. Since these firms assumingly have seized their operations or have deregistered they were deleted from the sample. The above-mentioned operations are summarized in table 10-3 below.

Table 10-3: the predefined revenue span

Revenue size	Number of firms
Less than MSEK 10	24 002
More than MSEK 100	821
# Number of remaining firms	**6 318**

The next sequence in preparing the sample for screening was to narrow down the geographical scope. The geographical scope of the sample was confined to an area that can be reached within one hour of traveling by car from Gothenburg. This area was selected using the *directions* function in Google maps[1], in which all firms located in municipalities within one hour of Gothenburg was kept in the sample, as summarized in table 10-4.

[1] www.maps.google.com

Table 10-4: The geographical scope of the sample

The geographical scope of the sample	
Municipalities represented in the sample	Ale, Alingsås, Bollebygd, Borås, Göteborg, Härryda, Kungsbacka, Kungälv, Lerum, Lilla Edet, Mark, Mölndal, Orust, Partille, Stenungssund, Tjörn, Trollhättan, Uddevalla, Varberg, Öckerö
# Number of remaining firms	**4 503**

The final step prior to initiating the quantitative performance analysis is to remove too young firms from the sample. This is not as straightforward as one may think. Many company groups have newly registered parent companies even though the firm in which the groups operations are performed might be older. This calls for a temporarily variable to be invented that takes the value of the oldest registration date in each company group. This modified registration date can then be used to sort out too young firm or company groups from the sample, as summarized in table 10-5.

Table 10-5: The age of sample firms

The age of sample firms	
Firms registered later than 2002-12-31	716
# Number of remaining firms	**3 776**

All the predefined variables have now been applied, which has led to a rather dramatic reduction of the gross sample first extracted from the database. Since it became apparent that some firms in the sample at this late stage still lacked important data, random manual controls were performed. Judging by these controls it appeared that some firms that missed data at this stage had gone into bankruptcy, however some of them also appeared to be insufficiently updated in the database. Since a complete data set is needed to perform the intended quantitative assessment of the firms, these firms were deleted from the sample, as shown in table 10-6.

Table 10-6: The final sample

A final quality check of the sample	
Firms that have gone into bankruptcy or due to other circumstances lack important data	225
# Number of remaining firms	**3 551**

The different screening steps that has been applied has reduced the gross sample of over thirty thousand firms to 3 551. These firms will be assessed in conformity with the screening framework presented in chapter 5. However, such analysis requires data to be collected on the industries represented in the sample, which leads us to the next passage of the screening procedure.

Building a Database with Industry Metrics

In order to enable a relative analysis of the sample firms' performances, a data set need to be acquired on all the industries that are represented in the firm sample. Consulting the sample of 3 551 firms selected it was found that they are distributed over 306 distinct industry groups. In order to create a relevant data set that can be used as a base for comparison requires all firms in these industry groups to be extracted. Again, the Retriever database was used to extract the data set, subject to the following limitations. First, the absolutely largest firms are not included since they are assumed to serve another kind of market than the firms that Privest targets. Also, firms younger than five years are not included since they cannot be thought of as fully established in the market. The general properties of the industry database are summarized in table 10-7 below.

Table 10-7: The industry database

Properties of the firms included in the industry database	
Revenue size	MSEK 1 – MSEK 500
Firm age	Registered before 2006-01-01
# Total number of firms found	**118 977**

Using the Pivot table tool in Microsoft Excel, this extensive data set was then structured to reveal relevant metrics, such as the average EBITDA margin of a specific industry year by year. Equipped with such detailed metrics on the industries represented by the firms in the sample, the quantitative analysis of the sample can commence.

Applying the Screening Framework

Having formed the sample of 3 551 firms that fulfills the predetermined variables and established an industry database that enable comparison with the represented industries, the next step in the screening process is to apply the variables defined in section 5.2.2. The following subsections present how the various variables was implemented and how the point awarding system was designed to favor or suppress high and low performers respectively.

The first assessment was made on the industry level. As already thoroughly described in section 5.2, the intention here is both to favor strong performing industries in the points system and to sort the 306 industries into four different groups. These industry groups, their descriptive names and point distribution are summarized in figure 10.1 below.

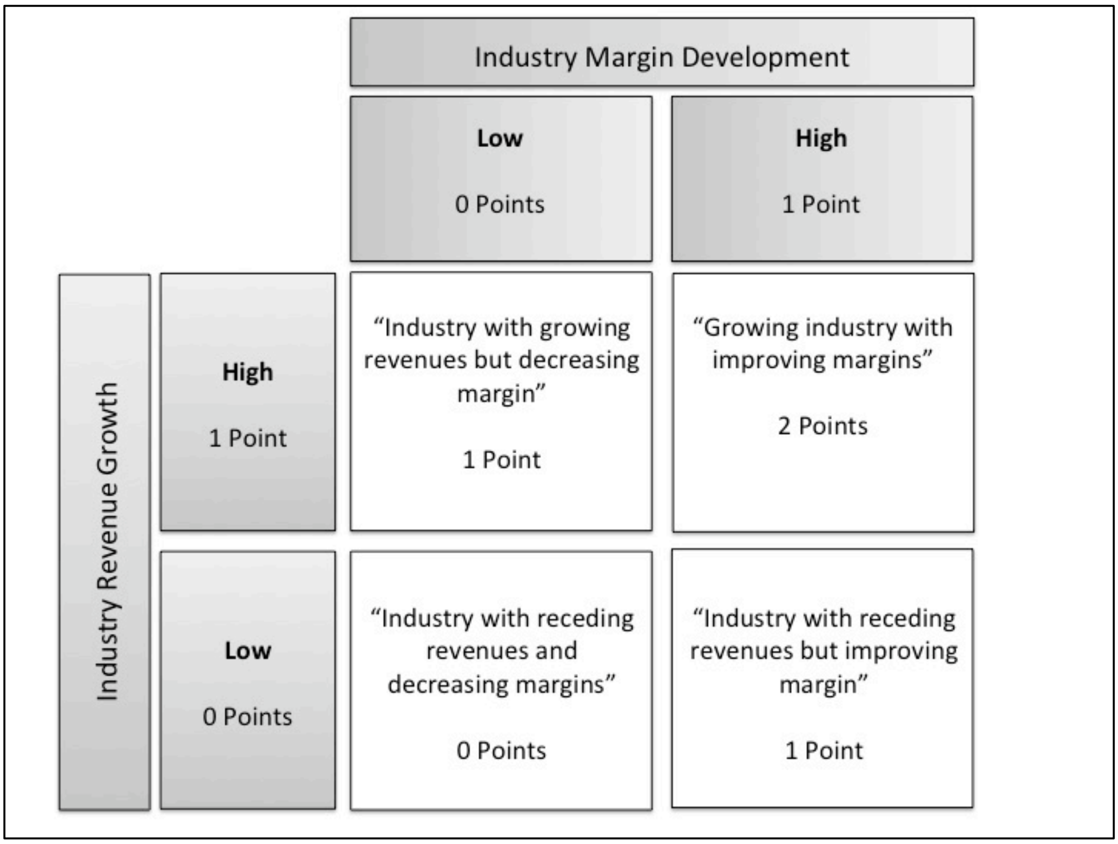

Figure 10.1: The industry level cases, their descriptive names and point distribution

To ensure total clarity, the definition of the variables used at industry level bear to be repeated. The industry revenue growth is measured as the five-year CAGR, with *high* meaning anything above zero and *low* referring to zero or less. The measure of industry margin development is defined in exactly the same way, the only difference being that it is measured on the industry's average EBITDA margin and not on its absolute revenue size.

Next, the different firm level cases was rendered and given names according to a very similar manner to the industry cases explained above. This time however, the firm's revenue growth –still measured as the five-year CAGR– is compared to the industry average. In the same way, the firm's EBITDA margin was measured relative to the average industry EBITDA margin. To reduce the influence of year-to-year variations a three-year average of the profit margin was utilized. The resulting firm level cases, their descriptive names and their point distribution are summarized in figure 10.2 below.

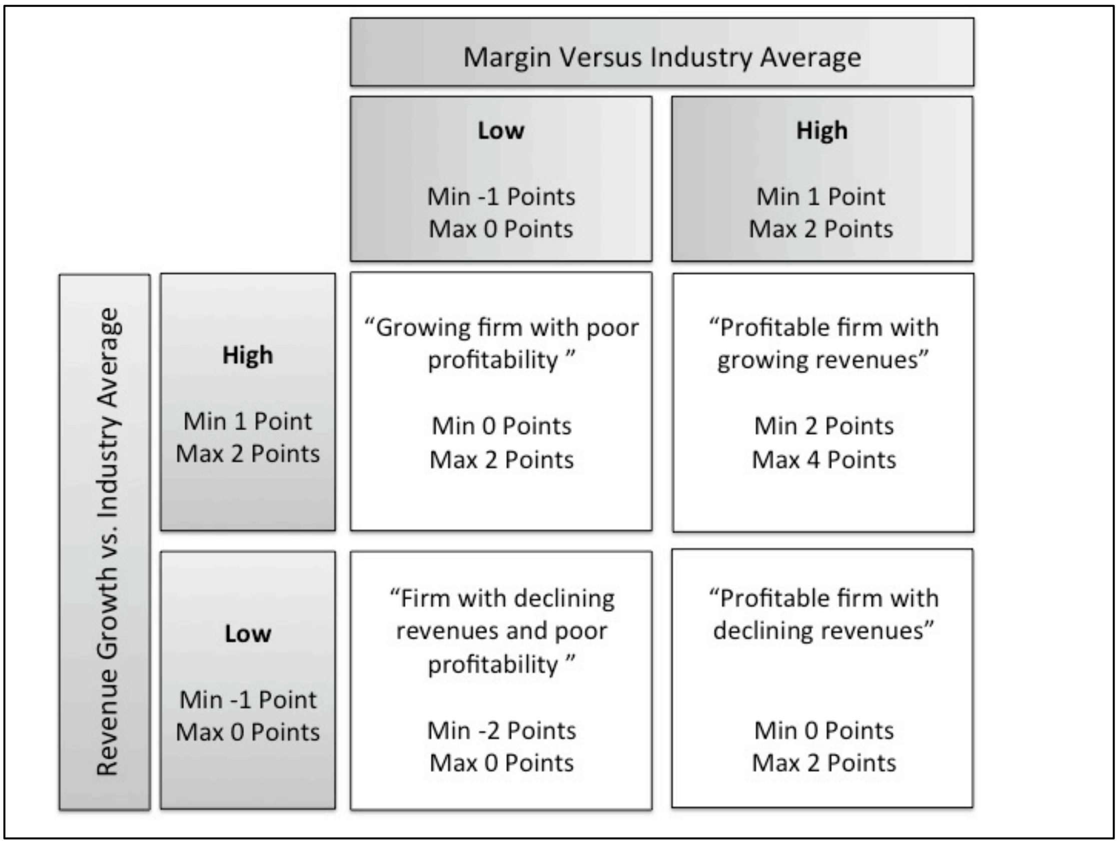

Figure 10.2: The firm level cases, their descriptive names and their point distribution

As can be observed in figure 10.2, the point distribution in the various firm level cases is more dispersed than in the industry level cases. This difference captures the notion that the emphasis should be more on the firm's performance, even though industry characteristics are a natural part of the analysis. For both variables that span the firm level cases, the point awarding system works in two steps. First, one point is given if the firm performs better than the industry average and zero points are distributed to those that do not. Then, a relative point is given in relation to the firm's over or under performance compared to the industry. This relative point corresponds to the difference in percentage between the firm and the industry, but limited to plus or minus one point respectively. A firm that has an EBITDA margin of 15% while the industry has a margin or 10% thus receives 1,05 points.[1]

The work progress described above establishes the foundation of the quantitative analysis as it defines the various industry and firm cases, and distributes the first points. As the borders of the analysis frame are now set, the rest of the variables in the screening framework aim to favor positive performance and flag various risks that might be present among the sample firms. In the following text, these remaining variables will be presented and explained one by one, starting with those that measure financial performance.

[1] One point for being more profitable than the industry average plus 0,05 points (15% – 10%) corresponding to the over performance.

Cash flow stability

To measure the stability of cash flows, a variable needed to be created under the subject of two properties:

(1) It should recognize a high variability in cash flows.
(2) It should take the absolute size of cash flows into consideration.

With this two properties in mind, a variable was designed to measure the difference of the largest and smallest absolute cash flow –estimated as EBITDA– in the five last years and put this number in relation to the average estimated cash flow size over the same period. The variable is thus defined as:

$$Cash\ flow\ stability = \frac{Max(Cash\ flows) - Min(Cash\ flows)}{Average(Cash\ flows)}$$

Hence, a value of one means that the variability in cash flows stands in proportion to the average size of the cash flows. Consequently, the lower the value of the variable, less variability is observed in the cash flows.

The point distribution for this variable works in the following way. All firms that have negative cash flow for any of the last five years receive minus one point directly. The remaining firms receive a point value corresponding to one minus the value assigned to their Cash flow stability variable[1]. The awarded points are, however, limited to minus one and one respectively. Furthermore, all firms that receive minus one point are labeled as risky from a cash flow perspective.

Financial solidity

The implementation of this performance variable in the screening procedure is rather straightforward as ready-to-use data on financial solidity are available in the extracted data set. The trick here is instead to capture both of the following aspects:

(1) A low financial solidity implies high risk.
(2) Over a certain level, an increase of financial solidity does not make the business proportionally less risky.

Emanating from these properties, the point awarding system is designed to give a point that corresponds to the firm's financial solidity relative to a critical level of 25%. Thus, the point awarded can be expressed using the following logics:

$$Point = Min(Solidity_{Firm} - 25\%,\ Solidity_{Industry} + 25\%)$$

[1] I.e. Point given = 1 – Value of the Cash flow stability variable

The possible points to be awarded are thus positively bounded by the industry average plus an arbitrary margin of also 25%. On the negative side, the limitation is not fixed, although the firm's financial solidity typically is greater than zero. Furthermore, all firms that receive a negative score are labeled as risky from a financial perspective.

Profitability

The quantitative analysis of the firm's profitability is based on data that have been directly extracted from the database, without any additional operations to prepare it. The extracted figures measures the return on operative capital employed, which isolates the profitability from effects that stem from financial activities.

Here, the point awarding system gives points in relation to the firm's performance versus the industry average, measured as a three-year average. Just as with the other variables, the up and downside are limited to minus one and one respectively. Thus, the point awarding logic can be expressed as:

$$(1) \qquad Point = Min(Firm_{\%} - Industry_{\%},\ 1)$$

$$(2) \qquad Point = Max(Industry_{\%} - Firm_{\%},\ -1)$$

The first logic rule applies if the firm's profitability exceeds the industry on a three-year average. If the firm on the other hand underperforms the industry, the second rule applies instead.

Industry risks

In the quantitative screening, firms that belong to industries that are associated with elevated risks of political character are labeled as risky in the same manner that has previously been described. However, no points were awarded to help tell these firms apart from the others. The industries that were flagged as risky from a political risk perspective are presented in table 10-8.

Table 10-8: Politically risky industries

Risk character	Industry
Political risk	Primärvårdsmottagning, Sluten sjukvård, Vård & omsorg med boende, Hälso- & sjukvård, övriga, Sociala insatser, Specialistläkare ej på sjukhus, tandläkare, Veterinärverksamhet, Öppen hälso- & sjukvård, Specialistläkare på sjukhus, Arbetsmarknadsutbildning, Eftergymnasial utbildning, Personalutbildning, Samhällsvet. & Humanistisk F&U, Universitets- & Högskoleutbildning, Grundskoleutbildning, Gymnasial Utbildning

All the industries that are flagged as risky belong to the school and healthcare sectors identified in chapter 5.

Risk of high owner dependence

The task of measuring owner dependence in the sample firms is hard to say the least. In order not to influence the results of the screening too much, this measurement was designed to highlight only the most obvious risks related to owner dependence. This was achieved by controlling the number of employees in all firms, whereupon all firms with three employees and less were labeled as potentially risky from a dependence viewpoint. This is by all means a rugged estimate, but it helps to sort out the worst cases.

Likelihood of pending generation shift

Just as owner dependence, the likelihood of a pending generation shift is hard to impossible to estimate by quantitative measures. On the other hand, the task deserves an attempt since it is crucially related to the purpose of the screening. Therefore, a variable was designed that track the age of the CEO, chairman or other board members and recognizes if any of them are fifty years, or older.

Having defined all variables and applied them across the sample, the next phase in the screening procedure was to weigh the awarded points and provide a structured presentation of the result. The total score for each firm was weighted to one using the weights presented in table 10-9, and thereafter multiplied with a hundred to easier discern different performance levels.

Table 10-9: Variable weights in the point awarding system

Variable	Weight
Industry growth	12,5 %
Industry profitability	12,5 %
Firm revenue growth	15 %
Firm profit margin	15 %
Cash flow stability	15 %
Financial solidity	15 %
Profitability	15 %
Sum	**100 %**

The result of the screening framework was then represented in a table in which the various industry and firm situations divide the vertical dimension and the identified risks and likelihood of a pending generation shift spread the horizontal dimension of the table. The table, which is shown in figure 10.3 contain information on how many firms that are included in each cross-section of the sample and what the average points are for each cross-section. It can be observed that the average points awarded tend to be higher toward the upper right corner of the table, which can be expected due to the construction of the point awarding system.

	Likelihood of generation shift								
	No				Yes				
	Risk adjacent		No risks identified		Risk adjacent		No risks identified		
	Number of firms	Average points	Number of firms	Average points	Number of firms	Average points	Number of firms	Average points	Grand Total
Växande branch med växande marginal	**396**	**31,52**	**262**	**51,74**	**262**	**51,74**	**229**	**50,43**	**1149**
Bolag som växer med lönsamhet	93	57,22	124	63,75	58	63,66	111	61,10	386
Ej växande men lönsamt bolag	29	38,07	41	50,88	16	39,24	28	50,24	114
Växande men ej lönsamt bolag	155	30,63	66	40,07	113	28,21	67	41,30	401
Ej växande bolag utan lönsamhet	119	11,00	31	29,67	75	13,57	23	25,79	248
Bransch med krympande omsättning men växande marginal	**86**	**21,96**	**65**	**43,46**	**87**	**43,46**	**52**	**42,93**	**290**
Bolag som växer med lönsamhet	23	49,16	38	56,09	14	44,02	27	54,56	102
Ej växande men lönsamt bolag	5	26,52	6	37,57	7	17,76	8	39,71	26
Växande men ej lönsamt bolag	38	18,80	12	32,65	45	22,14	13	30,54	108
Ej växande bolag utan lönsamhet	20	-4,46	9	8,45	21	3,08	4	11,06	54
Branch med växande omsättning men krympande marginal	**562**	**13,68**	**554**	**37,55**	**345**	**37,55**	**413**	**36,31**	**1874**
Bolag som växer med lönsamhet	82	44,71	245	51,72	45	39,06	169	51,02	541
Ej växande men lönsamt bolag	28	20,52	79	37,18	9	24,42	59	34,20	175
Växande men ej lönsamt bolag	250	15,63	159	25,74	145	15,92	131	27,99	685
Ej växande bolag utan lönsamhet	202	-2,28	71	15,57	146	0,92	54	12,77	473
Branch med minskande omsättning och minskande marginal	**85**	**2,74**	**53**	**28,10**	**50**	**28,10**	**50**	**42,12**	**238**
Bolag som växer med lönsamhet	10	36,73	21	39,63	11	36,20	24	46,15	66
Ej växande men lönsamt bolag	3	3,28	4	47,94	1	29,45	10	18,51	18
Växande men ej lönsamt bolag	41	3,78	21	21,64	22	1,70	11	20,99	95
Ej växande bolag utan lönsamhet	31	-9,67	7	1,60	16	-16,98	5	116,46	59
Grand Total	**1129**	**19,74**	**934**	**41,41**	**744**	**20,08**	**744**	**41,51**	**3551**

Figure 10.3: The screening framework visualized

The Microsoft Excel model was designed so that the firms in each cross-section of the sample can be explored individually, using automatically generated graphs and metrics from the underlying data set. Using the model in this way enables a new sample of firms to be selected for the qualitative screening phase.

10.1.2 Progress of Qualitative Screening

Using the quantitative screening model, twenty firms were selected for further screening in the qualitative phase. These twenty firms were selected based on their salient performance in the quantitative screening and the different investment situations they represent. However, all firms were selected from the group that might show indications of pending generation shifts and were no risks had been identified. The sample then went through two steps aiming to assess the willingness to sell and the firms' dependence on key persons.

<u>Willingness to sell</u>

Being cautious not to scare the owner away by asking if he is thinking of selling his firm, the first contact established with the sample firms aimed to explain the thesis' research and the benefits of creating a new kind of small business owner. As expected, most respondents declined to partake as an example in the thesis, but there were also a small group who expressed and interest because of their own upcoming generation shift. These owners and their firms are naturally of particular interest for Privest, since an explicit will to discuss a sale is a first step towards an acquisition.

<u>Owner dependency</u>

An initial survey of key person dependency in the firms was conducted by gathering information from news-sources, the firm's web site and annual reports, predominantly through Internet searches. As an example on what to look for, an organization chart with well-defined areas of responsibility was positively recorded as a sign of limited dependence.

The assessment also included short discussions with the owners over telephone, even though this discussion foremost centered on the owner's appreciation and interest in the work constituting this thesis. Consequently, a deeper understanding of the person dependence requires on-site visits and interviewing with the owner and other employees.

During the qualitative screening process, two firms stood out as extra interesting for Privest. Both firms are strong performers in their respective industry and could not be dismissed as too dependent on the owners upfront, but their most interesting characteristic was that their owners were willing to discuss a future transaction. Therefore, these two firms were selected for deeper investigation as investment cases.

10.2 Integrating the Analysis Into Investment Cases

This analysis aims to provide insights into the two identified investment opportunities, following the hypothesis driven investment framework suggested in section 9.2.

10.2.1 Investment Case 1

The firm of study in this investment case (hereby referred to as "Firm A") has five employees and operates as an importer and wholesaler of equipment for professional kitchens. Firm A was founded in the mid of the 20^{th} century and is today jointly owned by two brothers, the second generation of the founding family.

Fifteen years ago Firm A had 20 employees, many more agency commitments to manufacturers, and covered a much larger part of the service spectrum associated with large scale catering equipment, including the service of having in-house architects that designed and planned kitchens. However, the increased workload that these operations in the end carried with it weighted down too much on the two brothers, who decided to rescale and focus their business scope. As a result, Firm A is now a small and efficient sales organization that provides stable returns and let its owners sleep well at night.

Firm A stands out in its category in the quantitative screening with a higher than average score. Some of the more important observations made during the screening process is outlined in the points below.

(1) Firm A belongs to an industry with growing revenues and margins.
(2) Firm A itself is not growing, but it is more profitable than the industry average.
(3) Firm A has a higher than average score (56,4 versus 50,3).
(4) Firm A's high score is predominantly driven by a high margin compared to the industry and stability in cash flows.

The high margin and stable cash flows demonstrated by Firm A makes it a typical buyout candidate. However, there are still uncertainties that must be dealt with in the screening process, even though it was not possible to detect any risks in a quantitative way. Given that Firm A only has 5 employees it can be expected that the owner dependency of Firm A is high. In the qualitative screening phase this hypothesis could not be either proved or disproved, since no factual evidence could be obtained. It was on the other hand found that the two owners were interested in Privest's investment idea and were willing to discuss it further in an interview.

Internal Analysis

Firm A is essentially a very lean sales organization. All employees are employed as sales and customer service personnel, although they are also responsible for an additional area. This means that when customers call to order, it does not matter who receives the call. Any employee can book the order without having the customer wait for his or her contact to be available. The additional responsibilities are focused on guaranteeing a strong service offer in connection to the physical products Firm A sells. The core of this service offer is accessibility to spare parts within 24 hours and technical documentation on the products that is required for installation and maintenance. The technical documentation is developed or translated to Swedish in-house, which Firm A's owners claim put them in a market leading position in that respect.

All activities that are not directly related to sales and customer service are contracted to service providers. While this is entirely true regarding administrative tasks, not all of the inventory and logistics activities are outsourced today. However, the first trials to do so have turned out positive and Firm A therefore aims to explore the opportunity to outsource all inventory and logistics further.

Firm A's high level of specialization and its related efficiency reinforces its position in the market and raise barriers for new entrants, who are not likely to be able to compete on the same terms. Firm A's efficiency is thus one source of competitive advantage, but there is also another source to consider. The service offer, including readily access to spare parts and technical documentation in Swedish differentiates Firm A from its competitors.

Even though it can be concluded that Firm A has a set of strengths, there is also a downside that must be highlighted. Since the lion's part of the market is located in Mälardalen, Firm A's location in the Gothenburg area is not ideal. As a consequence, Firm A does not enjoy the same physical proximity to the customers as some of the competitors do.

Firm A's Financials

Firm A's financial performance supports the hypothesis that Firm A has a competitive advantage. The operational margin (EBIT) is higher than the average wholesaler of professional kitchen equipment (9,6% versus 6,6%) and although sales are not growing they are kept steady at around MSEK 30, as shown in the figure below.

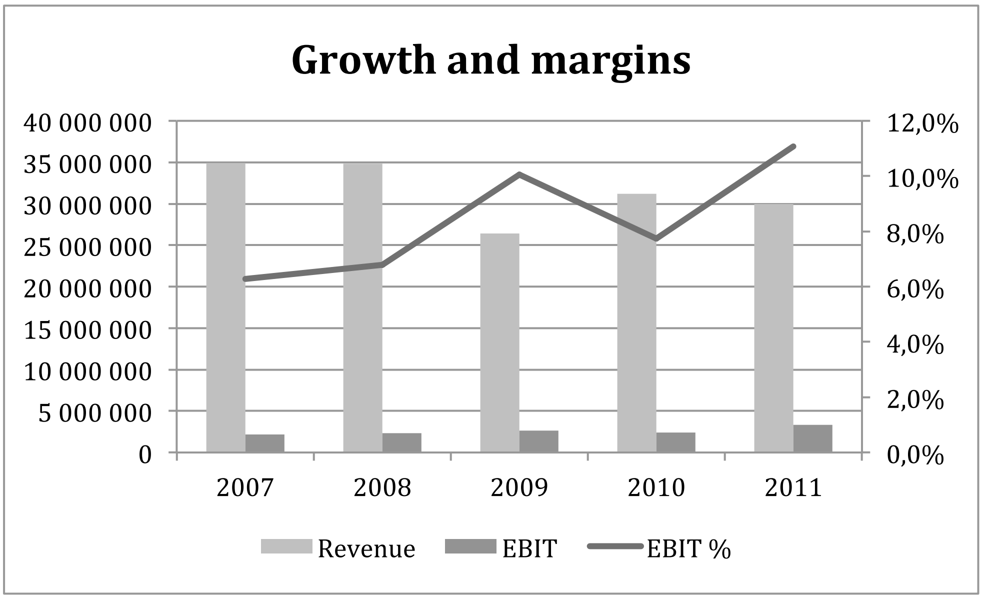

Figure 10.4: Firm A's financial performance

The main takeaways from the analysis of Firm A's financial situations can be summarized into the following points:

(1) Firm A has no long-term debt.
(2) Firm A's working capital is very low, or even negative, due to the absence of fixed assets and large amounts of short-term debts to suppliers (Accounts payable).

The negative working capital can be interpreted such that Firm A's operations are self financed, or to a great part financed by Firm A's suppliers. Therefore, Firm A's operation requires very little capital to be tied up, resulting in Firm A having a very lean financial structure. This makes Firm A very profitable, but at the same time the high performance also inhibits further value enhancement. Since there is no debt to reduce and very little capital tied up in the operations, it can be concluded that initiatives aiming to enhance the value of Firm A is not likely to emanate from the financial structure.

External analysis

At first sight the large scale catering equipment industry has a rather straightforward structure. However, a study of the value chain reveals some interesting details. A first observation is that there are two types of firms that serve the demand for professional kitchen equipment. First, there are importers and wholesalers who market and sell goods supplied by manufacturing firms that typically reside outside Sweden. Second, there is also a group of manufacturing firms that have in-house sales organizations and therefore competes directly with the wholesalers.

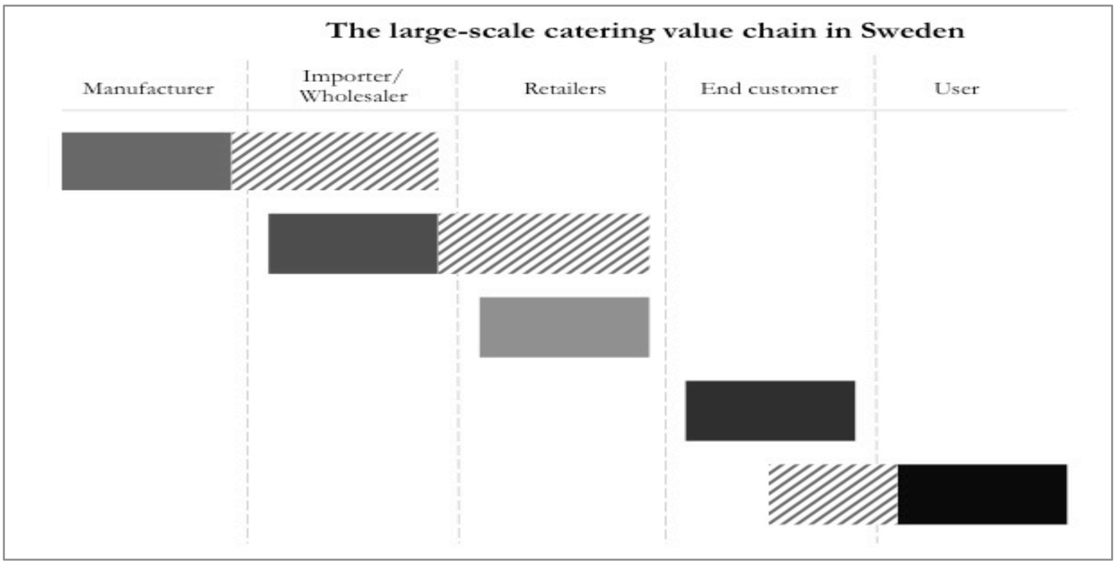

Figure 10.5: Firm A's industry value chain.

The wholesalers and manufacturing firms' customers are retailers that deliver equipment to the value chain's end customer and provide services like installation and maintenance. Even though the end users, i.e. chefs and catering professionals, might not coincide with the retailers' customer (e.g. a restaurant owner), it is important to point out that the end user has a significant influence on the en customers' buying decision. Therefore, advertisement is often directed to the end users trough trade magazines.

In order to establish a size estimate for the Swedish market it is assumed that the main competition for Firm A stems from other wholesale firms and not manufacturing firms. This assumption will lead to a low estimation, yet it is still valid since it is hard to establish the source of manufacturing firms' revenues, which is dominated by the internationally large Electrolux professional. Through the Swedish trade organization for catering and restaurant equipment it is possible to trace 10 wholesalers who compete directly with Firm A. Based on their revenues, a minimum market size estimate for the Swedish market is MSEK 518. Over a ten year period, this market has grown with 5,6% annually, and a bit slower the last five years with an annual growth of 2,8%.

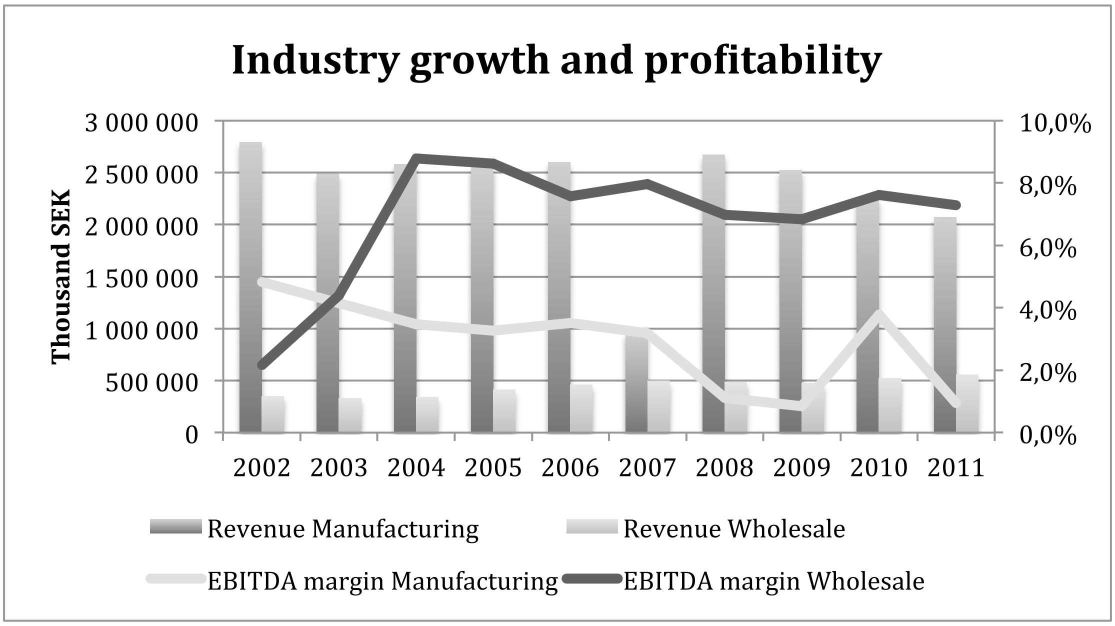

Figure 10.6: The industry growth and profitability.

A main takeaway from the analysis of the external environment is that the wholesaling firms do not seem to be under competitive pressure. Over the studied ten-year period they are all growing their revenues and make a profit. In fact, over the last five years the 11 firms that form the sample for the analysis only display five individual losses, whereof two stem from a young firm that entered the market three years ago. It can therefore be concluded that competition among the industry rivals are not a problem today, as there is space enough for all firms to make a profit.

Possibility of a successful transaction

The central issue regarding transactions in small firms is the firm's dependence of its owners. The firm that is the object of study in this analysis is in this respect no exception, as customer and supplier relations to a large extent resides in the owners. The question whether ownership of Firm A can be successfully transferred therefore comes down to finding a financing arrangement that sustains the sellers' incentives to transfer tacit knowledge to the buyer for a sufficiently long period of time.

The most attractive transaction alternative, from an investor's perspective, is to structure the acquisition as a management buyout. However, in this case none of Firm A's employees are suitable to be included in a management buyout transaction. Either they are nearly the same age as the current owners and will retire too soon, or they are newly employed and lack both the theoretic background and experience levels that would be required by them in the management role after the acquisition.

Since it has been established that there are no prerequisites for a management buyout, the possibility to successfully acquire Firm A thus becomes contingent on the potential of introducing a new operational leader in Firm A and establish an incentives structure that ensures the sellers' will to transfer their knowledge to the new operational leader to as great extent as possible post-acquisition. In such a transaction, the role of an advisor on the seller's side becomes central since an advisor can both help the sellers transfer tacit knowledge to the buyer and help explain the financing arrangement required to mitigate the owner dependency. If such a financing arrangement can be found and if both parties then acknowledge the necessity to implement it remains an open question and requires further investigation.

Opportunities for value enhancement
There are benign opportunities to enhance the value of Firm A should it be acquired. It should be noted though, that these opportunities subsist almost exclusively in the possibility to add more sales to existing revenues. In the financial analysis presented above it was concluded that Firm A is very lean from a financial perspective and that no value is likely to be extracted from excessive working capital. Additionally, the potential to achieve an arbitrage situation is very hard to anticipate but the owners' low emphasis of emotional values when discussing possible divestment alternatives can be interpreted as lowering the chances of gaining anything from negotiating such desires.

Assuming that outsourcing all activities that are not central to Firm A's operations help reduce the overall cost of operations, it can be concluded that adding more sales is the only way of enhancing the value of Firm A. In practice, a viable approach to do so would be to establish sales representatives in Mälardalen, where about 60% of the Swedish market is located.

Summary and conclusion
Reconnecting to the generic hypothesis that the Investment framework's analysis emanates from (cf. section 9.2), it is now time to synthesize the analysis and decide whether Firm A is an attractive investment opportunity or not. It is clear that Firm A stood out in the quantitative analysis and that no obvious owner dependence could be identified in the qualitative screening, in which the owners expressed interest in discussing Privest's proposition closer. It is also clear that there are opportunities to enhance the value of Firm A post-acquisition and that Firm A has a competitive advantage and a strong position in the value chain that provides a good ground for future expansion.

There is on the other hand evidence that point out that it will be hard to successfully transfer the ownership of Firm A. Since a management buyout transaction will not be possible, the transaction must take another form that both introduce new management and establish incentives for knowledge transfer between seller and buyer. Although all other analysis that is supported by the Investment framework lifts forward Firm A as attractive, the success of the investment is in the end contingent on the finding and mutual appreciation of such a financing structure between seller and buyer.

10.2.2 Investment Case 2

In this investment case a study is performed on a firm that will be referred to as "Firm B" in the text. The firm is an actor in the solar shade industry and was inherited by one of the current owners. Today, the ownership is split between two owners who hold an equal stake of the firm's shares. Both owners are active in the sense that they work operatively in the everyday activities.

Firm B is a designer and manufacturer of solar shade products where both consumers and businesses are among the end customers. The products are mainly distributed through one of the approximately one hundred resellers covering most parts of Sweden. The firm also has its own shop in relation to the production site to cover the market in the Gothenburg region. The product range includes eight product categories with a total of twenty product variants. Moreover, the firm supplies solutions for controlling the different products, for example through an iPhone application. Firm B position itself in the premium market segment.

The following results are associated with Firm B and found during the quantitative screening process:

(1) Firm B belongs to an industry with declining revenue and profit margins.
(2) Firm B is profitable and demonstrates positive growth.
(3) Firm B has an total score slightly below the industry average (45,6 versus 46)
(4) The revenue growth and the level of profits are the main determinants of the firm's overall score.

The qualitative screening revealed no obvious owner dependency and the owners of the firm demonstrated both a positive attitude to discuss an exit and an interest in the Privest investment idea.

Internal Analysis

<u>Organization</u>

Firm B has 23 employees but during high-demand periods, mostly occurring during spring and summer, an additional temporary staff of 10-12 employees is recruited. The organization is split between a division focusing on the Gothenburg area and one that targets rest of the Sweden. Five employees are responsible for the former geographic area with two persons in production and three working on direct sales. The rest of the employees work towards the rest of the Swedish market with production, administration, purchase and sales to retailers.

The organization is divided into several teams with one employee responsible for a group of three to four other employees. There are no formal guidelines or rules for managing the business' processes such as ISO standards. However, the owner of Firm B points out that through careful hiring and a down-up culture the firm has managed to set up a group of individuals that works in the same direction. This is according to the owner an important reason for the success of the firm and its ability to deliver superior quality. In addition, some procedures are documented regarding safety and working environment as well as employment policies. Firm B does also have an agreement with the labor union IF Metall.

From the organizational layout of Firm B there are mainly two important things that could pose a challenge for new owners. First of all, and with less impact, the lack of documentation of working practices and procedures might become a challenge if the tacit knowledge possessed by the current owners is not properly transferred. However, and as will be discussed further, Firm B has reached an organizational level of maturity where the knowledge about the business migrates from the owners to the employees. The second challenge is related to the culture that is prevailing in the firm, and if new owners have a different perspective of how the business should be organized, resistance to change might be significant.

Production facilities

Firm B owns its production facility that was built in 2006, when the firm faced a strong growth and needed to increase their capacity. The production, or more correctly, assembling of components is made on demand. Components are bought both in a standardized fashion from large suppliers or from smaller suppliers providing components based on an exact specification from Firm B. The existing production capacity has however started to reach its limit in terms of current sales levels and product range. Although the owner of Firm B states that the demand is low right now, the decision to add more products to the current product range requires a further expansion of the site or by moving the business into other facilities.

Retail network

The owner of Firm B states that the firm's past growth is much related to the establishment of a network of retailers and good relations with these retailers have proven to be seminal for the business' growth. Most of the retailers are small and local firms but some larger players exist in this part of the value chain. In the case of an acquisition it is important to identify if there is a risk that these relations will seize to exist if the current owners leave the business. Hence, securing the relationships should be of high priority for a new owner willing to overtake the business.

Being the most important channel to reach the end customers, retailers have to be accounted for in any strategic initiative that might affect them. Potential channel conflicts might arise if Firm B starts to deliver a significant amount of products direct to the end customers. Such an event could arise if Firm B decides to form close relationships with large construction companies, and decide to deliver directly to them. This is a highly probable case, which will be more closely elaborated upon in later sections, and it relates to an industry trend that promises growth opportunities for the particular business Firm B is in.

Initial forming of relationship with large construction firms

In order to explore future growth opportunities Firm B has held initial discussions with large construction firms about the implementation of the firm's products in construction projects.

Brand

Firm B has according to its owner a recognized brand name at the Swedish market that is associated with high-quality products.

Financial Analysis
From a financial perspective Firm B shows impressive performance. Figure 10.7 below illustrates a steady revenue level of approximately 50 mSEK during the observed period. Prior to this period, Firm B experienced a strong growth from a revenue of 17 mSEK in 2002. The profitability of the firm has been kept at high levels with a slightly positive margin development. The steady cash flow generation is beneficial from an investment perspective, particularly if a significant amount of leverage is used to finance the buyout. As previous discussed, a volatile cash flow might affect the investment firm's ability to cover the financing costs and hence there is an increase in the credit risk.

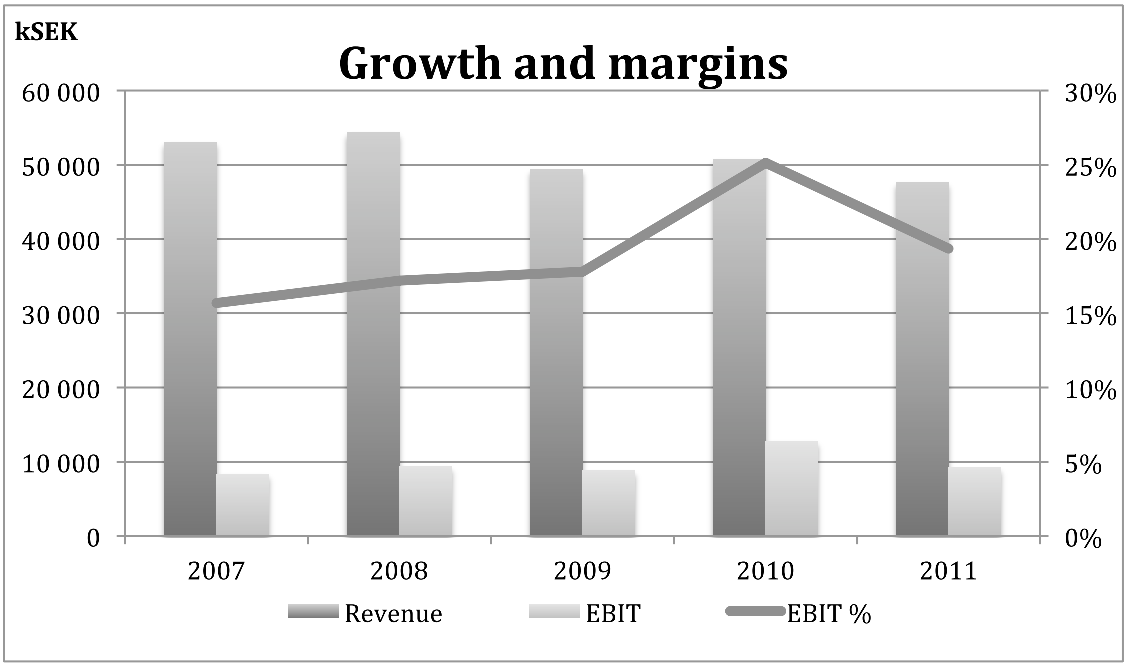

Figure 10.7: Firm B's financial performance

interest. First of all, a significant increase in the value of the inventory level is noticed between year 2009 and 2010. The explanation for this increase is according to the owner new procurement routines. Since the value of the purchased components are not associated with high obsolesce, Firm B started to purchase components during the fall when the demand is low and hence the prices are discounted. Another valuable effect of this procurement strategy is that part of the work can be done during period of low demand to be better prepared during high demand periods in spring and summer.

Secondly, Firm B's financial solidity has increased during the observed period and was in 2011 70 per cent. The firm still has a large amount of long-term debt that was used to finance the new building. Although Firm B has good liquidity and could potentially pay off the debt with its current cash positions, the owner states that the debt's interest terms were negotiated at attractive levels and therefore paying of the entire debt has not been made.

External Analysis
In this part of the investment case relevant industry characteristics will be outlined; estimating the industry size and growth, highlighting particular market trends and

mapping the industry value chain are the main objectives of this section. Moreover, each of the actors in the value chain will be elaborated upon.

Market characteristics

Demand of solar shade products is obviously driven by the need to shade and cool certain areas, both inside and outside a building. However, there are also other often complementing purposes for purchasing solar shade solutions such as reducing a building's energy consumption, controlling the amount of light, and having it as a part of the interior or exterior design. Most solutions are based on fabrics, which is an important determinant of the overall quality of the solar shade product.

Although there is a myriad of substituting solar shade solutions, Firm B solely supplies products based on fabrics. To provide an estimate of the relevant market, 14 solar shade producers have been identified on the Swedish market that mainly supply the same products as Firm B. Based on the figures of the last three years (2009-2011), the average revenue of all 14 producers amounted to MSEK 437. This figure provides a minimum estimate of the market size.

According to one of the owners of Firm B the market for solar shade products is not expected to grow significantly in the future. The solar shade market is highly correlated to the overall economic performance, especially for the premium market segment since investments in solar shade can be substantial. It is acknowledged that the market more or less stagnated in 2009 as a result of the global economic crisis.

General market trends

There are mainly two important market trends in the solar shade industry in Sweden:

(1) Solar shade solutions for energy efficiency purposes *and*
(2) A design, or fashion trend

The first trend was briefly touched upon in the previous section. Solar shade solutions have been recognized as suitable for enhancing buildings' energy efficiency. Related to this energy efficiency trend is the automation of solar shade solutions. It has become increasingly common to automate all kinds of solar shade products to provide optimal levels of comfort and energy need based on the weather.

Finally, solar shade products are used as a part of the esthetic design of a building and hence fashion trends are important to track. Trends are highly linked to the particular geographical market and in Sweden the trend is dominated by a minimalistic design[1] together with the use of elemental colors.

The industry value chain

The solar shade industry in Sweden consists of mainly five different actors as illustrated in the figure 10.8 below. As seen in the figure the suppliers of components and producers of solar shade products can be vertically integrated covering several parts of the industry value chain. Moreover, the end customer can either be the actual user of the solar shade or an intermediary actor, e.g. a construction company.

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[1] http://www.icakuriren.se/Hem-Tradgard/Inredning/skydd-mot-solen/

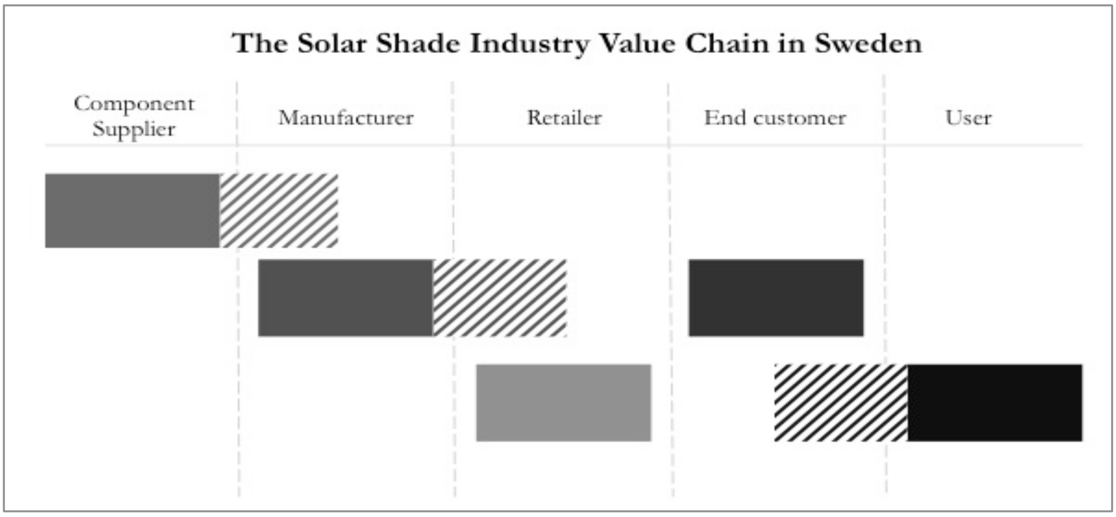

Figure 10.8: Firm B's industry value chain

Component suppliers

Component suppliers provide all the necessary elements to produce various types of solar shades. The suppliers of components have different characteristics based on what components they supply. For the fabrics and textile producers, a set of large international actors dominates the supply of required materials. The quality of the fabrics is according to the owner one, if not the most, important factor in solar shade products, implying that the solar shade producers rely on the large and established fabric producers.

Suppliers of control and steering devices together with suppliers of other components needed to produce solar shades are mainly local and smaller in size. According to the owner of Firm B it is also common to partner with overseas suppliers, in China or Turkey for example, to push down the price of the more basic components. Firm B has suppliers in China producing 10 components with the required level of quality.

Retailers

For larger solar shade producers, the most common channel used to reach end customers is through retailers across Sweden. Retailers are most often local actors since they help customers with measuring, advising on solutions as well as installing the solar shade products. The retailers provide showrooms with different producers' solar shade products but do commonly not keep any inventories. Most solutions are tailor-made and orders are placed to the producers when the end customer purchases a product.

Customers

Customers can be divided between end customers and users. In most of the cases these two coincide, however in certain situations the purchaser is not the actual user of the solar shade product. This is obvious when the end customer is for example a construction company that pre-equips the building with solar shade solutions prior to selling of the real estate. The increased interest for solar shade solutions in enhancing energy efficiency will most likely affect the ratio between purchasers as users and purchasers as non-users.

Firm B's products are targeted at the whole range of end customers including consumers, real estate managers and construction companies. The products can be delivered both to a single household but also to a larger project such as public buildings. The owner of Firm B although admits that additional products could be added to existing offer, as retailers currently have to complement their range of products with other supplier's as to be able to meet end customer's demands.

Competitive Environment

14 solar shade producers, including Firm B, are identified on the Swedish market where they compete with the same type of products and in the same segment. Firms that supply components but also produce solar shade products are omitted from the competitive analysis as it is hard to discern what share of their business is related to sale of solar shade products. However, it is important to mention that such competition exists and at the Swedish market one such firm is found that has a total revenue of approximately 250 mSEK in 2011. Firm B's competitors are geographically dispersed but almost all of them distribute their products all across the Swedish market.

Revenue and revenue growth

From the data collected over the last ten years it is found that only one firm has entered the market, in 2003, and that none of the competitors left it during the same period. Although the data is not exhaustive on competitors, Firm B's owner also acknowledges the fact that the industry is established with little room for new entrants. Moreover, he says that Firm B together with one or two other solar shade producers are market leaders in the premium segment. Although some competition for the largest retailers exists between these firms, the owner states that their respective markets are fairly separated.

The total revenue in 2011 was 438 mSEK for the 14 producers, with five actors having more than 30 mSEK in average revenue the last three years and together constituting approximately 60 % of the entire revenue. No one of the firms exceeded 90 mSEK alone during the last three years. Firm B had a three-year average revenue of mSEK 49.

During a period of 10 years the revenue has increased by five per cent per annum. For Firm B the same figure amounts to 12 per cent, putting the firm at the top in terms of revenue growth. The same calculations for the last five years show a weaker development where the compounded annual growth rate of the industry was -1.3 percent and for Firm B -2.5 percent. A summary is presented in figure 10.9 below. However, only three firms managed to have a positive annual growth rate with no competitor performing better than 6.7 percent growth per annum.

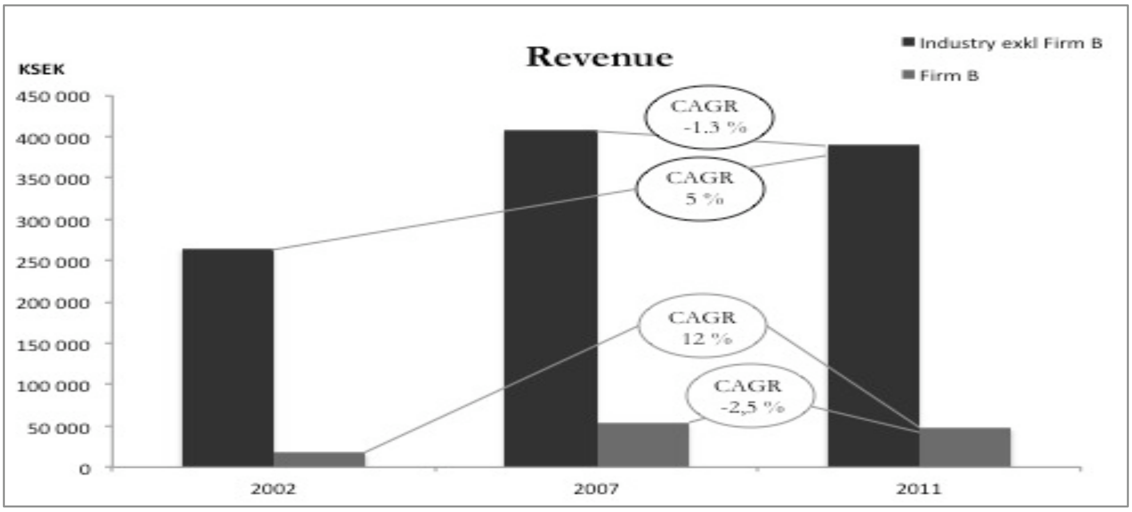

Figure 10.9: Revenue growth for industry and Firm B

<u>Profits and profit margin development</u>

Looking at the profit (EBITDA) the last five years the industry as a whole generated 33 mSEK in average, with only one firm showing negative five-year-average of 0.2 MSEK during the period. Firm B accounted for almost one third of the competitors' total profits for the observed period; the competitor closest to Firm B generated 6.7 MSEK in average for the last five years. Firm B's dominant position among its immediate competitors is further illustrated by looking at EBITDA over revenue. Figure 10.10 below compares Firm B's profit margin to the rest of the industry.

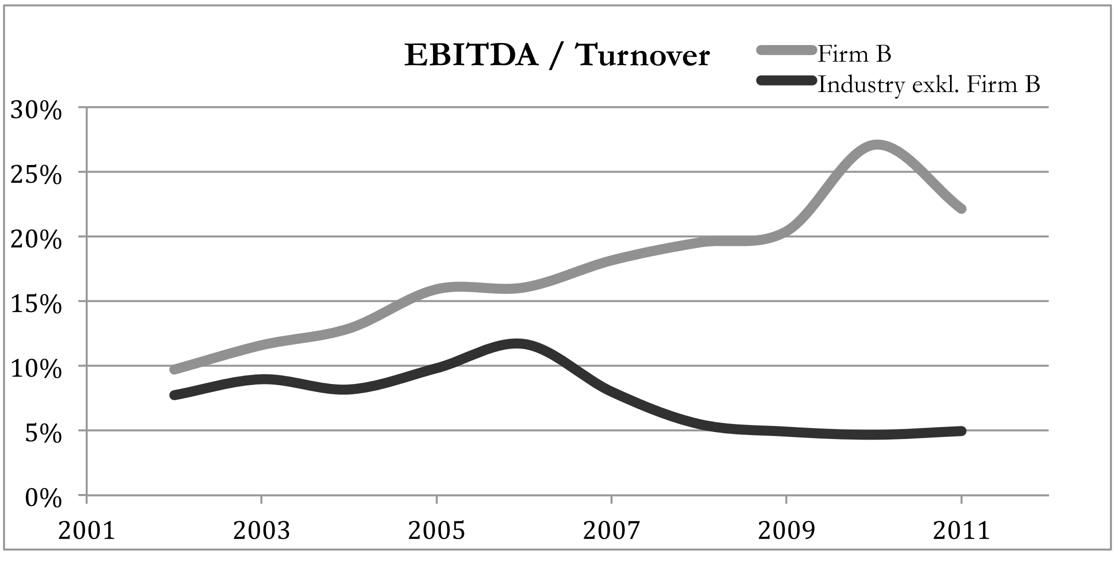

Figure 10.10: Profit margin development for the industry and Firm B

As the figure illustrates the overall industry margins seem to have established at five per cent since 2006. At the same time Firm B's profit margin has steadily increased since 2002 with an increased volatility for the past two years.

During the most recent years the Swedish solar shade producers have faced an increasing competition from foreign exporting firms. These foreign firms face troubled domestic markets and decide to dump their prices on other markets, including Sweden. However, Firm B's owner says that this effort has met limited success, as the products provided by the foreign firms are not in line with the preferences of the Swedish markets customers.

Possibility for a successful transaction

Although Firm B has left the organizational structure where "everything is in the owners' head", with responsibilities and knowledge gradually migrating from owners to employees, the firms is still quite dependent on its current owners. First of all the owners have a great knowledge about the solar shade market in Sweden ranging from trends to product specific characteristics. More importantly the owners have built strong relationships with other actors in the value chain, something that is according to one owner seminal to the success. It is frequently mentioned that the producer-retailer relationship is particularly important and has to be maintained in order to sustain access to the market.

Looking at potential ways to organize a successful transaction, one potent suggestion is to make an MBO. There are a couple of employees at Firm B that has the potential to succeed the management of the firm. However, they still need to take over current relationships and acquire a deeper knowledge of the industry. This process requires a closer work together with the current owners and might take one to two years. The financial resources of these employees are strictly limited and whether they have enough money and will to invest as a part of an MBO needs further investigation, although it should not be expected. The option to pursue an ordinary buyout is maybe more relevant, as the owner suggests that the transfer of tacit knowledge and important relationships to new managers should not differ significantly in time compared to transferring it to employees. Furthermore, the current owners have indicated that they are willing to stay at the firm for a period of one to five years as employees or advisors in order to share their knowledge relationships and thereby increase the possibility of a successful transaction. Further dependencies on persons other than the owners could not be discerned, but requires a closer evaluation.

A final remark on transaction issues relates to any emotional values that the owners of Firm B are attached to and that could have a significant effect on the transaction. The owner admits that, at the end of the day, everything has a price. However, the owner stresses that he would like to see the new owners recognize and continue to keep the firm as a non-hierarchical bottom-up organization where the employees work relatively freely and are included in shaping the future of the firm.

Opportunities for value enhancement

The first investigated value enhancement initiative is related to the discussion in the last part of the previous section, financial arbitrage. Being responsive to the current owners' emotional values and related demands is in the case of Firm B only a prerequisite; most probably it is not a factor that can drive down the purchasing price. Hence, no value enhancement of the firm should be expected prior to the transaction.

Driving sales in Firm B seems to be a viable option for new owners. As today's retailers have to complement Firm B's products with other producers, extending the product range is a viable option to utilize current sales channels to increase revenue.

However, such a value enhancement initiative requires additional investments since the current production facility's capacity is limited.

A more long-term value driver is related to the potential of the energy efficiency trend that is expected to increase construction companies' demand for solar shade solutions. New owners should carefully evaluate such opportunities and continue to build on the relationships with construction firms.

Summary and conclusion
In this investment case Firm B has been evaluated according to the guidelines of the investment framework and the hypothesis that Firm B is an attractive investment opportunity will now be discussed. First of all, from the quantitative screening it was found that Firm B performed well in an underperforming industry. One interpretation of this finding is that the firm is in a unique position compared to its peers and the attractiveness lies in the ability of the firm to stand against the negative industry trend. Secondly, the barriers to a successful transaction are expected to be low in this case as there are good prospects for mitigating the relatively limited owner dependency. Opportunities to enhance the value of the firm are identified but most likely require additional investments. Finally, the internal analysis found that the firm has developed some strong resources and capabilities that are reflected in the financial analysis and the competitor analysis, as the firm performs significantly better than its peers. The external environment on the other side reveals both potential growth opportunities related to energy efficiency but also some threats related to foreign competition. Based on the internal and external analysis Firm B has an attractive position in its industry. The findings from this investment case support the hypothesis that Firm B is an attractive investment opportunity. However the relative attractiveness of the firm has to internalize a price discussion, which is suggested as a further step into the acquisition process.

10.3 Summary

This chapter has presented how the investment framework was deployed in practice to find attractive investment opportunities in the Gothenburg area. Following the quantitative screening framework, a large number of firms were condensed into a manageable sample, which could be organized and assessed in relation to the variables including in the framework. After extracting a set of interesting firms, the screening moved into a qualitative phase in which focus is upon the owners' willingness to sell and the firms' dependency on key persons. This screening step resulted in two firms being selected to be studied as investment cases. The investment cases allow deeper analysis of the studied firms and integrate findings stemming from the entire investment framework. It can be concluded that the investment framework sufficed to generate two attractive investment alternatives, albeit an acquisition of Firm A involves further considerations regarding the possibility to perform a successful transaction.

11 Conclusion and Discussion

This chapter presents some conclusions that can be drawn from the work presented in this thesis. It also provides a discussion on what implications the investment framework has for various stakeholders in small firm transactions.

The purpose of this thesis is two folded. First, it stipulates the development of an Investment framework that addresses how attractive small firms can be found in a larger sample of firms, how transactions in small firms ought to be managed and finally, how value can be enhanced in small firms post acquisition. This part of the purpose was addressed in part I of this thesis, which results are summarized and put into context in chapter 9. The second part of the thesis's purpose is to deploy the Investment framework in order to find, analyze and present a few investment opportunities. This part of the purpose was addressed in part II of this thesis, in which two firms that are viable to invest in are presented. In the progress of deploying the Investment framework in practice, its inherent assumptions have been tested. The following sections aim to highlight some insights that surfaced during the practical implication.

Going through the Investment framework in the order it was presented in this thesis, the first stop in this review is the screening framework. During the practical implementation it became evident that the quantitative screening unfolded according to plan, as it effectively separated strong from weak performers and flagged those firms that were associated with a risk. Considering the Privest concept's conditions of finding sound firms with strong cash flow it must be concluded that the quantitative screening framework performed satisfactory. On the other hand, the quantitative screening framework has not been proven under other conditions, for example in a quest to identify potential turn-around investments. Although the quantitative screening in theory should be able to perform under other investment conditions, such application has not been verified in practice. Another observation made during the screening process is that the qualitative screening steps are troubled with information asymmetry. Even though the theoretic ground of the screening framework incorporates the notion that the degree of owner dependency or willingness to sell is hard to anticipate, the practical implementation of the qualitative screening revealed that this problem is to be taken seriously.

When used in practice, the framework for transaction management revealed both strengths and weaknesses. One of the strengths is that the transaction framework lifts forward the issue of owner or key person dependency of small firms. During the process of deriving the two investment cases, the owner dependency of the firms was invariably present and therefore it is arguably one of the main determinants of an investment opportunity's attractiveness. Since owner dependency is seemingly always present in small firms it has to be mitigated by investors. To offset owner dependency using financing arrangement might be a viable approach, but succeeding with such attempts presuppose a rather well developed relationship between seller and buyer. Therefore, another strength of the framework for transaction management is that it highlights the role of the buyer-seller relationship, and its role as a balancing mechanism. On a negative note, the transaction management framework fails to provide any deeper understanding of the possible financial arbitrage that might be realized in a transaction. It is clear that such arbitrage is both theoretically understood and observed empirically, but in practice the transaction framework did not facilitate the anticipation of it.

The framework for value enhancement in small firms performed well during the practical implementation of the screening framework. Its main strength is that it very generic and yet still focuses the analysis at a few areas which have been verified as extra potent in small firms. The downside of having a generic framework is that it demands more of the analyst's attention and energy than a checklist, but as the analysis progressed it became evident that the strength mentioned outweighed this weakness. Regarding the practical use of the framework for value enhancement it must also be commented upon that no financial models were built to test assumptions, leaving some parts of the framework unutilized. Such financial models were left out of the investment cases since not enough verified data could be gathered to base assumptions on. However, this does not mean that part of the framework covering financial modeling is obsolete. If taking steps closer to an acquisition through a due diligence, data will become available and the value enhancement framework can be applied to test assumptions made in the acquisition process.

Taking an all-encompassing perspective on the implementation of the Investment framework to find a few investment opportunities, it can be concluded that the Investment framework could logically be integrated into the investment case. It can be understood if the investment case as a concept might appear as abstract for a person that is not acquainted with the Investment framework presented in this thesis. If so, it is recommended to think of the implementation of the Investment framework as an attempt to prove or disprove a hypothesis regarding each studied firm, as explained in section 9.2. On a similar note, it is important to notice that although this thesis apply the Investment framework on a larger sample of firms in order to find viable investment opportunities, the framework can also be applied to individual firms. This is important to point out since investment professionals typically do not use screening methods, but continuously analyze opportunities that emanate in their networks.

Upon concluding that the developed Investment framework at an overall level can aid investors seeking attractive investment opportunities in small firms, it need to be pointed out what implications the Investment framework has for various stakeholders. Three stakeholder groups with a direct interest in the Investment framework are investors, small business owners and academia. In the following sections, the implications for these groups that arise from the Investment framework will be discussed.

For investors, the proposed Investment framework provides guidance in the process of finding, assessing and managing direct investments in small privately owned firms. The rationale for using the developed framework in such investment processes lies in that small firms differs from general private equity investment, that are typically made in firms that have a more tested rasion d'etre and that are not subject to significant owner or key person dependence. Moreover, it is worthwhile to note that an investor in a small firm not necessarily must be a financial investor. Industrial investors are also likely to acquire small firms and although their investment criteria might differ somewhat from what has been discussed in this thesis, the investment framework can contribute to their acquisition processes, predominantly through the frameworks for transaction management and value enhancement.

On the opposite side of a transaction in small firms we find the small business owners. This group can benefit from the development of the Investment framework in two ways. First, using the framework for transaction management incorporated in the investment framework stipulates a pragmatic problem solving approach rather than unrelenting negotiation. Through mutual acknowledgement of the other party's needs, both parties are supposed to come well out of the transaction. Furthermore, a second perceived benefit of enabling a more nuanced transaction process in small firms is that more transactions are made, and thus the aggregated knowledge regarding small firm transactions will grow. Ultimately, increased knowledge of transactions in small firms will lead to more investors pursuing investments, and with them more capital entering the small business domain.

The transfer of ownership of a small firm between a seller and buyer is not only of interest for the transactional parties. Academia also takes interest in studying small firms, and transactions thereof, from several different angles of incident. A first interesting aspect of this thesis, from an academic perspective, is therefore that it draws on many different academic areas to develop the Investment framework, resulting in a cross breed of different ideas and research streams. Another interesting aspect of this thesis is that it not only develops a theoretically appealing Investment framework; the proposed framework is tested in practice, which reveal both strengths and weaknesses that are of interest for academics since it provides directions for further research.

The deployment of the Investment framework highlighted two areas in particular that are interesting to study. First, small firms' dependence on owners or other key persons is a major obstacle for transactions in small firms. Therefore, a better understanding of how such dependence inhibit transactions outlines a research agenda that can be addressed from several academic viewpoints. Second and lastly, there is theory that explains the reason for financial arbitrage to be realized due to emotional values in small firm transactions and additionally, there are empirical observations that support this theory. On the other hand, it was proved rather hard to anticipate such financial effects in practice. Thus, a second interesting avenue of research can aim to explain the financial arbitrage that stem from emotional values in small firms, and ultimately provide a model that can be used to anticipate financial effects in practice.

12 References

The following references have been used in the research presented in this thesis.

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13 Appendices

The following appendices contain information that is supportive for the research performed in the thesis.

Appendix I: Interview respondents

The following interviews have been carried out within the progress of writing this thesis.

Small business owners

Kjell Andersson, CEO and owner, Grimmereds verkstad AB (Göteborg, 2012-04-14)

Håkan Berglund, CEO and owner, Tollor AB (Göteborg, 2012-03-14)

Lotta Hallbeck, Vice president and owner, Microbial Analytics Sweden AB (Mölnlycke, 2012-03-21)

Karsten Pedersen, CEO and owner, Microbial Analytics Sweden AB (Mölnlycke 2012-03-21)

Henrik Pålsson, CEO and owner, CM Hammar AB (Göteborg, 2012-03-28)

Non-disclosed name, CEO and Owner, Firm 1 (Göteborg 2012-09-18)

Non-disclosed name, CEO and Owner, Firm 2 (Göteborg 2012-09-18)

Private equity professionals

Britta Ersman, Head of private equity, Andra AP-fonden (Göteborg, 2012-04-18)

Richard Glückman, Business analyst, Nordic Capital (Stockholm, 2012-05-31)

Mattias Molin, Venture manager, Traction (Stockholm, 2012-06-04)

Anders Nyberg, Investment manager, Procuritas (Stockholm, 2012-06-04)

Lars Rutegård, CEO, Nischer (Stockholm, 2012-06-05)

Transaction (M&A) specialists

Mats Axell, Founding partner, Censor M&A (Göteborg, 2012-05-24)

Andreas Karlsson, Associate partner, IMAP (Göteborg, 2012-05-18)

Svante Rösman, Founder, M&A Networks (Göteborg, 2012-05-11)

Johan Forsén, Transaction director, Skarpa (Göteborg, 2012-05-15)

Management consultants

David Hallgren, Manager, Accenture Strategy (Göteborg, 2012-06-20)

Fredrik Wincrantz, Consultant, Burson-Marsteller (Stockholm, 2012-06-01)

Appendix II: Interview Guide

This appendix contains an example of the interview guide that was used throughout the semi-structured interviews with private equity professionals, M&A specialists and management consultants. During interviews, the interview guide emphasized some topics more than others.

PRIVEST 2012: Intervjuguide

Datum:
Företagsnamn:
Intervjurespondent:
Syfte:

Välja bolag

Hur identifierar ni potentiella investeringsobjekt?

Vilken är den vanligaste kanalen för att hitta investeringsobjekt?
Vilka relativa för och nackdelar ser ni med dessa?

Hypotes 1: Databaser
Används databaser för att gallra fram potentiella ”targets”?

- Vilka?
- Vilken data eller information är viktig i databasen vid gallring?

Hypotes 2: Företagsmäklare
Använder sig PE-firmor av företagsmäklare för att hitta intressanta ”targets”?

- Vad är fördelarna respektive nackdelarna med denna kanal?
- Vilka företagsmäklare använder ni er av?
- Vad är avgörande för ert val av företagsmäklare och vad gör dem bra
    - Geografi: lokala, nationellt täckande
    - Funktioner: exempelvis BackOffice

Hypotes 3: Genom kontakter och nätverk
Finns det några formella nätverk man kan vara medlem i?

- Hur etablerar man sig i de informella nätverken?

Vad är ett attraktivt investeringsobjekt?

Hypotes 1: Industrirelaterade faktorer
Vilka faktorer är intressanta på industrinivå?

Exitstrategier
Hur påverkar möjligheterna till att göra en exit investeringsbeslutet?

- Förändras något om vi förlänger investeringshorisonten?

Vad krävs för att göra en exit?

I vilka fall påverkar svårigheten att göra en exit ert investeringsbeslut?

- Vilka typer av bolag är generellt sätt inte säljbara?
  - Vilka faktorer är viktiga att identifiera här?

Industritillväxt
Hur mäter man industritillväxt?
- Vilka nyckeltal bör man fokusera på? Varför?
- Hur värderas tillväxt mot andra faktorer?
- Vad är god tillväxt enligt er?
- Är det en viktig faktor?

Finansiellt Arbitrage
Spelar möjligheten till finansiellt arbitrage någon roll i investeringsbeslutet?
- Hur vägs det in med övriga faktorer?
- Vad gäller för småbolag?

Hypotes 2: Bolagsrelaterade Faktorer
Vilka faktorer är intressanta på företagsnivå?

Lönsamhet
Hur mäter man lönsamheten?
- Vilka nyckeltal bör man fokusera på? Varför?
- Vilka nivåer är attraktiva?
- Hur värderas lönsamhet mot andra faktorer?
- Är det en attraktiv faktor?

Professionell management
Vilka kvaliteter söker PE-bolag efter hos ledningen för potentiella "targets"?
- Hur värderas ledarskapet mot andra faktorer?

Vilken roll har ett väl fungerande styrelsearbete och ledningssystem?

När väljer ni att själva sätta in egen ledning och vilka kvalitéer bör dessa personer ha?

Möjligheter för värdedrivande aktiviteter
Vilken roll spelar möjligheterna till förbättringar när en potentiell investering analyseras?
- Hur värderas förbättringsmöjligheter mot andra faktorer?

Balansräkning
Kollar ni något i balansräkningen för att välja ”targets”?

En catch-all fråga:
Vad är det viktigaste att tänka på när man analyserar potentiella investeringar?

Transaktionsrelaterade frågor

Ägarstruktur, relationer och företagsledning

Hur kan ägarstrukturen påverka en företagsöverlåtelse?
- Vilka effekter har det på förhandlingen?
- Vilka problem medför dålig kommunikation och bristande förtroende mellan ägarna?
  - Kan man urskilja vissa egenskaper som föranleder detta?
  - Kan ett PE bolag överbrygga sådana bekymmer och på vilka sätt?

Hur kan organisationsstrukturen påverka överlåtelsen?
- Hur kan en extern VD eller icke-ägande företagsledning påverka en överlåtelse?
  - Vad är implikationerna av detta?

Hur viktig är en väl upparbetad successionsplan för en smidig transaktion?
- Vilka typer av problem kan uppstå vid en överlåtelse om ägaren/ägarna ej förberett sig på en sådan?
- Hur kan ett PE bolag hjälpa till vid sådana problem?

Förhållningssätt som köpare

Hur bör man som köpare uppträda då man närmar sig ägare av småbolag?

Hur, om ens, kan PE bolag jobba för att öka säljarens förtroende i en transaktion?
- Hypotes: Köparen kan påverka ägarens förtroende och därmed vilja att sälja genom att förklara sina tänkta strategier och diskutera dessa med ägaren
- Hypotes: Köparen kan öka ägarens förtroende genom att tillmötesgå ägarens emotionella värden

Är det vanligt att man erbjuder ägaren att vara kvar i företaget efter försäljningen?
- I vilken form?
- Vilka är fördelarna samt nackdelarna?

Ägarberoende

Hur kan man jobba för att motverka ägarberoendet i potentiella ”targets”?

Extern hjälp

Vilka tjänster bör man ta in externt vid en transaktion?
- Varför är just dessa viktiga?

Värderingsfrågor och prissättning

Hur förhandlas priset på företaget?
Vilka finansiella faktorer är väsentligast för ägaren när priset diskuteras?
Tas hänsyn till ägarnas emotionella värden (positivt/negativt) vid en förhandling?

- Hur hanteras det när priset diskuteras?
- Vilka typer av värden försöker man oftast få med som säljare?
- Hur hanteras olika ägares disparata inställning till vad som skall ingå i värderingen?

Annat

Uppfattas transaktioner med mindre bolag som mer kostsamma då de inte har sina "books in order"?

- Är detta ett faktiskt problem?
- Är detta en anledning till att PE-industrin generellt sett inte är närvarande bland de små bolagen?

Hur hanterar man möjlig problematik kring svarta pengar, mutor etc.?

- Hur kartlägger man detta och hur jobbar man för att undvika det?

Hur viktigt är det att hålla koll på nyckelanställda och försäkra att en transaktion inte medför flykt av viktiga resurser?

- Ifall nyckelanställda väljer att lämna, hur överbryggar man det gapet?

Subsequent development of portfolio companies

Development opportunities

Vilken typ av förbättringsmöjligheter brukar vara enklast att uppnå?
Vilken typ av förbättringsmöjligheter brukar vara svårast att uppnå?

Finansiellt arbitrage

Hypotes: Många samtida rapporter antyder att tiden är förbi då man enkelt kunde uppnå en värdeökning genom finansiellt arbitrage.

Hypotes: Småbolagsägare kan släppa på priset emot att köparen möter dess emotionella värden.

"Financial engineering"

Vilka möjligheter brukar finnas att optimera kapitalstrukturen hos portföljbolag (*så att bolagets kapitalkostnad efter skatt minimeras*)?

- Hur man jobbar med dem etc.?

Förbättrad operationell effektivitet

Vilken sorts operationella förändringar bör man fokusera på i små bolag?

- Höja intäkterna?
- Skära i kostnaderna?
- Minska operationellt kapital?

Brukar någon av ovanstående vara svårare/lättare?
Hur ser PE-bolagen på att adressera ovanstående områden parallellt?
Hur adresserar man ineffektivt ledarskap?

Ökat strategiskt fokus
Hur arbetar PE-bolag med strategiska frågor hos portföljbolagen?

Hur viktig är en strategisk plan för utveckling av portföljbolag?

- Hur reflekteras det i investeringsbeslutet?
- Vad gör man mer konkret?

Reducerad "agency cost"
Hur kan man angripa denna fråga i praktiken?

Är det relevant att utföra förändringar som inte leder till en faktisk kostnadsreduktion?

Mentorskap
Hur arbetar PE-bolag med mentorskap i portföljbolagen?

- Hur stöttar man ledningen/mellanchefer/anställda?
- Används mentorskap som en informationskanal för återkoppling/vertikal kommunikation?

Hypotes: Utvecklingsprojekt bör genomföras i en specifik ordning
I vilken kronologisk ordning bör de ovan nämnda områdena adresseras?
Finns det situationer då förändringar på något av dessa områden inte borde eftersträvas?

Catch-all fråga
Vad är det enklaste sättet att öka värdet på ett portföljbolag relativt arbetsinsatsen?
Om du fick välja ett utvecklingsområde att göra ett projekt på, vilket skulle det vara?