CHALMERS

The Establishment of Private Equity in Sweden

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

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Göteborg, Sweden, 2012
Report No. E 2012:012

MASTER'S THESIS E 2012:012

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Chalmers Reproservice
Göteborg, Sweden 2012

Abstract

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The institutionalization of private equity is perhaps one of the most important advances in the field of modern finance and the private equity market is an important source of funds for start-ups, private middle-market companies, firms in financial distress and public firms seeking buyout financing. Swedish risk capital companies do today globally own 850 companies employing 850 000 persons with aggregated revenues of SEK 250 billions. The purpose of this thesis is to understand and explain how the private equity industry emerged in Sweden and to explain the establishment during the 1980s and 1990s.

The results and conclusions of the thesis are based on a literature review and on primary data mainly collected through interviews with people with an insight in the early private equity industry in Sweden. The literature review focuses on the origination of private equity in the U.S. and in the U.K., the impact of the deregulation of the Swedish financial system and financial technology development. Theory regarding private equity success factors, entrepreneurship and transaction costs is also presented. The interviews especially contributed to a detailed mapping of the origination of private equity in Sweden and an understanding of the key driving forces.

The thesis presents a relatively unchallenged course of event mapping for the introduction of private equity in Sweden. Several factors have been identified as relevant to the introduction of private equity. The most important are inspiration from the U.S., the deregulation of the capital market in Sweden and the positive economic climate in Sweden at the time. There are also several reasons that were important for the early growth of the industry. These are pension funds investments, the OTC-list, divestures of conglomerates and the success of early private equity funds.

Key words: Private equity, Sweden, Establishment, Industry Growth, Industry Drivers, Private Equity Success Factors

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List of Abbreviations

EBIT	Earnings Before Interest and Tax
GP	General Partner
LBO	Leveraged Buyout
LP	Limited Partner
IPO	Initial Public Offering
MBO	Management Buyout

General Comments

The term private equity has multiple meanings; in the literature it is both referred to as all non-public equity as well as the quite specific financial model of interest in this thesis. To avoid misunderstanding in the thesis, private equity refers to the financial model and the term non-public equity is used as for the rest.

2 Introduction

The following section presents the problem formulation of the thesis as well as it presents a brief background on the topic including a motivation of the research.

2.1 Background

The institutionalization of private equity is perhaps one of the most important advances in the field of modern finance (Cendrowski et al, 2008). The private equity market is an important source of funds for start-ups, private middle-market companies, firms in financial distress and public firms seeking buyout financing. It is one of the fastest growing markets for corporate finance, over the history far surpassing others such as public equity, bond markets and the market for private placement debt (Prowse, 1998). The most celebrated aspects of private equity is the investments in small often high-tech firms and these investments often fuel explosive growth. For example, Microsoft, Dell Computer and Genentech all received private equity backing in their early stages. The private equity market also supplied equity funds in the huge leveraged buyouts of large, famous companies such as Safeway, RJR Nabisco and Beatrice in the 1980s.

Private equity is clearly a fascinating industry that has changed the global economic landscape. Today private equity firms have a large influence across industries all around the globe and at the industry peak before the financial crisis about USD 700 billion was invested per year, a value roughly equal to the size of Mexico and India's nominal gross products. Add to this that private equity firms in 2010 had about USD one trillion in dry-powder - id est capital in funds available for private equity firms to invest - providing a significant influence in the world economy. Swedish risk capital companies do today own about 850 companies, which globally employ 850 000 persons. The Swedish companies that are owned by risk capitalists have aggregated revenues of SEK 250 billions. However, the development of the industry in Sweden has been impressively rapid. During the 1980's, the business model arrived from nothing and has developed into an essential economic force in Sweden and does today receive daily attention in media. But there are still many questions regarding the establishment of private equity in Sweden that remain unanswered. Why did private equity emerge in Sweden when it did? What economic factors are of importance to explain the establishment and the early growth of the private equity industry? These questions have not yet been addressed previously in Swedish economic research and this highlights the relevance of this thesis. Moreover, one question is under constant debate in the industry: who was it that actually introduced private equity in Sweden?

2.2 Purpose and Aim

The purpose of this thesis is to understand and explain how the private equity industry emerged in Sweden. The aim is not only to describe the event history but also to understand the underlying driving factors of why it appeared. The objective of the thesis is to answer the following question:

- How can the establishment of private equity in Sweden during the 1980s and 1990s be explained?

2.3 Limitations

The report aims to provide trustworthy conclusions on the establishment of private equity in Sweden and the key drivers stimulating it. However, due to limited amount of available data and previously performed research, the results are dependent on qualitative interviews. A large number of potential interview candidates were approached on behalf of the thesis, but the results are based on the input from those that were wiling to contribute to the research. Furthermore, the thesis does not aim to exactly quantify and measure certain key drivers inter-mutual relevance since this work would be quite extensive; rather it aims to present a logical mapping of the introduction and a likely event story.

2.4 Structure of the Report

Chapter 2: Describes the procedure of the research and provides transparency of the work.

Chapter 3: Aims to provide the background necessary to understand the thesis topic as well as presenting the theoretical framework used for the conclusions of the paper.

Chapter 4: Presents the gathered empirical results of the research with data collected both from interviews and literature sources.

Chapter 5: Analyses the material obtained in the previous sections of the thesis. It is structured to be able to answer the purpose of the thesis.

Chapter 6: This section presents the conclusions of the thesis based on previous sections of the report.

3 Methodology

The following sub-section describes the procedure of the research and is important to provide transparency of the work.

3.1 Choice of method

According to Kumar (2005) there are three different ways a research can be characterized; what application it has, what the objective is and what inquiry mode the research is intended to have. The application of this research is rather pure than applied, meaning that it is defining something new instead of using other pure research to understand a phenomenon.

The next step is to define the objective of the study. The objective of a study can be divided into four different categories; descriptive, correlational, explorative or explanatory. The descriptive study is systematically describing a situation or the object of research. The correlational study explains the correlation between two different variables, which are linked together with a cause and affect objective. The third type of objective is the explorative study that often is used when there is limited knowledge about the subject and the aim is to define what next actions that need to be taken (Wallen, 1996; Kumar, 2005). The fourth type of objective is the explanatory research, which tries to explain the relationship between two different aspects and how they affect an outcome (Kumar, 2005). This research is descriptive since it aims to describe a historical event story but also correlational, since it attempts to understand the correlation between different changing societal variables and the growth of private equity in Sweden.

The next step is to describe the inquiry mode; that is if the research is a qualitative research or a quantitative research. According to Andersen et al, it is important to clarify that the two different types are not two different methods but rather two types of the same method (1994). The quantitative research is structured and the qualitative research is unstructured. The quantitative research is measurable and the result is often presented numerically. The qualitative research is not measurable (Andersen et al, 1994). This thesis is mostly qualitative due to the limited amount of data available on the topic. The next step, after this research, would be to perform a more quantitative study.

3.2 Work process

This section presents the work process of the thesis and tries to increase the transparency of the work by enhancing the understanding of the research approach.

3.2.1 Background & Research Process

The thesis was initiated through a dialog with *Christian Sandström*, PhD in Innovation Management from Chalmers University of Technology, Gothenburg, Sweden. Christian Sandström's research concerns technological shifts and how they change industries. A discussion regarding the potential impact of technological innovation on the origination of new business models such as private equity led to an interest in the research topic. Furthermore, the rise of new, disruptive industries is an important part of the global economy and a very limited amount of data was available on the upsurge of private equity. When conducting an investigation it is of importance to understand the problem and its implications which will determine what theories and methods to apply (Wallén, p. 45, 1996). Therefore the problem formulation presented in Secton 2 as well as the chosen method were discussed and adjusted in cooperation with thesis supervisor Christian Sandström.

The first part of the research was a literature review on the topic. The aim was to collect all available and relevant secondary data. Secondary data is information gathered and compiled by others and can be exemplified by a number of different sources such as articles, literature and annual reports (Lundahl et al, p 37, 1992). This helped to provide a background on the topic as well as to identify existing information gaps. This work was of great aim in understanding the topic and determining interviewees to include in the research. The second part consisted of collection of primary data primarily from interviews. Primary data can be defined as first hand data, information and observations that a researcher gathers directly from the subject that are surveyed (Lundahl et al, p 37,1992). This part focused on directly answering the problem statement and filling the existing knowledge gaps. The third part consisted of collecting more secondary data based on the interviews to be able to understand the viewpoints of the interviewees. The fourth part of the process was the compilation and analysis of results. It consisted of discussion and triangulation of results with relevant interviewees. One should note that the results are mainly based on qualitative considerations and do not aim to prove a certain factor's relevance on the introduction of private equity in Sweden; rather it intends to discuss potential influencing factors as well as providing an overview of the topic and build up a logical mapping of the origination of private equity in Sweden. The conclusions of the thesis are based on the results of the analysis.

3.2.2 Theoretical Framework

The theoretical section will start of by presenting a theory of what private equity is and definition of important concepts. The rationale behind this sub-section is that the private equity model is a relatively unfamiliar concept among common men and that it also important to define private equity in able to facilitate the discussion of its origin later on in the thesis. Private equity is complex and has been developed rapidly since its invention. It is also closely connected with other types of risk capital and the difference between private equity and venture capital is for example quite vague.

Moreover, general success factors of private equity are discussed. The purpose of this section would be to understand what factors that generally stimulate private equity and then try to understand the economic climate in Sweden before and during the introduction of private equity to see if any changes played a vital role in private equity's origination. The aim is to be able to use these as a guide in the discussion of what have facilitated private equity in Sweden.

Furthermore, a section describing technological innovation in the financial sector in the Nordic countries was included with the aim to understand its potential affect on private equity origination. A discussion of transaction cost and financial transaction costs was undertaken to understand their potential effect on private equity development. Theory regarding entrepreneurship is also explained to be able to understand the degree of entrepreneurship involved in the private equity introduction. A brief background of the deregulation of the financial markets in Sweden is also included. Discussion of potential effects by the deregulations provided by other researchers will also be provided to understand its impact. The changes in pension management regulations are also presented. Furthermore, a literature review of the background of private equity in the U.S. and in the U.K. was undertaken. The aim was to briefly understand how and when private equity was introduced in other early countries. The reasons why it is of interest to understand the history of the U.S. private equity industry was since private equity originates from the U.S. and also that there are much more information available on private equity development/origination in the U.S. compared to its Sweden equivalent. Private equity was also introduced in the U.K. before it came to Sweden and some interviewees claims that some inspiration came from the U.K..

3.2.3 Empirical Research and Analysis

This section aims to present all the primary data gathered in the research together with some secondary data connected to the topics. As mentioned, a second round of interviews helped validating the results and filled gaps. Interviews and literature were also used to determine the main drivers of the private equity introduction. Focus was put on the interviews and therefore, it was important to obtain objective interviewees. The spread of interviewees was therefore wide including individuals involved in the introduction as well as academics that have performed research related to the topic and represents of risk capital trade organizations (See list of all interviewees in the sub-section Data Collection). The last stage in the work process was to analyse all collected primary and secondary data and draw conclusions. The results and conclusions was processed with supervisor Christian Sandström and also triangulated in the second round of interviews.

3.3 Data Collection

Data was collected form several sources and multiple sources has validated data used for important conclusions of the thesis. When performing data collection it is important that the measurement is valid and reliable. Validity means it is important to measure what is to be measured (Wallén, p. 65-67, 1996). Validity is ensured by clearly defining what is to be measured and detailed planning before data collection. Reliability means that the method used for the data collection should not give random errors (Wallén, p. 66, 1996).

3.3.1 Primary Data

Most of the primary data collected in the research consists of interviews. Interviews are one of the most important sources of information when collecting data for a case study (Yin, 1994). The interviews were semi-structured in the sense that a flexible interview process was used. A flexible interview process allows new questions to be brought up during the interview as a result of what the interviewee says but that the interviewer generally has a framework of themes to be explored. The interviews were held in two rounds. The first round included a large variety of interviewees with different point of views on the research field ranging from economic historians to Swedish private equity entrepreneurs. The aspiration have been to rather perform a fewer number of high-quality interviews than to strive to do as many interviews as possible. The second round consisted of follow-up interviews that aimed to triangulate the data as well as it tried to challenge standpoints and fill remaining information gaps. No new interviewees were included in the second round.

Below follows a presentation of all interviewees together with the rationale of why they were included in the research.

Mikael Ahlström, founder of one of Sweden's first private equity firm Procuritas and the man behind the first leveraged buyouts in Scandinavia. INSEAD has named Mikael Ahlström one of the 50 alumni "who changed the world" due to this contribution.

Christer Dahlström, co-founder, partner and executive chairman of Priveq, one of few Swedish private equity firms left from the 1980s. Mr Dahlström was also involved in the start of IK Investment and Nordic Capital, two of the first private equity companies in Sweden.

Sven Fritz, professor emeritus at the Department of Economic History at the Stockholm University. Sven Fritz has done research related to the thesis topic and contributes with the general knowledge of Swedish economic history. He is also the author of the article *Mobiliseing av riskkapital i historiskt perspektiv*.

Håkan Lindgren, Professor of Economic History at Stockholm School of Economics since 1995 and head of The Institute for Research in Economic History. Håkan's background as an economic historian combined with his vast knowledge of financial markets was considered as extremely contributing.

Jonas Rodny, Communications Manager at the Swedish Private Equity & Venture Capital Association. Represented the trade association of private equity in Sweden, an organization that has followed the development of private equity closely for many years.

Stefan Sjögren, Assistant Professor/lecturer at the Department of Business Administration at the School of Business, Economics and Law, University of Gothenburg, Sweden. His research includes a broad range of corporate finance related topics.

Per Strömberg, Professor of Finance and Private Equity at the Stockholm School of Economics. Per is considered a world-leading researcher within finance and the hope was that his in-depth knowledge of the industry could help fulfill the purpose of the thesis.

3.3.2 Secondary Data

A variety of sources were used; among them are books, databanks with relevant articles, Internet searches and interviews performed by external researchers. A critical approach was especially held regarding Internet sources and the information gathered from this source had to be validated by other sources to be included in the thesis.

4 Background & Literature Review

This section aims to provide the background necessary to understand the thesis topic as well as presenting the theoretical framework used for the conclusions of the paper.

4.1 Important Definitions regarding Private Equity

This subsection aims to provide a brief understanding of the concept private equity. There exist a large variety of different ways of defining private equity and a selection of them will be presented here to provide a brief understanding of what private equity is. The European Private Equity and Venture Capital Association defines private equity in the following way:

> "Private equity is the provision of equity capital by financial investors – over the medium and long term – to non-quoted companies with high growth potential…Private equity covers not only the financing required to create a business, but also includes financing in the subsequent development stages of its life cycle. When financing is required by a management team to buy an existing company from its current stakeholders, such a transaction is called a buyout... Private equity and venture capital may refer to different stages of the investment but the essential definition remains the same: it is the provision of capital, after a process of negotiation between the investment fund manager and the entrepreneur, with the aim of developing the business and creating value… Private equity firms have a main goal: seek out companies with the potential for growth and with the aim to put in place the capital, talent and strategy needed to permanently strengthen the company and raise its value".

The European Commission has written the following definition: "Private equity is the provision of capital and management expertise to companies in order to create value and subsequently, with a clear view to an exit, generate capital gains after a medium to long holding period" (p. 9, 2006). They continue by stating that the term private equity (in this thesis called non-public equity) is very broad and often include venture capital, expansion capital and buyouts but buy-outs are what usually are considered as private equity. Venture capital and expansion capital is known under the term venture capital, which can be seen in Figure 1 (European Commission, p. 9, 2006). Venture Capital firms do typically invest in young or emerging companies, and typically do not obtain majority control. The European Commission continues by defining buyouts as majority investments made in companies together with existing management or with a new management team. These normally use sophisticated financial techniques that involve bank financing. Buy-out funds do not focus on any one industry (p. 10, 2006).

Europe	Venture Capital	Expansion Capital	Buy-outs
United States	Venture Capital		Private Equity

Figure 1 Overview of the Private Equity (Non-Public Equity) Industry

4.1.1 The private equity business model

The European Private Equity and Venture Capital Association has presented the private equity business model described below. It is presented in Figure 2 and can be broken down into four main phases.

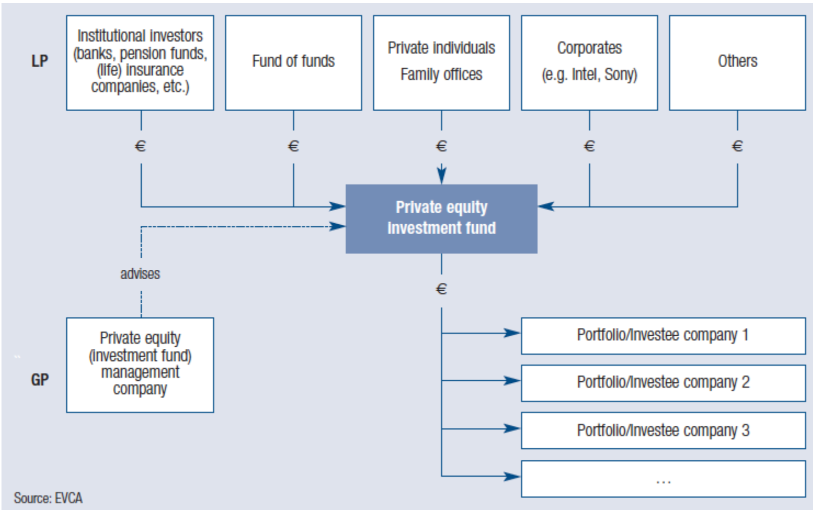


Figure 2 The Private Equity Business Model

1. **Creation of a fund and underwriting by professional investors:** Private equity firms (known as General Partners (GPs) establish investment funds that collect capital from investors (known as Limited Partners or LPs). The private equity firms use this capital to buy high-potential companies (known as the portfolio on investee companies). Thus, private equity fund managers invite institutional investors and individuals with particular expertise to subscribe to an investment fund for a set period (on average ten years). As investment funds are for the most part closed, the Limited Partners cannot leave those funds before their term. This financial stability is one of the clear advantages for the entrepreneur who seeks s private equity investment. The Limited Partners receive a pre-negotiated stake in the equity of the investment fund and they become fully-fledged shareholders. Limited investors are usually pension funds, fund of funds, corporates etcetera. The capital supply of Swedish private equity funds is presented in Figure 3.

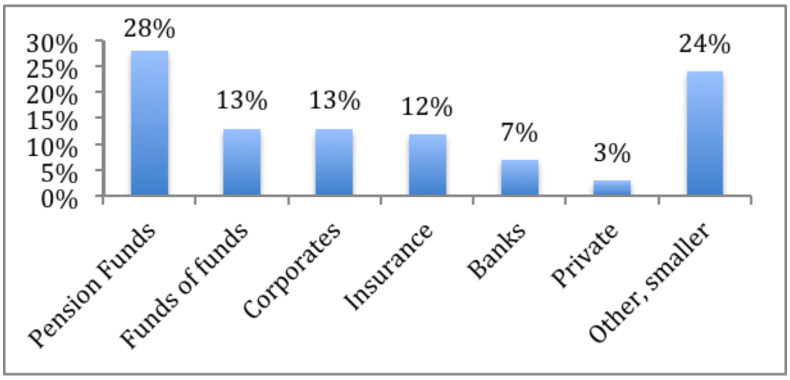


Figure 3 Swedish Private Equity Funds Capital Supply (Source: SVCA)

2. **Investing the fund:** Once the target amount of capital has been raised, the subscription is closed. The private equity managers then seek high-growth companies to invest in, following the investment strategy they proposed to the Limited Partners. The average global private equity fund size in 2006 was €322 million. The private equity management team essentially makes investments in the first five years of the fund.
3. **Managing the investment:** The fund managers run their investment operations and prepare exit strategies depending on market conditions, agreements drawn up in advance with the entrepreneurs and opportunities for disposal. Because the fund manager on behalf of the investors is concerned with creating value in the company, he will follow his investment over the long term and will participate in any subsequent rounds of financing required.
4. **Redistribution:** When fund managers decide to exit their investment, the capital recovered from the exit is redistributed to the original investors on a pro-rata basis depending on the size of their initial investment. These reimbursements, along with the capital gains allow the Limited Partners to honour their insurance contracts, pensions or savings deposits. Limited Partners are looking for significant profit from their investment to compensate for the fact that their capital is tied up for long and to ensure that they can reimburse the money allocated to them by their clients.

Private equity firms today are generally referred to as leveraged buyout investment firms (Kaplan & Strömberg, 2008) Leveraged buy-outs (LBOs) are defined as the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital. In an LBO, there is usually a high debt to equity ratio. Because of this high ratio, the bonds are usually not investment grade and are referred to as junk bonds (Investopedia).

4.2 Theoretical Private Equity Success Factors

To understand why the Private Equity industry was established in Sweden, this section will present theory and previous papers regarding what factors that attract private equity to a certain country. According to Groh et al in their paper "The European Venture Capital and Private Equity country attractiveness Indices", the most important factors are the protection of investors and the size/liquidity of the capital markets as well as the availability of adequate investment opportunities. They write that institutional investors everywhere allocate their capital via chains of agents and networks in certain regions, and among certain countries. Usually, there is a concentration in 'hotspots' or core economic centres. These hotspots evolve mainly for two reasons. First, there is a professional community to support transactions, and to promote the flow of capital. Second, there must be expectation for demand of the committed capital (2009). Groh et al have done an in-depth analysis of the available research regarding key factors determining the existence of venture capital and private equity in a country. These factors, together with other factors suggested by the literature review, are presented and explained in detail below.

4.2.1 Economic Activity

The state of a particular country's economy affects the private equity activity since pure economic size is an indicator for the body of corporations and deal flow opportunities in general. Economic growth should also lead to demand for finance. (Romain, Van Pottelsberghe de la Potterie, 2004) Nowadays private equity is cyclical and significantly related to GDP growth. For example GDP, price levels and working force could be used as measures of economic activity (Romain, Van Pottelsberghe de la Potterie, 2004). Ahlström et al writes that an active LBO market is characterized by a large and developed economy, the larger the role in economy of conglomerates and by any trends of de-nationalization and de-conglomeration (p. 10, 1986).

4.2.2 Capital markets and liquidity of stock markets

It is important for a market to have a well-developed stock market that permits exits through an IPO for private equity to exist (Black & Gilson, 1998). Mikael Ahlström et al writes that "the sophistication of the country's capital market is critical in aiding the development of a significant LBO market, particularly in facilitating exit and realization of earning or capital gains for providers of risk capital…Clearly, the more developed the public exchange, and particularly an "over the counter" (OTC) market for smaller capitalizations, the more confidence the risk capital provider will have of a timely out". Cetorelli and Gamera (2001) writes that bank concentration promotes the growth of those industrial sectors that have higher need for external finance by facilitating credit access to younger companies (2001). In general, bank-centred capital (opposite to stock market-centred capital markets) markets show less ability to produce an efficient private equity structure. It is also the secondary institutions, including the bankers' conservative approach to lending and investing and the social and financial incentives that reward entrepreneurs less richly and penalize failure more severely, that compromise economic activity (Jeng & Wells, 2000). Studies show that risk capital flourishes in countries with deep and liquid stock markets. It is also said that the number of potential transactions plays a vital role in making a region attractive to private equity investments for limited partners. Measures of capital and stock market liquidity could be IPO volume of GDP, stock market capitalization and central bank discount rate (Kaplan & Schoar, 2005) (Schertler, 2003) (Chemla, 2005).

4.2.3 Taxes

Two types of taxes do primarily affect the venture capital industry; those directly related to the asset class (e.g. taxes on dividends and capital gains) and those with an impact on corporations and entrepreneurship (e.g. corporate taxes) (Gompers & Lerner, 1998). The direct impact on private equity is more difficult to understand. Low tax rates decrease the value of tax shields in debt financed transactions but tax factors have probably not played a vital role in the development of private equity, but rather in the development of venture capital (Cullen & Gordon, 2002).

4.2.4 Investor Protection

Legal structures and the protection of property rights also appear to influence the attractiveness of a private equity market. The legal environment strongly determines the size and extent of a country's capital market and local companies' ability to receive outside financing. The cost of capital is also lower for companies in countries with better investor protection, which of course is favourable for private equity activity (La Porta et al., 1997 and 1998).

4.2.5 Human and social environment

Labour regulation is especially affecting venture capital but have a potential impact on the private equity climate in a country. According to Groh et al, the higher rigidity, and the lower the private equity activity.

4.2.6 Entrepreneurial opportunities

Entrepreneurial opportunities affect the access to viable investments, which is very important for a region to be a strong private equity region. The total number of companies in an economy is an important factor affecting the private equity industry. Privatization is also a factor stimulating private equity (Groh et al, 2009).

4.2.7 Information/ awareness:

The concept of an LBO is not necessarily obvious or natural; managers might not even consider the option of an LBO, particularly given the unique financing strategies, which have developed. LBO activity therefore to some extent depends on a widespread knowledge of the LBO as an option by which managers may own their business they run (Ahlström et al, 1986).

4.3 Entrepreneurship

Joseph Schumpeter defines an entrepreneur as a person who is willing and able to convert a new idea or invention into a successful innovation. The term entrepreneur originally denoted anyone who undertook a project, and it subsequently grew to mean a merchant, employer or manager (Herbert and Link, p. 45-46 1988). Schumpeter argues that entrepreneurial rewards flow from the temporary monopoly rents that arise when the entrepreneur successfully carries out "new combinations" (p 84, 1942). Schumpeter, as referred to by Mourdoukoutas (1999), treated entrepreneurship as a distinct and separate function of the firm and identified five ways of revolutionising the pattern of production:

1. The development of a new product, i.e. a product never introduced before, or the substantial improvement of quality of an existing product
2. The discovery of a new production method. The term discovery does not necessarily mean scientific discovery but the genuine application of an existing method to an industry.
3. The discovery and exploitation of a new market. The term discovery does not necessarily apply to a new geographical market or an unknown market, but rather a market that an industry has not explored before.

4. The discovery and exploitation of a new source of supply of raw materials. Again the term "discovery" does not necessarily apply to new geographical resource market or an unknown resource, but rather a resource that was never used in a certain industry.
5. The discovery/development and implementation of a new way of organization.

Overall, innovating new and improved goods and services, new and expanded markets, and improved production methods, organizational structures, and supply sources were the functions that Schumpeter attributed to the entrepreneur. He also implied that it is itself an innovative act to find a new place in which to use an invention (Baumol et al, 1993).

It is also of importance to discuss what it is that determines innovation. In Robert Solow's famous Nobel Prize winning model, innovation is like manna from heaven; something that policy makers cannot control. Although they may modestly influence it by way of government-funded research or incentives for research and development, the pace of innovation is essentially taken as a given. A growing number of economists have been uncomfortable with that assumption, and over the past two decades they have put much effort into a better explanation of innovation's role in economic growth. These researchers, according to Baumol et al, using increasingly sophisticated statistical methods, have posited a range of other variables that influence innovation, some of which governments can control (like openness to goods and investment from abroad, spending on research and development, and training of more scientists and engineers), and others of which governments cannot control (like geographic location) (p. 6, 2007). Baumol et al also present their four elements of a successful entrepreneurial economy (p. 7, 2007):

1. It must be relatively easy to form a business, without expensive and time-consuming bureaucratic red tape. Abandoning a failed business must also not be too difficult because, otherwise, some would-be entrepreneurs may be deterred from starting it in the first place. A reasonably well-functioning financial system must also exist, one that channels the funds of savers to the users of funds, entrepreneurs in particular.
2. Institutions must reward socially useful entrepreneurial activity once started; otherwise individuals cannot be expected to take the risks of losing their money and their time in ill-fated ventures. Here the rule of law – property and contract rights in particular – is especially important.
3. Government institutions must discourage activity that aims to divide up the economic pie rather than increase its size. Such socially unproductive activities include criminal behaviour as well as lawful "rent-seeking" behaviour (i.e. political lobbying or the filing of lawsuits designed to transfer wealth from one pocket to another).
4. Government institutions must ensure that the winning entrepreneurs and the larger established companies continue to have incentives to innovate and grow, or else economies

will sink into stagnation. The ostensible importance of effective antitrust laws here comes to mind, but most important is the openness to trade.

4.4 Transaction Costs

Noble Prize winner Ronald Coase first introduced the concept of transaction costs in 1937, describing it as "the cost of using the price mechanism". He further defines the price mechanism as discovering what prices are, negotiating and closing a contract and he hints at problems of enforcement, but he stops short of any clear definition of transaction costs. Coase attempted to understand the rationale for having economic organizations and questioned why, if the market is such a good coordinator, much of the economic activity results in planning by companies. His answer was the transaction costs.

Many definitions and interpretations have been made after the introduction. Allen writes that transaction costs are "the costs of establishing and maintaining property rights" (1991). Demsetz stated the neoclassical definition of transaction costs by claiming that transaction costs are "the costs resulting from the transfer of property rights" (1964). A neoclassical approach dominates in finance and a typical definition of transaction costs are:

> "In general, transaction costs are ubiquitous in market economies and can arise from the transfer of any property right because parties to exchanges must find one another, communicate and exchange information. There may be a necessity to inspect and measure goods to be transferred, draw up contracts, consult with lawyers or other experts and transfer title. Depending upon who provides these services, transaction costs can take one of two forms, inputs or resources – including time – by a buyer and/or a seller or a margin between the buying and selling price of a commodity in a given market" (Stavins 1995, p. 134)

In order for an exchange to take place, the costs to execute should be low. These costs does not only involve the actual price of the exchange but also the costs related to gathering of information of available alternative, evaluate them, negotiate and make a deal and sign the contract. If every household would go through this process every time a transaction should be made, things would be too complicated and the implied transactions costs too high; exchange would not take place. By coordinating in a company these transactions costs can be decreased. The model below tries to illustrate the relation between companies, institutions and markets to coordinate economic transactions:

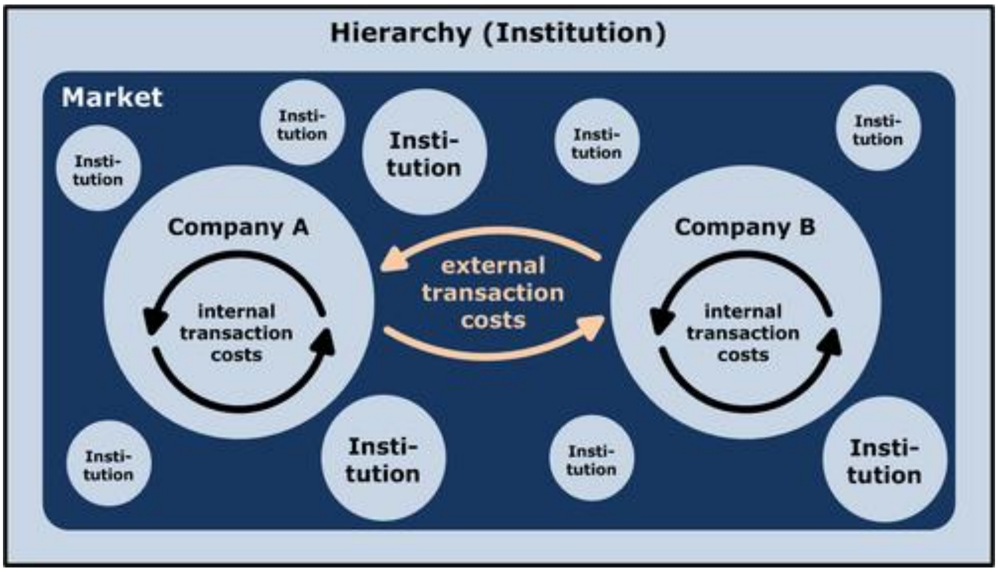


Figure 4 Transaction Costs (Source: Wikipedia)

In this model, presented in Figure 4, the company will grow when the external transaction costs are higher than the internal transaction costs. If the internal transaction costs are higher than the external transaction costs the company will instead be downsizing (e.g. by outsourcing). As a consequence the size of the firm will be a function of the costs of using the market. In an economy with high transactions costs, the companies will be large and incentives for new technologies will be low. The period up until 1950 saw more regulation and several wars. These increased the transaction costs. Consequently the companies were big. Since 1950 markets became deregulated, resources and capital became available, political and economic stability spread, communication costs decreased and subsequently transaction costs decreased uninterruptedly. The theory also implies that in the absence of transaction costs, there is no economic basis for the existence of the firm.

4.4.1 Transaction costs connected to Private Equity

The transaction cost examples mentioned above are all relevant to private equity firms. Furthermore, any kind of financial transaction incurs substantial costs to find appropriate investors and debtors, to retrieve and consolidate information, as well as to negotiate and finalize contracts. Therefore, transaction costs increase the price of financial relationships. Transaction costs are driven by the frequency with which a transaction occurs, the uncertainty related to the transaction, potential opportunistic behaviour and the specificity of the assets (Lenz & Kaserer, 2009). The authors write that a decreased equity to debt ration leads to higher transaction costs (p. 36). Further, since the authors do not believe in a perfect capital market, and states that the delegation of property rights incurs costs of monitoring and control for the principal within financial transactions. LBOs are the most common form of private equity transaction (Bain, 2011 "Global Private Equity Report"). Candidates for a buyout tend to operate in more mature industries and tend to have a higher level of free cash flow and limited positive net present value investments available; therefore the costs of monitoring and control enhances. Agency costs are also negatively correlated with concentration of ownership meaning that the more owners, the larger the transaction cost.

4.5 Technology development

This section aims to provide a brief description of financial innovations and technology developments within the financial sectors. Discussions with thesis supervisor Christian Sandström led to a focus on digitalizing of money and computerization of trading and therefore the section will describe the effect of computerization on the stock exchanges. The section also aims to provide a short discussion of whether it exists a technology lag between the U.S. and Sweden.

4.5.1 Computerization of the Swedish and U.S. Stock Exchanges

The Stockholm Stock Exchange had in its first auction in 1863. Up until 1993 there was just one market place in Sweden for securities, and during the period 1979-1993 the exchange was a regulated monopoly. In 1974 the computerization of SSE started with communication hubs and services between actors. SSE went on to introduce its own market system SIX, Stockholm Information Exchange, in 1987 and then SAX, Stockholm automated exchange, in 1989 which automatically matched buy and sell orders. Prior to that all trading had been done on the floor of the Stockholm Stock Exchange building and the stock members no longer needed any representatives in the stock exchange building. The brokers could receive order from their clients and send the order through to SAX. This meant that the traders could sit anywhere in the world and trade (Karlshamn). The trading volume on the Stockholm Stock Exchange can be viewed in Figure 5. Irding concludes that this large increase in trading volume was due to "rapidly decreasing transaction costs".

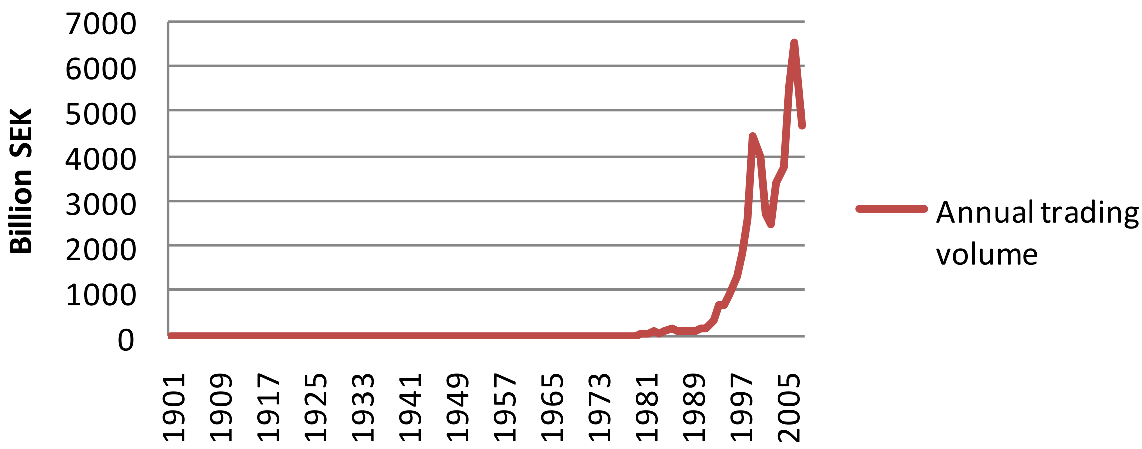


Figure 5 Stockholm Stock Exchange annual trading volume 1901-2008 (Source: Statistiska Centralbyrån)

The New York Stock Exchange (NYSE) is the world's largest stock exchange by market capitalization and it roots back to 1792. In 1971, the electronic quotation system NASDAQ entered the market for over the counter stocks. NYSE responded to the electronic stock exchange competition by introducing DOT, Designated Order Turnaround, in 1976 and later on its follower SuperDOT. The system electronically transmitted all orders, except for the largest, from a brokerage house to a specialist and also recorded the trade's execution. The specialist could choose to execute the order to the quoted price or find a better price in the crowd. When the order was executed a response to the broker was sent and the broker could then call the investor and confirm the transaction. The system eliminated the need for the floor brokers, which basically ran around looking for the best price between the specialists and the other floor brokers. The trading volume on the NYSE can be viewed in

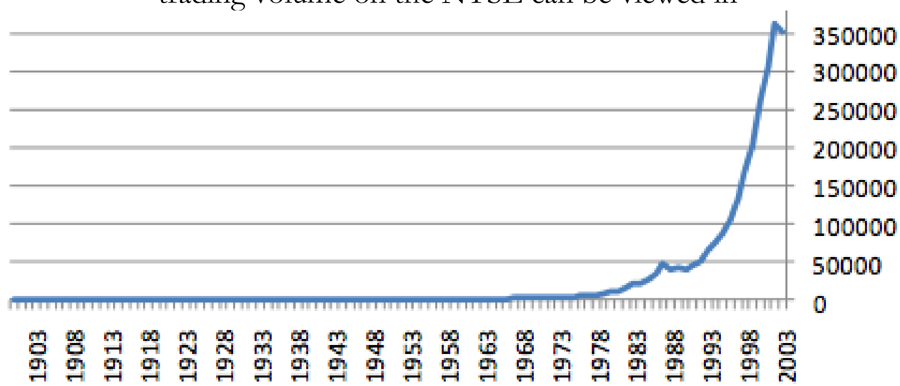


Figure 6.

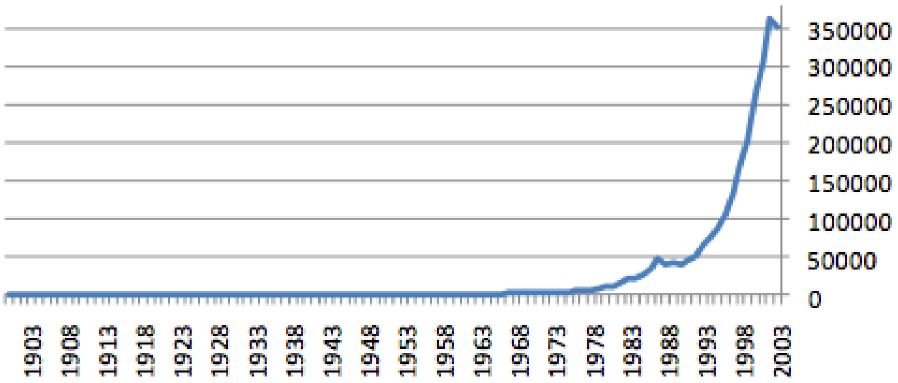


Figure 6 NYSE number of annual traded shares (millions) **Source: Nyxdata**

NASDAQ is an American stock exchange founded in 1971 and the second-largest stock exchange by market capitalization in the world. When the trading started, it was the first electronic stock market in the world. However, at first it was merely a computer bulletin board system and did not actually connect buyers and sellers. Until 1987, most trading occurred via the telephone, but during the October 1987 stock market crash, market makers often didn't answer their phones. To counteract this, the Small Order Execution System (SOES) became mandatory, which provided an electronic method for dealers to enter their trades. Even after the introduction of SOES, most trading was still done by the phone, according to Irding. However, the scene was turned around when NASDAQ became accessible through the Internet about two decades after its introduction. The trading volume on NASDAQ can be viewed in Figure 7.

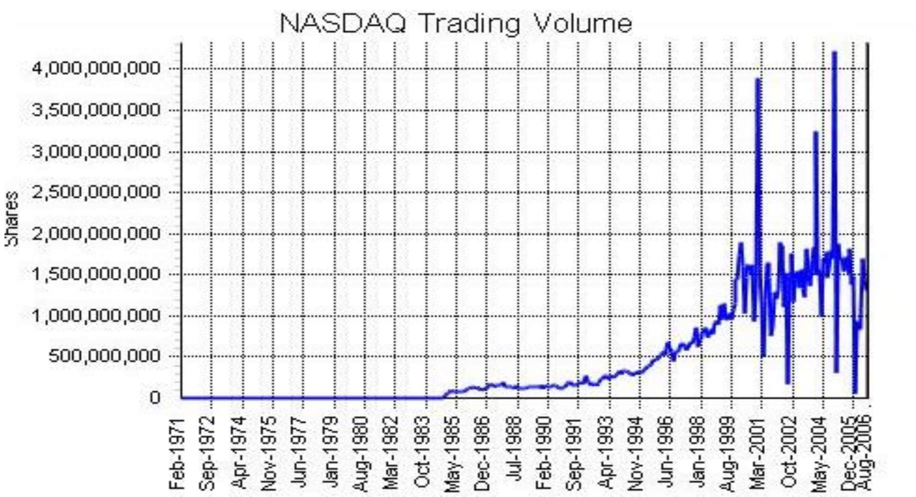


Figure 7 NASDAQ Trading Volume 1971-2006. Source: Data360

4.5.2 Examples of Effects on the Financial Market Place

Irding writes that "the most fundamental reason for existence of securities markets is to ease firms ability to raise capital and debt". Irding concludes that transaction costs were reduced due to the introduction of a digitalized stock exchange. He mentions the following reasons to decreased transaction costs:

- Simplified ownership of stock
- Increased liquidity
- Information and time
- Reduction of uncertainties of not making the trade at a fair price as well as political and regulatory uncertainties.

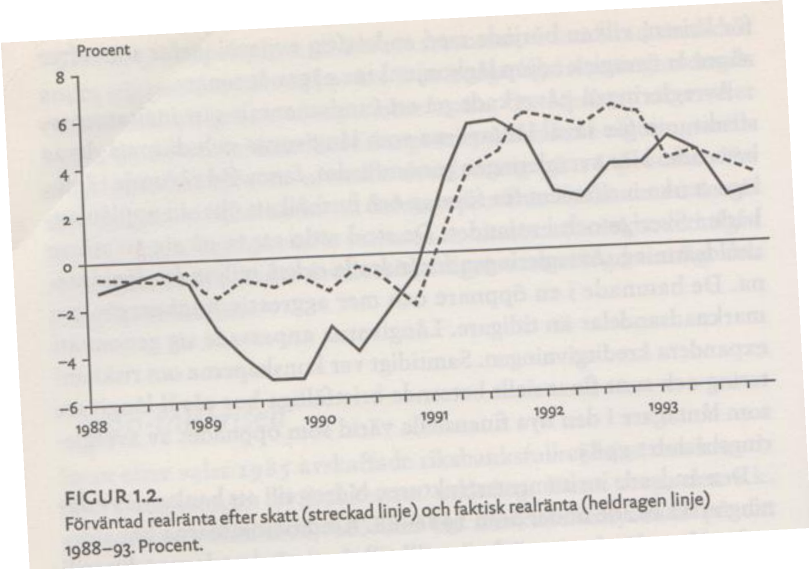
Irding explains; "for a very long time, up until the eighties, the proof of ownership of shares was a physical paper… All matching had to be correct and the physical shares sent out. The process was troublesome and errors were done. When these became electronic this removed this "bottleneck" and enabled increased trading." The bid-ask spread of stocks decreased due to an increased liquidity in the market. Regarding information and time he refers to the costs (including time) involved in gathering the necessary information about the stock and trade it. Technological advances have enabled what is referred to as a network economy with tremendous increase in information and the ease of which you can gather information. Brokers have experienced increased transparency and competition. The technological advances made trading easy with just a click online compared to when you had to go to the bank, get a price (uncertain if you got it at fair value), order and get a physical delivery of the stock. Irding concludes that:

> "It is important to note that all of these transaction cost decreases actually come from technological advances and the subsequent increase in competition. The bid ask spread was lowered by better quotation, the commission through being able to handle larger volumes at a cheaper price, the removal of the physical ownership to electronic and the ease of which information can be spread with a subsequent decrease in uncertainties... hone-trading and internet made it available to day traders, but these could never have existed if the commissions and transactions costs hadn't decreased. Massive profits were available to the one who used technology better." (Irding)

4.6 Deregulation of the Swedish financial market

The period 1985 – 1995 is very interesting and unique in the Swedish financial history. It included a so called "boom and bust"-cycle when Sweden first experienced a period of strong economic growth and then one of the most serious economic crises ever seen in the country during peace time. It is believed that the financial revolution in Sweden during the 1980s is the main reason and the propulsion behind the overheating of the economy, which later on resulted in the financial crisis (Jonung, 2003). The financial revolution includes the deregulations during the 80s, which for example meant that the Central Bank lost its possibilities to control the credit grant, as well as the new instruments and technology that grew on the newly deregulated markets. The deregulations of interest and credit streams opened up for rapid development of the financial technology and expansion of the credit market when banks started to loan more money to companies, financial institutions and households (Jonung, 2003). Many financial companies were created during this period and they loaned money from banks, which they later on invested (Finanshistoria). The increase of credit grant was extensive during the second half of the eighties. From 1985 to 1990 did the private sectors debt level increase from 100 percentages of GDP to 150 percentages (Finanshistoria).

During the 1980s the financial sector in Sweden was transformed. The market had been regulated for 30 years and it was deregulated in small steps. Characterizing for the deregulation was the establishment of new financial instruments e.g. treasury bills, bank certificates and different derivatives (Larsson & Sjögren, 1995). In 1985 the quantitative regulation of the Swedish banks lending was abolished, which in Swedish economic history is called the November revolution. This is said to have had significant impact on what happened in Sweden during the next coming ten years and an important element of what later became the financial crisis of the early 90s (Jonung, 2003). The deregulation affected the incitement structure for both borrowers and lenders and therefore their behaviour (Jonung, 2003). When the deregulation was performed, there were strong incitements for the companies and households to increase their lending. The lenders ended up in a more open and competitive environment than previously. At the same time, the knowledge of risk management was limited among both borrowers and lenders in this "new" financial world. The result was a strong increase in lending from the banks between the years of 1986 and 1988 (Jonung, 2003). Referring to Larsson and Sjögren, the deregulation led to that the lending increased significantly and that a liquidity surplus was created in the Swedish economy (1995). The increase was especially large regarding commercial loans and the sector within commercial loans that saw the largest increase was the financial sector (Larsson & Sjögren, 1995). As an example, *Första Sparbanken* increased its lending to financial companies by three times between 1987 and 1990. The real interest during these years was on a level below zero percentage due to taxes and inflation. Jonung describes that these low real rates, displayed in Figure 8, made it tempting to take loans to finance investments as well as consumption (2003). This credit expansion was not neutralised through economic-political interventions (Jonung, 2003).



FIGUR 1.2.
Förväntad realränta efter skatt (streckad linje) och faktisk realränta (heldragen linje) 1988–93. Procent.

Figure 8 Expected real interest rate after tax (dotted) and actual real rate in Sweden 1988-93 (percentage)

An article by Johan Selander in *Svenska Dagbladet* describes the climate in Sweden during the years 1985 to 1989.

> "Swedish companies have to a large extent started to borrow direct on the market, outside of the banks. This have increased the competition and put pressure on the margins…But the deregulation has made it possible for the banks to lend unlimited volumes…It is the banks that have taken advantage of the credit expansion that have made the largest profits – so far. *Skånska Banken*, which has been more precautious, dropped in the profit table 1988 and Affärsvrlden put on the timetypical headline "Precautious lending brought down Skånska Banken". In the new, daring world of finance has the old word of hounour precautioness became invective" . (Selander, SvD 28/3, 1989)

Larsson and Sjögren write that this article was one of few sceptical about the deregulations. Overall, media was pro deregulations and took party with the actors on the financial market. The time period was strongly characterized by investments and expansion (1995). The last larger leap in the deregulation of the Swedish financial sector was the deregulation of the currency control in 1989. This regulation had prevented Swedish portfolio investments in financial assets in foreign currencies as well as it had prohibited foreigners to have assets in Swedish crowns. For example, it limited the establishment of an efficient bond market (Larsson & Sjögren, 1995).

During the early 90s, the financial crisis hit Sweden. The real interest rate increased rapidly, leading to falling asset prices. Many borrowers were unable to meet their obligations and the banks made enormous losses (Jonung, 2003). Due to this economic downturn, the surrounding European currency anxiety and heavy speculation towards the fixed Swedish crown, the Swedish central bank decided in 1992 to apply a fluent currency with inflation objectives (Jonung, 2003).

4.7 Swedish pension funds investment in private equity in its early phase

Pension funds are an important investor in Swedish risk capital and has represented between 15 and 25 percentage of all invested capital in risk capital funds between 1995 and 2010 (p. 13, 2006, European Commision) (p. 5, Private Equity 2010). By the turn of the year 2010, the *Allmänna Pensionsfonderna* (AP) had invested SEK 54 billions in different risk capital funds. The private pension giants *Skandia Liv* and *Länsförsäkringar* had together invested another SEK 25 billions (Pensioner göder nolltaxerarna, http://www.svd.se/naringsliv/pensioner-goder-nolltaxerarna_6038445.svd). Helene Wall, chief lawyer at the *Swedish Investment Fund Association*, encourages a detailed analysis of the *Allmäna Pensionsfonden*'s regulations to understand the changes in regulations that determines Swedish pension fund investments in risk capital. In 1960 were three AP funds introduced (AP1, AP2, AP3) but these are only allowed to invest in interest bearing papers. In 1974 was the Fourth AP fund introduced and in 1988 the Fifth AP fund. These were both allowed to invest in a wider category of derivatives e.g. in shares. The sixth AP fund is not of relevance to this thesis due to its birth in 1996, which was after the first private equity funds were established.

The Fourth AP fond made its first investment in a private company in 1980 (SEK 5 million investment in Lindab Ventilation AB) and thereafter did their private equity activity increase rapidly (AP 4 Årsredovisning 1988). In 1980 did the board take a decision to start invest in private equities but primarily direct to companies to help them towards an initial public offering. However, in this early stage, the fund was only allowed to invest in Swedish equities and the fond could not own shares in bank or insurance companies (AP 4 Årsredovisning 1981). The fund was not allowed to own more than ten percentages of the voting shares in a company and most of the investments made were in smaller ventures (AP 4, Årsredovisning 1982). A change in the regulations for the AP funds was introduced in January 1984. An important part of this was a larger possibility to invest in foreign securities (to facilitate investments in global Swedish companies) and better opportunities to invest in private equities (AP 4 Årsredovisning 1983). During the larger part of the 80s, a third of the Fourth AP funds investment in private equity was invested in venture capital and the rest as minority investments in different companies. The Fourth AP fund invested together with Nordic Capital in the publishing company *Liber* in 1990. In 1993, the Fourth AP fund made a strategic decision that they should only invest in investment consortiums specialized in private equity and in investment targets with clear exit strategies. During the year, the Fourth AP fund agreed to invest SEK 150 millions in *Nordic Capital*. Nothing is mentioned in the annual reports about changes in regulations motivating the possibility to perform these investments (AP 4 Årsredovisning 1993). The history of the fifth pension fund is more difficult to understand due to limited availability of annual reports.

4.8 Establishment of private equity in the United States

Investors have been acquiring businesses and making minority investments in privately held companies since the dawn of the industrial revolution. Private equity financing – especially venture capital - can trace its roots back to private financing models employed by the railroad and textile mills in the nineteenth century. Due to structural restrictions imposed on American banks under the Glass-Steagall Act and other regulations in the 1930's, there was no private merchant banking industry in the United States and the investment banks were confined primarily to advisory businesses. Investment banks would later enter the space but long after independent firms had become well established.

Before World War II, private equity investments were primarily the domain of wealthy individuals and families. It was not until after World War II that true private equity investments began to emerge and the first venture capital firms was created; *American Research and Development Corporation* (ARD) in 1946. It has been said that the modern risk capital industry was introduced as a way to capitalize on all inventions made during the war. ARD is what many consider as the first organized venture capital firm in the United States and invested in its early years mainly in high-tech companies. These firms were the first institutionalized private equity investment firms raising capital from other sources than wealthy families, but it should be noted that venture capital was the dominating investment form during these early years. In September 1970, ARD went public and raised over $38 million.

During the 1960s, a bull IPO market continuously drove the venture capital industry and the top firms were now able to realize significant returns on their investments through lucrative exits. During the sixties and the seventies, venture capital firms focused their investment activity primarily on starting and expanding companies often in electronic, data processing or medical technology. Consequently, venture capital came to be almost synonymous with technology finance. The buyout industry also came to prominence and the first U.S. LBO took place in 1964 with the acquisition of Orkin Exterminating Company in 1964 by Bear Stearns. This deal was made by three individuals working at the time for Bear Stearns; Jerome Kohlberg Jr., Henry Kravis and George Roberts. One should note that management buyouts have existed since the emergence of commercial activities, however the leveraged structure commonly used in private equity today was invented by these men. They created in 1976 one of the first private equity firms and one of the most legendary firms ever; Kohlberg Kravis Roberts (KKR). This was the introduction of the form of a private equity fund that is still in use today.

A reason to why the private equity industry did not boom after its introduction is due to the slump of the American stock market during the 1970s and investors were unable to realize the returns they had come to expect through initial public offerings (IPOs). Add to this the introduction of the Employee Retirement Income Security Act (ERISA) in 1974, which unintentionally punched the private equity industry. ERISA was aimed at tightening regulations for pension funding and investments, but had the unintended effect of causing pension managers to halt investing in "high-risk" investments (Cendrowski et Al, 2008). Institutional investors such as public and private funds are since the early 1980s private equity's largest investors. Due to this, private equity hit a nadir in 1975 when venture capital only raised $10 million.

The turnaround came in 1978, when ERISA's "Prudent Man Rule" where clarified and explicitly permitted pension managers to invest in private equity. Shortly thereafter, Congress slashed the maximum capital gains tax rate from 49.5 % to 28 % with the passage f the Stieger Amendment, greatly enabling private equity investors to realize better returns. The Tax Act of 1981 further lowered the maximum capital gains tax rate to 20 %. Add to this that the IPO market also experienced resurgence in the late 1970s with many star companies (e.g. Apple Computer) going public in the late 1970s and early 1980s. This was the starting signal of the private equity boom and venture and buyout funding surged dramatically through the 1980s. In the late 1980s, investment in buyout surpassed that for VC mainly driven by the low tax on capital gains, availability of bank debt and financial innovations (Cendrowski et Al, 2008). In 1988 was one of the largest buyout through all times executed – that was the KKR buyout of RJR Nabisco.

One should note that the industry once again plummeted in the late 1980s and early 1990s. This was mainly due to that institutional investors failed to renew their commitments to the arena in follow-on funds, and new funds were unable to find investors willing to lend capital. Moreover, an economic recession in the early 1990s further demoralized investors to invest in private equity and venture capital (Cendrowski et Al, 2008). However, with an economy in the making, the IPO-market of the mid-1990s began to pick up and the investment classes started to skyrocket again (Figure 9).

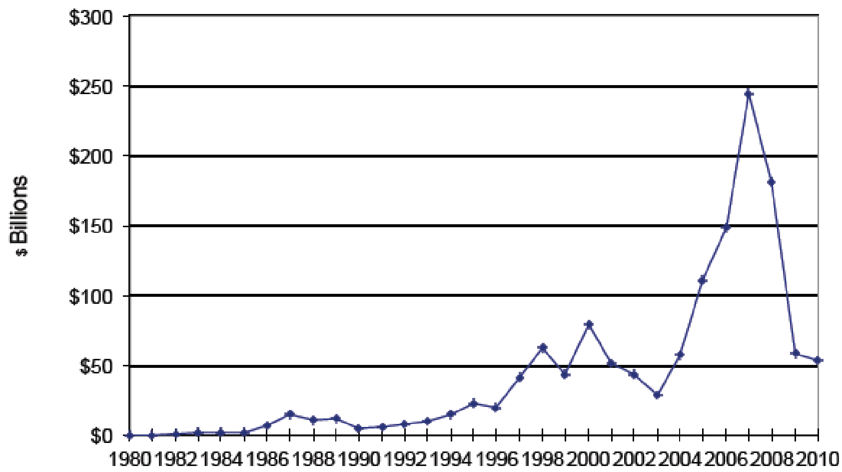


Figure 9 Private Equity: Historical Investment Commitments to U.S. Private Equity Partnerships 1980-2010 (in $ billions) (Source: Kaplan)

4.8.1 Key Drivers behind introduction of Private Equity in the United States

This section aims, based on the literature review, to present the key factors behind the introduction of private equity in the United States.

4.8.1.1 Economic Climate

There were several factors related to the economic climate during the period that has been mentioned as explanations of driving forces to the private equity origination.

4.8.1.1.1 Economic Growth in the United States during introduction years

General economic growth, as measured by real GDP, is also highly related to private equity investments, as economic growth creates new opportunities for venture capital entrepreneurs, and also the ability for firms under buyout management to grow. Analysis shows that the correlation between private equity investments and real GDP is 0.81 (Cendrowski et al, 2008). The growth of the private equity industry and the previous high returns also affected the inflow of capital in the industry towards the end of the eighties (Kaplan, 2007). He also says that the buyouts really got going after the initial success of the buyouts in the early and mid 1980s. The growth of the U.S. economy measured by GDP is presented in Figure 10.

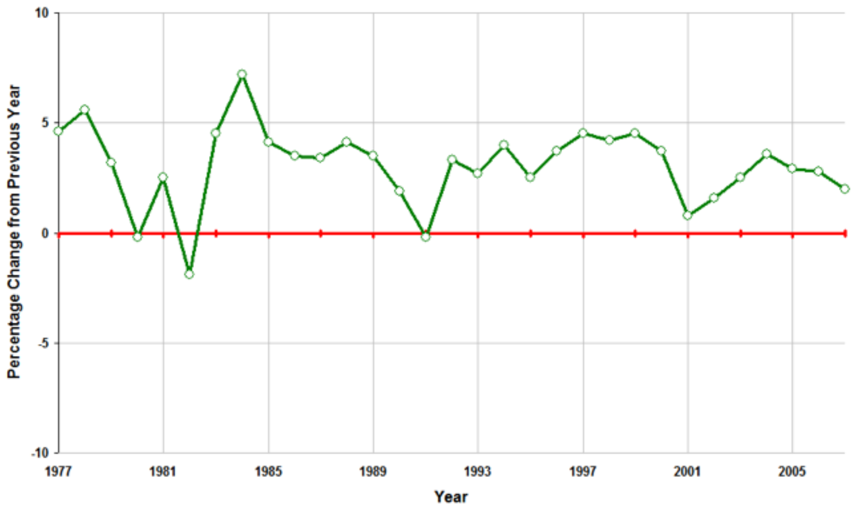


Figure 10: Annual Percentage Change in Real GDP US 1977 - 2005

4.8.1.1.2 Advantageous debt conditions on the market

Debt is a pivotal part of the buyout transactions, and especially in highly leveraged transactions. Therefore, market interest rates highly influence private equity investment activity. Using the federal funds rate as a proxy for a private equity firm's cost of debt, analysis has shown that there is a significant relationship between private equity investment levels and the FFR. The correlation level between the two from 1970 to 2006 is -0.44 with a high p-value at significance level less than 0.01. The development of the federal funds rates can be observed in Figure 11. Note the "valley" of cheap debt between 1985 and 1988, which probably helped fuel the private equity boom. Steven Kaplan agrees to this by stating that lenders in the mid- and late-1980s were very happy to lend, until problems started to surface in 1989 (2007).

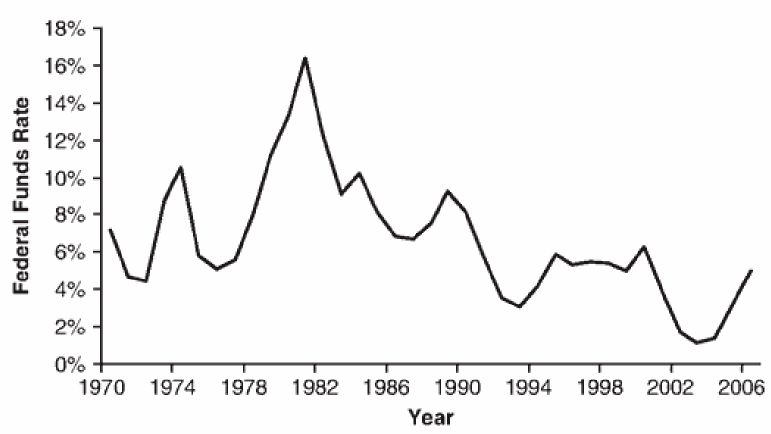


Figure 11 Historical Federal Funds Rates since 1970

Linked to this is the relationship between interest rates and stock prices; this spread has to be attractive enough for buyout funds to be able to make money. Steven Kaplan has calculated "earnings yield" (earnings as a percentage of stock price) less corporate bond rates since about 1980 and these show a high spread during the golden years of private equity (Kaplan, 2008). This has allowed private equity firms to borrow a lot of money to buy public companies at premiums over current values and still be able to make the interest and debt payments. This shows that either when stock prices go up relative to earnings or when interest rates spikes, it is likely to see a drop in public-to-private equity.

4.8.1.2 Takeover Threat

Steve Kaplan describes that an important reason for going private in the 1980s was the threat of takeovers. "There was considerably pressure on public company managements, but of a somewhat different kind. In those days, corporate raiders were threatening to take over inefficient companies, and going private was a mean of escaping the raiders" (Kaplan, 2008).

4.8.1.3 Regulatory Changes

An important regulatory change that eased the situation for the private equity companies was the Small Business Investment Act of 1958 providing businesses the right to help the financing and management of small entrepreneurial businesses. It was introduced since a major gap existed in the capital markets for long-term funding for growth-oriented businesses.

4.8.1.3.1 ERISA

The elucidations to ERISA in the late 1970s led to a large influx of capital to the private equity arena. Pension funds had invested to some extent in the asset class prior to the introduction of the act, but the act had put a damper on the investments. When the U.S. Department of Labor made clarifications of the rules, institutional investors once again returned to private equity (Cendrowski et Al, 2008). Figure 12 shows the impact of ERISA on private equity investment levels. Between 1975 and 1982, investment in private equity increased by over 22 times.

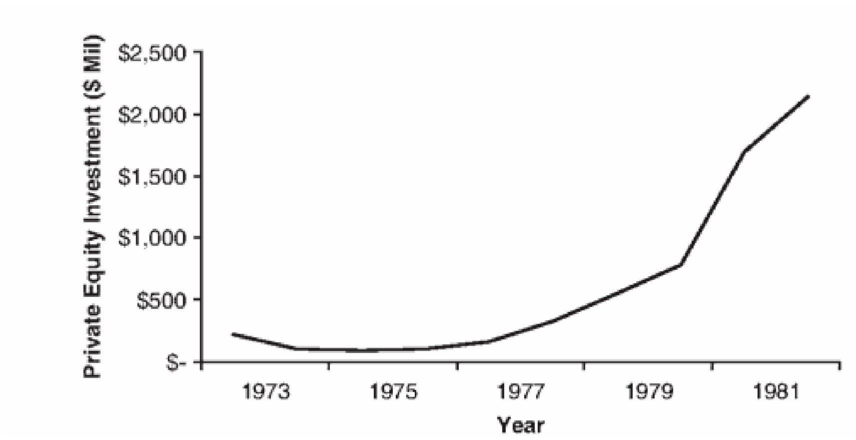


Figure 12 Impact of ERISA on Private Equity Investment Levels

ERISA was primarily enacted to protect interests of participants in employee benefit plans and it put pressure on those managing financial assets. For example, when originally passed in 1974, ERISA instructed pension plan managers that they should invest "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"; this is generally known as ERISA's "Prudent Man Rule". As these terms were quite vague, many plan managers believed that the act forbade them to invest in private equity (Cendrowski et Al, 2008). The latter clarifications made it clear that private equity investments were allowed although they were still limited. Private equity funds are not permitted to raise more than 25 percentages of the capital from pension "benefit plan investors".

4.8.1.3.2 Capital Tax Gain Reductions

Capital Tax reductions also contributed significantly to the popularity of private equity as an investment class. From the late 1960s through the 1970s, the federal capital gains tax rate increased dramatically. The tax had long been constant at 25 percentages since the early 1940s, the maximum tax rate on capital began to rise in 1968, to 26.9 %. The capital gains rate continued to rise through 1977, when it hit a historical high of 39.9 percentages. However, by the end of the 1970s, a dramatic shift in tax rate came and the rate was slashed to 28 percentages in 1979 with the passage of the Stieger Act and in the following years the tax rate decreased further. The historical capital gain tax rates can be seen in Figure 13 (Cendrowski et al,, 2008).

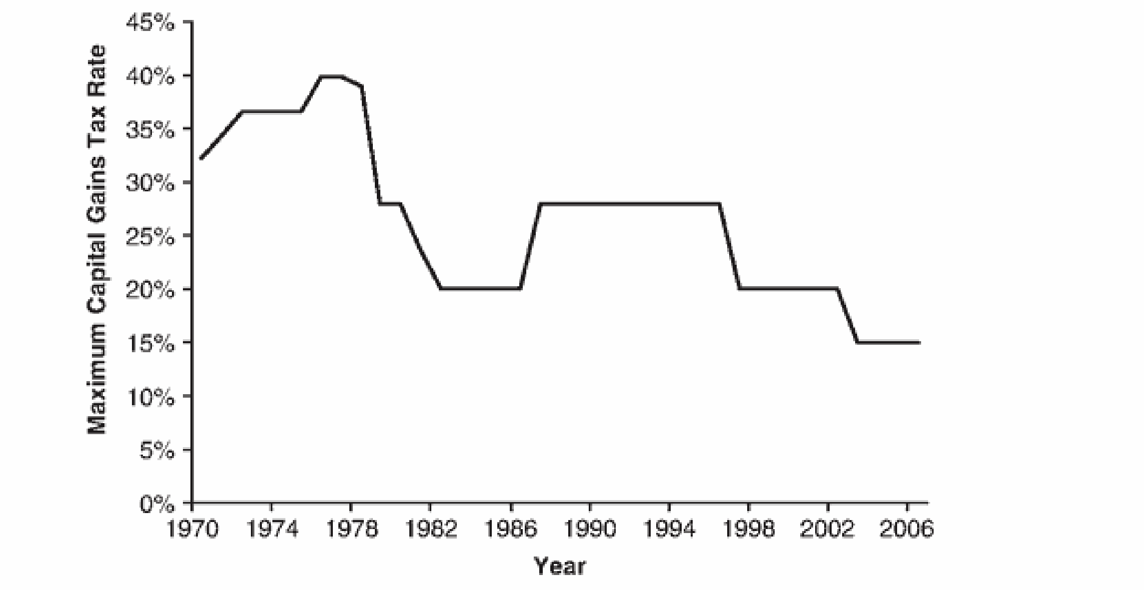


Figure 13 Historical U.S. Maximum Federal Capital Gains Tax Rates

Some may argue that capital gains rate taxes have little influence on capital inflows to private equity since many investors incur no tax liabilities on gains, but other assert that capital gain taxes bear heavily on the decision of would-be entrepreneurs to leave their current employers to start new businesses. This is due to the fact that entrepreneurs primarily benefit from the appreciation of their equity stake in new venture companies (Poterba, 1989). However, analysis has also shown that private equity investment levels and capital gains taxes rates are inversely related. E.g. the correlation between these to in the U.S. from 1970 to 2006 is -0.61 (Cendrowski et al, 2008).

4.9 Establishment of private equity in the United Kingdom

Evaluating how the U.K. market was developed and which factors contributed to its development can also assess the development of private equity in Sweden. Leveraged buyouts of larger corporations did not occur in the U.K. 1982 when NCF was bought for GBP 53 millions. Smaller LBOs had been taking place in the U.K. for many years before that. Ahlström et al present four potential factors that might have hindered the development of private equity and LBOs (1986):

1. Little availability of risk capital
2. The low status of the entrepreneur and risk taker
3. Poorly developed exit-routes for companies
4. Regulatory constraints, which forbid the purchase of companies using the companies own assets as payment or as collateral for acquisition loans

Ahlström et al concludes that there were several changes in the U.K. that affected the LBO activity positively. They note that a basic shift in the status of the entrepreneur took place in the late 1970s. Government regulations were also changed in 1981 allowing certain exceptions from the rule against purchasing companies using its own assets as collateral. This change "was critical in influencing the development of the market in terms of number and size of deals and their structure" (1986). Advisory companies specialising in LBOs were set up, such as *Candover Investments*. Additionally many generalist merchant banks and foreign commercial banks pursued deals. The activity of these firms and the influx of foreign capital, primarily with U.S. origin, had led to much publicity surrounding LBOs. "This publicity in turn has initiated a lot of LBO activity from managers interested in taking over their own business". The U.K. stock market had created an Unlisted Securities Market where the entry requirements in quantitative terms (exempli gratia sales, net worth) are substantially lower than for a primary stock market (Ahlström et al, 1986). In addition, certain merchant banks had created their own OTC market. All these changes are considered as important in the development of private equity in the U.K. (Ahlström et al, 1986).

5 *Empirical Research*

This section aims to present the gathered empirical results of the research. First a course of event regarding the introduction of private equity in Sweden is outlaid. Thereafter, a more detailed presentation is made on the empirics found on each of the key players involved. The section ends up in a presentation of all data regarded to the drivers of private equity introduction in Sweden.

5.1 Introduction of Private Equity in Sweden: Course of Events

The first form of risk capital was introduced in Sweden in the last decades of the 19th century when private investors helped entrepreneurs such as *Gustaf de Laval,* engineer and inventor contributing to the steam turbine, and *Ernst Thiel,* a Swedish industrialist and banker. Ivan Kreuger is another famous Swedish risk capitalist that succeeded in funnelling American risk capital into Sweden (SVCA, 2012). Many of Sweden's old, larger companies achieved financial help when they were started exempli gratia SKF and ASEA (SVCA, 2012). The Swedish risk capital industry was started in more organized form during the latter part of the 1970s but then focused on minority venture investments in the start-up and expansion phase of companies. In the beginning of the eighties about 30 Swedish risk capital firms were created and governmental funds were established. According to Sven Fritz, professor emeritus at the *Department of Economic History* at the *Stockholm University*, the venture capital industry flourished between 1982 and 1984. The pioneers within this segment were *Företagskapital AB*, *Svetab* (later Euroventure) and *Four Season Venture* (later Verdane), according to Christer Dahlström, co-founder of private equity firm *Priveq* in 1998 and previously Managing Director at Skandia Investment.

50 percentages of Företagskapital AB was owned by the government and had about SEK 30 to 40 millions at his disposal. Företagskapital AB had a portfolio including eight to ten companies with revenues of about SEK 50 to 100 millions per year. Most of them were smaller family owned companies from the Småland area in the south of Sweden. Svetab and Four Seasons invested in similar companies and became minority owners in their investments. All these mentioned venture capital companies and funds invested in non-public equity with risk capital and they generally perform minority investments in start-up phases of companies.

The private equity firm Priveq was founded in 1983 as a subsidiary to the insurance group Skandia Investment and is the Swedish private equity firm with the earliest foundation referring to an analysis of all Swedish private equity firms presented in Appendix. However, Skandia Investment became a private equity company in 1998 and then changed name to Priveq. Referring to Affärsvärlden, "Priveq Investment…was started already in 1983 as one of the first risk capital firms in Sweden" (Cervenka, 2006). However, the investment model of Skandia Investment differed relatively much from the model that private equity firm's use today, which is described in more detail below. According to Christer Dahlström, who was the head of the fund and also has received the nickname *Mr Skandia Investment*, buyouts did not exist at this time in Sweden. Furthermore, due to regulations, insurance companies were not allowed to own more than five percentages of the votes in a company; therefore Skandia Investment could only make minority investments in their investee companies. The interviewees seem to unanimous agree to that although Skandia Investment was founded first, their business model was relatively far away from the private equity business model of today.

There were some early LBOs in Sweden but in the mid-eighties[1], there were no one specializing in LBOs (Ahlström et al, 1986). The major commercial banks, insurance companies, venture companies, stockbrokers, management consultants, lawyers and accountants could put deals together if they cooperated (Ahlström et al, 1986). Management teams, who had tried to buy the company using bank debt as the only mean of financing, had initiated most LBOs that had been done. The equity portion of the deals had often been financed through their own equity plus bank credit lines secured with personal guarantees (Ahlström et al, 1986).

The next step in the development of Swedish private equity was the realisation of the first management buyout in Sweden. In 1988 the private equity firm *Procuritas* did buy the security solutions company *Gunnebo AB* from the stock exchange and make it private. Actually, this was the first company in Scandinavia to be bought out of an exchange. According to *Mikael Ahlström*, founder of Procuritas, this was definitely the start of private equity in Sweden. Procuritas also bought *Swedish Match* from *Stora Kopparberg AB* in 1988. These buyouts had many similarities to the private equity transaction model of today. The leverage in the deals was not as high as in the deals of today, mostly due to high cost of

1 One should note that Swedish laws at the time were similar to the laws in most other European countries, prohibiting the purchase of a target company by using the assets of the target as means of payment. Purchasing entities in Sweden had found ways around this legislation (Ahlström et al, 1986). One of the most popular forms of ownership transfer using the target's assets as payment is the classical structure using a holding company. Another way of doing LBO's in Sweden at the time was to buy the assets of the company using different forms of leveraged leases.

debt according to Christer Dahlström. Furthermore, these deals were made as separate investments and due to the limited committed capital Procuritas were forced to find syndicate partners to be able to finance the buyouts, according to Christer Dahlström. He continues to state that Procuritas during the 80s was more of an investment company investing in private equity, not what today is defined as a private equity firm. On the other hand, Jonas Rodny, Communication Director at SVCA, says in an interview that the first private equity firms in Sweden were Procuritas (first fund 1986), IK Investment Partners (1989) (at the time Industri Kapital) and Nordic Capital (1990).

According to Christer Dahlström, private equity was established in Sweden, as one of the first countries in Europe, in 1989. "The start of private equity in Sweden should be set to 1989" (Christer Dahlström, 2012). *IK Investment* (*Industri Kapital*) started its first fund *IK1989* in 1989, which had €108 million in committed capital and *Nordic Capital's Fund I* (€ 55 million) also in 1989. These are, referring to Christer Dahlström, the first firms doing activities with very high resemblance to what the private equity firms of today do. He continues by explaining that the structure of the model used by these early funds was very similar to those of today's private equity companies. They made majority investments in private companies and leveraged buyout models were used. Christer Dahlström says that the private equity model has of course become more sophisticated but the basis is similar. One difference is that, for example in the case of Nordic Capital, the early funds had a separate investment committee consisting of represents from the investors in the fund. They had a large influence before each investment decision, which not is the case today. According to Christer Dahlström this changed when international investors started to invest in Swedish funds. Since they invested in the management company, they demanded that the management of the private equity firm should be responsible for which transactions to do, not a separate investment committee. It is difficult to state exactly when this change came about, but it was after a couple of years after private equity's introduction in Sweden, referring to Christer Dahlström.

The first funds were very successful and some great investments were made (Dahlström, 2012). Nordic Capital raised its second fund *Fund II* in 1993 (€ 110 million) and IK Investments initiated its follow-up fund *IK1994* in 1994 (€ 250 million). Other famous private equity firms such as *Bure* (started 1992), *Accent Equity Partners* (1994), *EQT* (1995), *Novestra* (1997), Segulah (1997) and *Litorina* (1998) was also started in the nineties. Risk capital in Sweden is an important part of the industrial life in Sweden today. Private equity and venture capital firms in Sweden are today owners in about 700 Swedish corporations with a turnover of about 250 billion SEK corresponding to about 8 per cent of GNP.

These companies employ about 180 000 people in Sweden. 7 percentages of employees in the public sector do today work in companies owned by risk capital (Svenska Riskkapitalföreningen).

5.2 In-depth Analysis of Early Private Equity Funds in Sweden

The sub-section presents an in-depth analysis of the key players of early private equity in Sweden. The companies included are those that seemed to be of importance according to the course of event analysis. The section aims to help understand the actual start-up process and the driving forces behind it.

5.2.1 Priveq (Skandia Investment)

Priveq is a private equity firm active today that since its inception has invested about SEK two billions in over 100 companies via four different funds. Example of Limited Partners in Priveq is Fjärde AP-fonden, *Handelsbanken Liv*, *KF Invest*, *Skandia Liv*, Tredje AP-fonden and *Telia Pensionsstiftelse*. Priveq has for example invested in growth companies such as Carema Care, Hemtex and Nefab. Priveq was founded in 1998 and has its origin in Skandia Investment, which was founded in 1983 for investments in small and middle-sized enterprises by the insurance group Skandia. Up to that date Skandia had only invested in public companies, but the insurance company achieved more and more requests of capital from private companies heading for the stock exchange (Forsberg, 2010). Christer Dahlström says that Skandia and its CEO Björn Wolrath and CFO Björn Hall received many proposals during the early eighties from Skandia customers that thought that their private companies needed capital and competence to develop their businesses. After Wolrath and Hall had pulled a couple of these cases in front of the Skandia board, they realized that these investments were too small to be considered at the Skandia there but, according to Christer Dahlström, they still thought that these companies would be of interest to invest in. One day the board did discuss a potential investment in the turf company *Råsjö Torv* and Skandia then created a separate company for these kinds of investments (Forsberg, 2010). The name of the new company was *Skandia Investment* and Christer Dahlström was appointed as CEO. The fund was granted SEK 110 million, which was a huge amount of money at the time (Forsberg, 2010). As mentioned, insurance companies in Sweden were not allowed to own more than five percentages of the votes in a company in the early eighties. Therefore Skandia Investment could not achieve more than

33 percentages of the shares in an individual company. This led to that Skandia had to work closely together with the entrepreneur or the family behind the companies. Referring to Forsberg, it was not until 1998 that the company created a traditional private equity structure of the investment funds; that was also when Priveq Investment was created (2010).

5.2.2 Procuritas

As of June 2010, Procuritas had led, or co-led or advised, 29 buyouts in the Nordic region with a combined consideration over SEK 12 billions. Focus is on mid-sized companies in the Nordic region and examples of companies that Procuritas has invested in are Däckia, Habo and Swedish Match. Procuritas states that is has done private equity in Scandinavia since 1986 and claims it to be the first Nordic company focusing on buyouts (Procuritas, 2012). This view is strengthened by other sources, as noted above. The founder was Mikael Ahlström, who prior to the Procuritas foundation was Managing Director of *ESI Coal Inc.*, a U.S. natural resource and energy company and worked at *the Swedish American Chamber of Commerce* in New York. Mikael Ahlström holds an MBA at INSEAD and in 2009, Mikael Ahlström was named as "One of 50 Alumnus who changed the world" by INSEAD.

In 1980, during Mikael's time in New York working for ESI Coal Inc., he one day read the newspaper *General Commerce*. He heard about three men who had made a buyout of the conglomerate *Houdaille* producing automobile bumpers, machine tools, steel and a variety of other products in Florida. The names of the men were Jerome Kohlberg Jr., Henry Kravis and George R. Roberts, founder of the salready mentioned legendary private equity firm KKR. Mikael got interested in the business model and tried to convince his superiors on ESI that it also should do buyouts. He actually went so far that he presented a buyout model on a Chicago based company. However, the executives on ESI Coal Inc. thought that this business was too far away from their core and rejected the proposition.

Mikael Ahlström realised that he needed three things to be successful in the leveraged buyout market: "I needed to learn more; I needed more credibility and I needed a wider network. I needed to go to a business school" (INSEAD). A few years later, Mikael Ahlström moved back to Europe and he decided to take a MBA at INSEAD – one reasons was since it offered one year MBAs - and started there in 1985. He has himself described his time at INSEAD in the following way: "everything about my year was 'enlightening' – the business approach, the organisational behaviour, the teaching methods, the cultures, the teamwork" (INSEAD). In a course, Mikael Ahlström together with some fellow students convinced his professors that they should get the opportunity to do a project about leveraged buyouts in Europe. They wrote the work *Leveraged Buyouts – The Status in Europe* and found that the buyout phenomenon was very immature in Europe. Only a handful of firms existed in Europe, exempli gratia some in the United Kingdom and one in France. To the presentation of the work, Mikael Ahlström and his fellow students invited specialists working with buyouts and venture capital in London.

At the end of his MBA Mikael was confronted with a dilemma: on the one hand he had already made up his mind to set up his own company; on the other hand, he had received jobs offers from both global investment firm *Barings* and consultant firm *McKinsey & Company*. He contrived to have the best of both worlds. He asked Barings if instead of the job offer they would invest in his new venture, and McKinsey promised they would defer his job offer for eight months in case his company failed. (INSEAD) His wife was pregnant at the moment and due to insecurities in starting a new business, the deal with McKinsey was of high importance to him. This gave Mikael the security and confidence to start his buyout venture. Barings invested together with Handelsbanken and IKEA in the venture (in the GP), which was named Procuritas. Mikael Ahlström describes that his personality (especially his ambitiousness, attitude and drive) was the most important factor in he process of convincing these institutes to invest in him when he presented the new buyout model.

Procuritas was started in 1986 but the Gunnebo transaction in 1988 was the company's first important deal. According to Mikael Ahsltröm the founders of Nordic Capital, Robert Andreen and Morgan Olsson, were involved in these first buyouts since they at the time worked for Handelsbanken. It should also be noted that no foreign investors invested in the actual transactions. Procuritas also bought *Swedish Match AB* in 1989 by forest industry concern *Stora Kopparberg AB* and hold the company for three years. The first structured fund of Procuritas, the *Procuritas MBO Investment Consortium*, was established in June 1990, with a committed capital of SEK 254 million and it invested in seven Scandinavian buyouts between 1991 and 1995. Most of these companies were bought from strategic sellers such as KF, NCC and Scandic Hotels; none were a public company made private. It is also interesting to note that almost half of the companies were sold via an IPO in this first fund (Procuritas, 2012).

5.2.3 IK Investment Partners (Industri Kapital)

IK Investment Partners (formerly known as Industri Kapital) is a leading European private equity firm with Nordic roots, managing €5.7 billion in fund commitments. The firm focuses on investments in the Nordic region, Benelux, France and Germany and it invests mainly in middle market companies. "When IK Investment Partners first started as a Nordic focused firm, in 1989, private equity funds as such did not exist in the Nordic region and only in perhaps one or two locations in Continental Europe" (IK Invest). Björn Savén and Kim Wahl founded IK Investment Partners under the name Industri Kapital. The firm's origins lie in Enskilda Ventures, which in 1989 sponsored Björn Savén in raising the *Scandinavian Acquisition Capital Fund* (SAC) and established the London office. SAC closed with approximately €108 million in commitments mainly from Scandinavian investors. He had previously achieved an MBA at Harvard in the 1970s and had got introduced to one of the founders of KKR. Björn Savén has also himself said that he got inspiration from regular discussions with American and British HBS classmates who had worked with venture capital (IK News).

Björn Savén worked in London at the time, and private equity was establishing itself there and this inspired Björn, according to Christer Dahlström. Enskilda Securities, SEB's London-based investment bank, enabled the first fund IK1989 and it only consisted of money from the bank's pension fund. According to Per Strömberg, Björn's relation and contacts within SEB helped to convince the bank to invest. Also Skandia invested early in the fund. Christer Dahlström explained that they decided to commit since they already had discussed a similar business model with Morgan Olsson and Robert Andreen, whom later founded Nordic Capital and they were already interested in the business model. Skandia later invested in several early buyout funds; e.g. IK Investment, Nordic Capital and EQT. The commitment of SEB and Skandia helped Björn Savén, according to Christer Dahlström, to attract other investors.

"At the time, it was actually illegal for a Swedish bank to invest in private equity so we had to go via its London Merchant Bank, and there were all sorts of other restrictions too", explains Björn Savén, IK's founder and Executive Chairman in an interview with IK News (2009). He also describes the main challenges to overcome in the creation of the new fund: "It was a real challenge just to set up the administrative, legal and financial structure. At the time, there were foreign exchange controls in Sweden, there were legal issues with foreigners owning Swedish companies and there were tax problems too – all of these had to be overcome" (IK News). He continues by stating that much explaining of the concept private equity had to be made to investors and how it could create long term value to them. Most of the investors were completely unfamiliar with private equity as a concept. The fund did early start to recruit people that had worked with buyouts in the U.S.. One example of this is that they in 1990 recruited Harald Mix, who had that specific experience (IK News). In the first five years, the fund only operated in Sweden, Norway, Denmark and Finland due to the cultural similarity and smaller language barriers.

5.2.4 Nordic Capital

Nordic Capital focuses on leveraged buyout transactions primarily in the Nordic region. Nordic Capital has acquired more than 50 companies since its start in 1989 and is among the 50 largest private equity firms in the world. Examples of companies that Nordic Capital has invested in are *SATS Sports Club*, *KappAhl* and *Ahlsell.* Nordic Capital has today approximately € 4.5 billion of capital under management and has since its foundation acquired over 50 companies.

As mentioned above, Morgan Olsson and Robert Andreen founded Nordic Capital in 1989 but its first fund was launched in 1990. Morgan Olsson had held various positions within industrial and financial companies, including a position as finance director of previously mentioned company Svetab. Prior to founding Nordic Capital, Morgan served as Vice President in the Mergers & Acquisitions Department at *Svenska Handelsbanken*. Robert Andreen had had various positions at *SKF* and also been president of a regional venture capital fund and then headed the Merger & Acqusitions Department at Svenska Handelsbanken. Christer Dahlström explains that there was a close cooperation between Svenska Handelsbanken and Skandia at this time, which led to a close contact between Morgan Olsson, Robert Andreen and these two large financial institutions. Therefore did Svenska Handelsbanken and Skandia decide to commit SEK 500 million to Nordic Capital. This would lead to a fund larger than IK Investments', which had SEK 500 million in committed capital. But the financial institutions got into financial troubles during these years and Svenska Handelsbanken had to draw back its committed capital and therefore all committed capital in Nordic Capitals first fund came from Skandia; however Svenska Handelsbanken was still involved in the process. This fund was very successful according to Christer Dahlström. It invested for example in publishing company *Liber* and the pest control service company *Anticimex*. In the second fund, Nordic Capital was able to attract more investors for example *Atle AB*, *Bure Equity* and *Svenska Handelsbanken.*

5.3 Drivers of Private Equity Introduction in Sweden

This section aims to describe main drivers behind the introduction of private equity in Sweden according to the literature review and the interviews. They drivers are not presented in order of importance.

5.3.1 Economic environment

Economic growth has been considered as an important reason for growth of private equity in Sweden by most of the interviewees. According to Christer Dahlström, the timing of the introduction of private equity in 1989 was important. There was loads of capital available and therefore easier to introduce a new investment form. Mikael Ahlström agrees that there was capital available at the time and that the positive economic climate was important for the origination of private equity. He continues by saying that the Swedish industry had been very capital intensive and Swedish banks were used to lend to companies with low solidity. Therefore the first funds could obtain loans with relatively low interest although a high leverage.

5.3.2 Socio-political factors

According to Ahlström et al, Swedish managers, especially the younger ones, appeared to be more risk-prone than many others of their Continental colleagues in the eighties. Many managers in Sweden owned stakes in the company they worked for and "the public interest, maybe influenced by recent US and UK political and entrepreneurial trends, has evoked a sentiment among people in the industry that it is a positive to own shares in the company you are working for" (Ahlström et al, 1986).

5.3.3 Inspiration from abroad

The American buyout market was peaking during the 1980's with great returns and some spectacular buyouts, not especially the buyout of RJR Nabisco by KKR – one of the largest buyouts in the history of private equity. Mikael Ahlström says that these impulses from the U.S. were very important and that the RJR Nabisco acquisition made the buyout phenomenon famous also outside North America. The success of private equity in the U.S. made it easier for funds in Sweden to attract capital from investors since they could point on the performance of the American firms, according to Per Strömberg. Stefan Sjögren agrees on that the inspiration from the U.S. is an important reason for the private equity introduction. As mentioned above, both Björn Savén and Mikael Ahlström was directly inspired by early private equity pioneers in the U.S..

Sweden was one of the first countries in Europe to introduce private equity. One of the few countries there were it originated earlier than in Sweden was in the U.K.. According to Christer Dahlström, the introduction of private equity in the U.K. was important to the establishment of it in Sweden. He says that Björn Savén had been to the U.K. and had there been inspired by the model. Christer Dahlström also says that the most important reason to the introduction of private equity in Sweden was the inspiration from other countries (2012). Mikael Ahlström also believes that the inspiration from other countries was very important and that inspiration was gathered both from the United States as well as the Untied Kingdom.

5.3.4 Changes affecting the Financial Sector

Several structural changes occurred during the eighties that affected the financial sector. The ones mentioned as having affect on the introduction of private equity are deregulations within the financial sector, the introduction of the OTC list and an increased interest in private equity form pension funds.

5.3.4.1 Deregulations within the financial sector

The Swedish Central Bank deregulated the Swedish capital market November 21st 1985 when Kjell-Olof Feldt was Minsiter of Finance under the Prime Minister Olof Palme. The process is described more thoroughly in the Section 4. Håkan Lindgren believes that deregulations were important in the development of private equity in Sweden. He says that many of the deregulations in the middle of the eighties, from the deregulation of the capital market in 1985 to the deregulation of the exchange market in 1989, was important for the development of private equity. He states that this development was necessary for private equity to develop, due to the otherwise limited possibilities of obtaining loans. Before these deregulations, it was very difficult to get shorter loans, referring to Håkan Lindgren. According to Christer Dahlström, the deregulations created completely new opportunities in creating these kinds of businesses. He also says that it still was some rules that created problems for the birth of private equity; tax deductions were not allowed on companies making losses, but profitable companies were always taxed. Stefan Sjögren also believes that the foreign exchange deregulation in 1989 was an important reason for the private equity introduction. Mikael Ahlström agrees and says that the currency deregulation is an important reason to why private equity was not introduced earlier in Sweden. It led to increased internationalisation of risk capital and made it possible for foreign companies to buy assets in Sweden as well as it improved the market efficiency and decreased the cost of risk capital funds (AP 4 Årsredovsining 1987). All the above deregulations also led to the tax reforms in Sweden in the early nineties after the breakdown of the Swedish economy, according to Sven Fritz (1990). This promoted small entrepreneurship, new business creation and savings. According to him, this promoted risk capital in general in Sweden and the creation of new businesses (1990).

5.3.4.2 Introduction of the OTC list

Sweden was one of the first countries in the world that created an organized trade with smaller companies. It started with the so-called OTC-list on the Stockholm Exchange (later become the O-list) in 1982. The introduction of the OTC-list had a significant influence on Skandia Investment in the early eighties (Dahlström, 2012). They could invest as minority owners in private equity with a defined objective of entering the OTC-list. Skandia Investment made about 15 introductions on the OTC-list during the eighties and, according to Christer Dahlström, the OTC-list was very important in the origin of Skandia Investment. SVCA also writes that the introduction of the OTC-list was a contributing factor to private equity introduction (SVCA). On the other hand, Mikael Ahlström says that the OTC-list was not that important for the introduction of private equity in Sweden since there is always a buyer for a good, healthy company and that the OTC-list was of limited meaning. One should note that Procuritas was one of the first private equity funds that later did IPOs in Sweden.

5.3.4.3 Increased interest of Private Equity from Pension Funds

Stefan Sjögren believes that changed regulations for pension funds in Sweden could be an important reason explaining the private equity introduction. Furthermore, Jonas Rodny says that Swedish pension funds also actively searched for other ways to deploy their capital than on the stock market and therefore it got interesting to invest in private companies.

5.3.5 Decreasing transaction costs through technological innovations

Stefan Sjögren believes that the transaction costs in Sweden was decreased during the eighties and that this could be a reason to the development of private equity. He also believes that this for example facilitated opportunities to market spread and corporate governance by the private equity funds that were not possible before the technological innovations. Furthermore, he believes that the contract form also developed which also led to further reduced transaction costs. SVCA writes that the stock exchange rise, which was due to a lowering in transaction costs, was one of the most important reasons for the private equity origination in Sweden (SVCA). Mikael Ahlström agrees to that transaction costs were lowered during this time period but that it was not so important in the establishment of private equity. He states that people were more important than decreased transaction costs.

5.3.6 Success of Early Private Equity funds

Christer Dahlström says that an important reason for the success and early adaption of private equity was that the early funds were very successful. It was much easier to raise capital to the second funds than to the first funds since they in the second round could point at successful previous investments. He mentions Nordic Capital's acquisition of Liber in 1990 (one of the funds first transactions), which turned out to be a very successful investment when sold to a Dutch company in 1993. This transaction became famous within the financial world and increased the interest for the private equity model. This together with other great early transactions helped in the raising of the second fund of Nordic Capital. Procuritas first real fund is another example of an early success fund; it created a return of nine times the invested capital, which is a record in Europe according to Mikael Ahlström. Ahlström et al writes that there were many targets in suitable size for LBOs in Sweden the time (1986).

Moreover, another reason to the origin of private equity that has been presented was the divesture of subsidiaries by large Swedish conglomerates. Jonas Rodny says that one important reason to the success of the early funds was a changed industry philosophy among the large Swedish conglomerates. Many of these owned several subsidiaries that did not get the attention that they deserved and therefore underperformed. This provided an opportunity for the first private equity companies to buy good companies and give them the right attention and develop them to reach their full potential. One example of a Swedish conglomerate is Electrolux. It bought approximately 150 companies during the seventies and the eighties. According to Jonas Rodny, many of these units had great potential but did not get the attention they needed to create the value they could. Many of the conglomerates sold these kinds of companies, which meant excellent opportunities for the private equity firms. Once again referring to Jonas Rodny, there existed a large amount of low-hanging fruits for the early private equity companies. Håkan Lindgren, professor in economic history at the Stockholm School of Economics, agrees and says that the breakdown of the conglomerates definitely was important for the growth of private equity in Sweden. Christer Dahlström also agrees to the importance of the divesture of companies by the large conglomerates. He exemplifies by saying that Nordic Capital for example made many early transactions form *Kooperativa Förbundet*. He says that these companies had not fulfilled their potential valuation and Morgan Olsson and Robert Andreen were great in identifying potential value; therefore they were able to buy good companies to a low valuation. Per Strömberg continues by stating that the timing of the introduction of private equity was excellent for its continuous growth. The funds were able to obtain investors during the growth years by the late eighties. When the crisis arrived in the early nineties, there existed many financial conglomerates that sold assets. An example is that Nordbanken sold many assets to IK, also referring to Per Strömberg. The private equity companies had good liquidity (due to that investors already had committed capital in their funds) and there were many willing sellers. Per Strömberg says that there was many buyouts with great returns that were made during this early period of private equity in Sweden and the industry achieved a good reputation among investors.

However, Mikael Ahlström says that the sell-out of the conglomerates subsidiaries was important for the growth of private equity as a business model in Sweden, but probably not so important in the actual introduction of private equity. He says that there were some really good deals made due to this in the first years of the nineties, especially did Nordic Capital do a couple of great transactions. On the other hand, this was after private equity was introduced in Sweden, according to Mikael Ahlström.

5.3.7 Involvement of Strong Entrepreneurs

Christer Dahlström believes that one of the most important success factors to thy private equity was introduced was the role of the entrepreneurs behind the first funds. He says that these persons – exempli gratia Björn Savén, Robert Andréen and Morgan Olsson – played a vital role in the establishment. Their ability to sell the new concept and to persuade investors to invest in the idea was important as well as how they actually ran the funds. Christer Dahlström describes Björn Savén as an excellent and very bright individual. He continues by saying that Björn Savén's personality combined with the backing of large financial institutions (SEB and Skandia) was important in the private equity establishment. Stefan Sjögren agrees to that the entrepreneurs are important. However, he believes that they were not the decisive success factor. He believes in this case that the surrounding environment is more important than the actual entrepreneurs. Mikael Ahlström says that the entrepreneurs played a significant role in the introduction, but that private equity would have been introduced in Sweden later in Sweden even if these actual entrepreneurs had not existed. He explains that the largest obstacle was to overcome people's limited knowledge of the private equity industry. He exemplifies by saying that most people thought that MBO meant Management Buy Objective and that EBIT was an IT-term. When they tried to introduce the business model for lawyers, these were very sceptical and thought that it illegally tried to buy a company for its own money.

6 Analysis

This section aims to discuss the viewpoints presented by the interviewed economic researchers and the key individuals participating in the private equity introduction and link it to the theoretical review and background research that was undertaken. First is the course of event of private equity origination in Sweden discussed. Then the actual factors that drove the introduction as well as their importance is discussed.

6.1 Course of event: private equity establishment in Sweden

The course of event of private equity introduction in Sweden was thoroughly described in Section 5. In general, there have been few points of disagreements between the data sources and therefore the presented timeline seems reliable and trustworthy.

However, one important question regarding the introduction remains: which of these historical events was the first private equity activity in Sweden? The oldest private equity firm is Priveq but since its first fund, created in 1983 as Skandia Investment, only did minority investments working on a case-by-case basis, this seems relatively far away from the private equity model of today. Most of the interviewees seem to agree with this statement including Christer Dahlström, CEO of Skandia Investment. LBOs were made before the launch of Procuritas but not in an organized form and none of the interviewees regards this as private equity. However, it is more intricate to determine if the investments of Procuritas were private equity or not. It definitely was the first firm doing leveraged buyouts in Sweden and some sources consider Procuritas and Mikael Ahlström to be private equity pioneers. On the other hand, Procuritas did not in its early phase set up a private equity investment fund, which is the normal private equity business model as of today as presented in the Section 4. But if one considers the definition of private equity, the fund structure is not a prerequisite:

> "[Private equity] is the provision of capital … with the aim of developing the business and creating value… Private equity firms have a main goal: seek out

> companies with the potential for growth and with the aim to put in place the capital, talent and strategy needed to permanently strengthen the company and raise its value".

Therefore this paper takes the stance that Procuritas introduced private equity in Sweden. However, this depends on the definition of private equity and it would not be completely wrong to say that IK Investment and Nordic Capital were first.

6.2 Which were the factors driving the introduction?

It is quite obvious that there was not only one factor that facilitated the introduction of private equity in Sweden. Quite opposite, there is no doubt that there were many smaller changes and coincidences that led to the first private equity funds. The thesis does not aim to present all of them, but rather to present the driving factors and try to discuss their inter-mutual relevance.

Mikael Ahlström and Christer Dahlström, both highly involved in the private equity introduction, mentioned the economic climate in Sweden as an important explanation to the introduction of private equity, since it increased the availability of capital. Economic growth has also been considered as an important factor of private equity introduction in the U.S.. Furthermore, the theoretical section presented economic activity and economic growth in a country as important success factors for private equity growth due to the deal flow opportunities. GDP was, in accordance with the theory, used as a measure of economic activity and growth. The Swedish GDP growth during the interesting years is presented in Figure 14. The Swedish economy was growing at the time of introduction, however not as rapid as during the sixties and the seventies. Therefore it is reasonably to assume that the economic climate was a prerequisite for the private equity introduction but maybe not determinant; otherwise it could have developed in any time when the Swedish economy was growing.

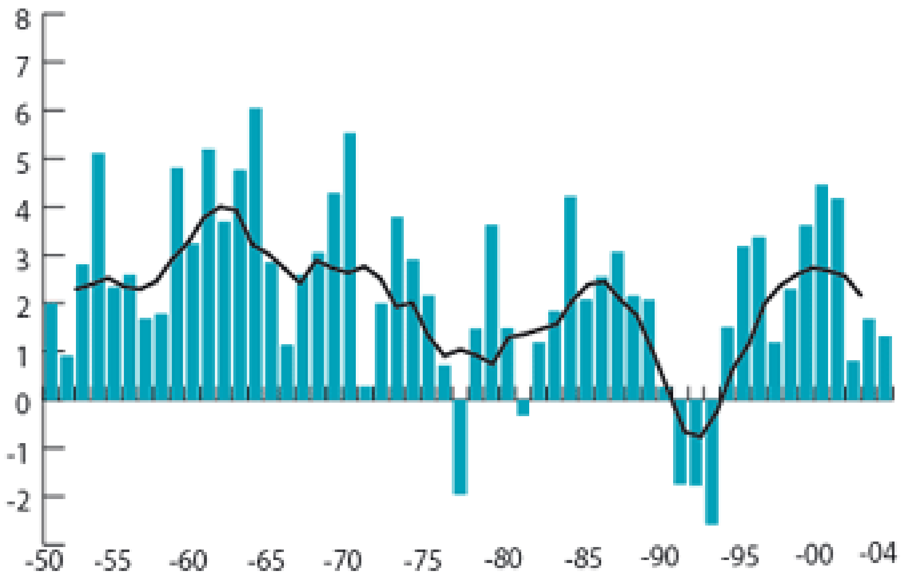


Figure 14 Swedish GDP growth 1950 to 2004 (Source: SCA)

A positive economic growth does affect the availability of capital, which as concluded benefit private equity, to some extent but there were also other factors contributing to the availability of capital, which is important for the origination of private equity. For example in the U.S., the clarifications of ERISA made institutional investors return to investment in the asset class private equity and the real private equity growth did not commence until these clarifications. It was especially the pension funds that now could invest in private equity funds to a larger extent and this became an important factor in the growth of private equity. Pension funds have been an important investor in Swedish private equity historically and, as has been noted, some of the persons interviewed consider it as an important reason to the introduction of private equity. Hence, it is interesting to see the increased focus from the Swedish pension funds regarding non-public equity in the early eighties. This increased the inflow of money into non-public equity and possibly also increased the interest of other investors in these types of companies. The Fourth AP-fund did also very early invest in Nordic Capital, which witness of a significant role of the pension funds in the private equity development. On the other hand, no pension funds invested in Mikael Ahlström's first buyouts. Therefore it is difficult to credit the pension funds investments in private equity as the facilitating factor but the pension funds have definitely played a significant role in the early growth of private equity. It does not seem to have been any regulatory changes that stimulated these investments.

Regarding institutional investors, the banks and companies that invested in Procuritas, Nordic Capital and IK Investment played a more significant role. Here it seems to have been the close interaction between individuals and the institutions that have been vital. One example is how Mikael Ahlström convinced Barings to invest in Procuritas. He had been offered a job at Barings earlier and had a close personal contact with them. Björn Savén also had close contact with SEB, which helped to convince the bank to invest in IK Investment. Robert Andreen and Morgan Olsson had worked at Svenska Handelsbanken and done work together with Skandia, which helped to convince these institutions to invest in Nordic Capital's first fund. These close personal contacts with the investors seem important in attracting capital to be invested in this new business model. This leads us to believe that the role of the entrepreneur was important.

Theory has also presented capital markets and liquidity of stock markets as important success factors of private equity. An explosive increase in trading on the Swedish stock exchange has been noted and this started in the late eighties but the real increase was in the early nineties. A similar pattern can be observed in the U.S., where the NYSE started to increase in trade during the private equity introduction but that the real boom was afterwards. Furthermore, the theoretical viewpoint is, as presented in Section 4, that the growth of private equity is quite correlated with the growth of the stock market lowering transaction costs and increasing confidence in risk capital. So the technological innovations that led to the increase in stock market trading volume seem to have contributed to the private equity introduction. As both Stefan Sjögren and SVCA believe, it helped in the development of private equity by lowering the transaction costs. Irding explained that the digitalization of the stock market led to lower transaction costs from increased liquidity and increased access to information. Each financial transaction is also explained to have become cheaper. As presented in the theoretical section, these are all important transaction costs within private equity. On the other hand, important private equity entrepreneurs believes that the lowering of transaction costs were not so important for the introduction of private equity in Sweden.

The digitalization of parts of the financial market may also have made it easier to borrow money through an easier process of obtaining debt and lowering of transaction costs. However, the main reason for the increased lending was the deregulation of the financial sector in Sweden, and this must be considered as a very important reason for the introduction of private equity in Sweden. First and foremost, it led to development of financial technology as well as an extreme expansion of the credit market. It also facilitated for foreign capital to be invested in Sweden, which of course also increased the inflow of money to Sweden. As Section 4 presented, the lending increased significantly, especially to the financial sector. Section 4 also presented the availability of capital as an important factor for a strong private equity market. So the inflow of capital facilitated private equity and this was much due to the deregulation of the financial market. The debt market was also highly favourable for a debt depending business model as leveraged buyouts are. The theoretical section presented the low real rates in the Swedish economy during the latter part of the eighties. Due to high inflation and taxes, the real rate was during some years negative, which of course offered favourable conditions for leveraged buyouts. Add to this that banks of tradition were relatively willing to lend money to capital-intensive companies with low solidity. This fact may have made it easier to convince investors to invest in the first private equity firms. Of course, it is not as easy on beforehand to determine the actual real rate but the expected rates were also negative, indicating a consciousness of the cheap debt opportunities. It has also been observed how the low Federal Funds Rate in the U.S. helped fuel the private equity boom there. The difficult question is to understand how important this was for the first private equity funds contra other factors such as the role of the entrepreneur. Would it have been possible for Mikael Ahlström and the other originators to convince institutions to invest in them if there would have been harsher times? The question is impossible to answer but it was probably much easier to convince the institutions when the availability of capital was high and cheap. The entrepreneurs also agree to that the availability of capital was very important in the introduction of private equity.

Section 4 presented the importance of having a well-developed stock market that permits exits through an IPO. In Sweden, the introduction of the OTC list did increase the possibility to IPOs. This has probably contributed to the private equity introduction by decreasing the insecurity in the investment phase by presenting a potential exit option. Christer Dahlström described how this helped Skandia Investment by providing a clear target to their investments and therefore decreased the exit insecurity. SVCA has also said that the OTC-list was one of the most important reasons behind the introduction of private equity in Sweden. On the other hand, Mikael Ahlström did not believe it helped fuel the introduction of private equity. Since Priveq followed a different business model and Mikael Ahlström is one of the most important entrepreneurs, it is believed that the introduction of the OTC-list was of secondary importance.

Many of the interviewees have mentioned the success of early private equity funds in Sweden as an important driving factor of the introduction. The divestures of Swedish conglomerates have been mentioned as a factor that provided great targets that later on created great returns, convincing investors to allocate more funds into private equity. This was probably very important for the early growth of private equity, however it is probably not a driving factor of the birth of private equity. Important examples can be observed; one of the first buyouts was in 1989 when Procuritas bought Swedish Match AB from Stora

Kopparberg AB. Nordic Capital and IK Investment also based their first funds on acquired companies from large conglomerates. But then they had already obtained committed capital. Of course, the funds' investment strategy could have been to invest in this type of companies but the first buyout in Sweden – Procuritas acquisitions of Gunnebo AB – was a public to private transaction. Therefore it cannot be said that the divesture of conglomerates was the driving factor of private equity origination, however it definitely helped fuel the growth of it. However, the early entrepreneurs could have been inspired by the fact that there were loads of low hanging fruits out there and this may have increased their belief in the private equity business model.

The American private equity market was, as has been noted, strong during the 1980's and the returns were great. This must have been important both as inspiration but also as aid to persuade investors. Private equity was not a new invention and examples of deals could be presented to the investors. It is also interesting to note that early American private equity firms clearly inspired both Björn Savén and Mikael Ahlström. It was also important that private equity had been introduced in the U.K. before Sweden; this helped Mikael Ahlström convince Barings to invest in his first buyouts. Some interviewees claim that the inspiration from abroad is the most important reason to the introduction of private equity in Sweden. If it had not been invented in the U.S. in the seventies, private equity would probably not have been introduced in Sweden as early as in the late eighties. But why did it take so long for private equity to transfer from the U.S. to Europe and Sweden? Why was not private equity introduced earlier in the eighties? This is probably were the other factors, such as the deregulation of the capital market, decreasing transaction costs and the positive economic climate, comes into play. A slower innovative transfer and adaption pace due to less globalization and continental integration during the eighties are also probably important reasons. This is difficult to prove and a thesis could be written on this topic alone, but it is likely that it existed a transfer gap that was larger in the eighties than today. The example of that Mikael Ahlström and Björn Savén was physically abroad when they were inspired indicates it. Moreover, there is a technological gap between the digitalization of the NYSE and the Stockholm Stock Exchange. NYSE introduced its electronic stock exchange system DOT in 1976 when the Stockholm Stock Exchange introduced its SAX in 1989. The boom in annual trading volume was therefore also later in Sweden compared to the U.S. (Figure 15). This is maybe not a proof of an existing transfer gap existing at the time, but it indicates the existence of it.

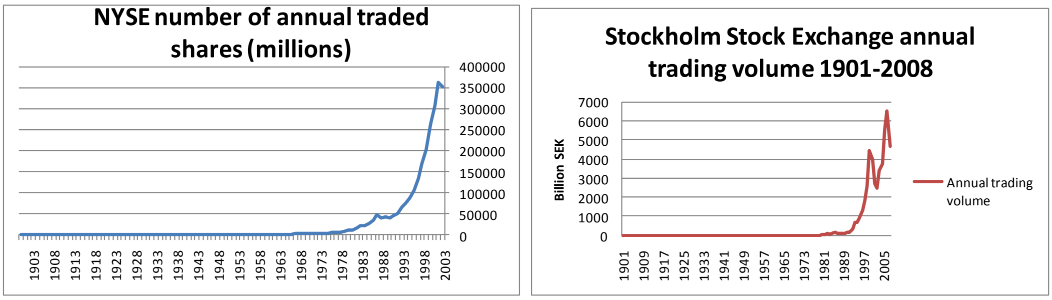


Figure 15: Annual trading volume NYSE vs. Stockholm Stock Exchange

Clearly, the private equity introduction in the U.S. was vital to its establishment in Sweden but the role of the Swedish entrepreneurs should not be down valued. The theory on entrepreneurship clearly states that discovery and exploitation of a new market is an entrepreneurial act and therefore the entrepreneurs' role in the Swedish introduction of private equity is fundamental. There is no doubt that the early private equity pioneers are outstanding individuals who played an important role. Their existence may have affected the year of introduction and if they had not existed, the introduction could have been delayed. On the other hand, it is unlikely that private equity would never have reached Sweden if these specific individuals had not been born. So the entrepreneurs were actually important in the introduction and probably affected the time of origination somewhat, but were not the driving factor of what facilitated private equity in Sweden. But the aim of this thesis is to present the driving forces of private equity and there the entrepreneurs definitely played a significant role.

There are also several factors that influenced the introduction of private equity in the U.S. that also have been considered but that not seem to have played a significant role in the introduction of private equity in Sweden. The takeover threat of companies has not been mentioned as a driving force of private equity introduction in Sweden. Reductions in the federal capital gain tax was by some considered as an important factor helping to initiate private equity in the U.S. but an analysis of the tax regulation in Sweden does not indicate any larger important changes (or any other similar taxes with potential effect on the private equity introduction) (Skatteverket, 2007). Therefore, together with the fact that any of the interviewees has mentioned it, changes in taxes should not be of great importance. Furthermore, as the literature review showed, it is argued that capital gains taxes have little influence on capital inflows to private equity since many investors incur no tax liabilities on gains but it probably affects venture capital more.

The literature review also introduced other factors that stimulate private equity in a country that have not been mentioned. Investor protection, human and social environment and entrepreneurial opportunities are factors that are important for private equity to flourish. These are assumed to be relatively strong in Sweden but no larger changes have been identified during the period of interest; neither in the literature review or in the interviews. Therefore these are not considered as driving forces of the private equity introduction.

6.3 Of these factors, which accounted for a more significant role in the private equity establishment?

Based on the discussion above, there are some factors that seem to have contributed more to the introduction of private equity than others. Key for the introduction is the inspiration from the U.S., the deregulation of the capital market in Sweden and the economic climate. It is not probable that private equity would have been introduced in Sweden in the late eighties if it had not been introduced in U.S. earlier since Sweden is not considered a leader within financial innovation. It also seems to be some kind of transfer gap between the U.S. and Sweden resulting in a quite long period between the introduction in the U.S. and in Sweden. The deregulation of the capital market was also extremely important since it increased the amount of capital available. The positive economic climate during the period affected coherently and probably made it much easier to obtain capital. The entrepreneurs, their new thinking and their networks also played a vital role, but more as enablers. Private equity would probably have been introduced in Sweden anyway but maybe at another point in time. It is difficult to estimate the impact of the lowering of transaction costs. Several ways have been mentioned on how it could have helped stimulate private equity but the fact that the first buy-out in the U.S. was made in 1964 and that KKR was founded in 1976 indicates that private equity could evolve before the financial industry was changed by the digitalization of the stock exchanges that led to a significant decrease in transaction costs. However, these factors were important in the growth of private equity; both according to theory presented in Section 4 and interviews in Section 5. The digitalization of the financial system could also have been important in making it easier to perform the type of complex transactions that private equity consist of. One example is the regulatory issues Björn Savén faced in setting up his first fund. It would probably have been difficult to create it in London before the digitalization of the financial system.

There are also several factors that were important to the early growth of the industry. Increased focus from pension funds towards private equity helped many early funds but did invest in the first buyouts and funds. The introduction of the OTC-list was also important and could have helped to convince investors to invest but it is not probable that this potential exit strategy stimulated the first buyouts since Gunnebo AB was sold to a strategic buyer. However, many early acquisitions were made public so it helped stimulate the early growth. The same holds for the divesture of Swedish conglomerates and the success of early funds; these factors definitely led to early growth of private equity but did probably not create the introduction of private equity in Sweden.

7 Conclusions

This section presents the conclusions of the thesis based on previous sections of the report. It aims to explain how the growth of private equity in Sweden during the 1980s and 1990s.

The course of event regarding the private equity industry's introduction can be mapped and is presented in the Section 5. There are relatively few, if any, points of disagreements regarding the story and it is therefore concluded that the one presented is accurate. The only discussion is if the first buyout in 1988 should be acknowledged as the start of private equity in Sweden or if it was the first funds in 1989 that was the real start. This depends on the definition of private equity but this thesis viewpoint is that private equity was introduced in 1988 when the first leveraged buyouts were undertaken.

Several factors have been identified as relevant to the introduction of private equity. The most important are the inspiration from the U.S., the deregulation of the capital market in Sweden and the positive economic climate in Sweden at the time. Without these in place, private equity would probably not have been introduced in Sweden. The entrepreneurs also played a vital role and affected the actual timing of the introduction but it is concluded that private equity would have been introduced even without these individuals, but maybe not in 1988/1989. The reduction of transaction costs and the digitalization of money also played a role but it is concluded that they are secondary to the factors presented above.

There are also several reasons that were important for the early growth of the industry. These are pension funds investments, the OTC-list, divesture of conglomerates and the success of early funds. These were all very important in the establishment of private equity as one of the most important economic forces in Sweden.

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9 *Appendix*

9.1 Foundation of private equity firms in Sweden

All firms that are members in SVCA have been included in this list and the analysis is based on information available on the homepages of the companies. However, one should notice that the list is not comprehensive but the interviewees have validated that no older Swedish private equity firms exist.

PE Firm	First Investment
3i	2001
Accent Equity Partners	1994
Altor	2003
Atle AB	1993
Bure	1992
Capman	2002
Cubera	2006
East Capital Explorer	2007
EQT	1995
FSN Capital	2001
IK Investment	1989
Litorina	1998
Nordic Capital	1990
Norvestor	2004
Novestra	1997
Ratos	1999
POD Investment	2000
Priveq	1983
Procuritas	1986
Scope	2001
Segulah	1997
Valedo	2006