# ARTICLE – Private equity: a growing market in transition

In recent decades, private equity firms have increasingly been investing in and acquiring companies in many countries, particularly in the United States. Slightly simplified, they can be referred to as private equity firms. Sweden is also home to large, internationally active private equity firms with significant investments in companies. Private equity firms provide companies with an alternative way of financing their operations, as well as effective corporate governance that has historically helped companies grow and generate returns. Private equity firms are often highly leveraged and need good access to credit. This makes the sector vulnerable to higher interest costs. The business is associated with risks that are difficult to assess for both the investors in private equity firms and the acquired companies as the business adapts to a changed interest rate environment. The fact that the sector is largely international in scope makes it difficult to assess how great the risks are from a Swedish perspective.

## Private equity: an investment strategy

Private equity, often called 'riskkapital´(risk capital) in Swedish, is an umbrella term for various ways of investing in companies that are not listed on the stock exchange and not a specific type of company.[69] The business model is that a private equity firm acquires companies, takes steps to make them more profitable, and then sells the companies, either to another larger company or by listing it on the stock exchange. The companies acquired become portfolio companies of the private equity firm. Sweden has a large private equity industry - private equity firms own around 1,200 companies in Sweden that employ around 260,000 people.[70] Private equity investments can be roughly divided into two categories: investments in relatively new companies (venture capital) and acquisitions of more mature companies (buyouts). In this article, we focus on the latter.

Private equity firms often have their own strategies and invest in different companies and develop their portfolio companies in different ways. For example, some acquire companies that are already doing well but could be even better. Others seek out companies with problems that the private equity firm believes it can solve. The latter is a riskier strategy, but also means that companies are cheaper to acquire. In general, private equity firms are keen to invest in sectors that are not particularly cyclical and where there is high growth potential. Because their targets are time-limited, private

[69] The Swedish term 'riskkapital' is often used broadly without distinguishing between different types of operations.

[70] According to information from the industry organisation SVCA.

equity firms want to be sure that they get a good return regardless of the prevailing economic conditions when the portfolio company is sold.

The business model of private equity firms typically involves more direct governance of companies when compared with listed companies owned by large institutional investors, such as mutual funds. Such investors are rarely able to fully familiarise themselves with the actual operations of the companies they own, which can lead to ineffective corporate governance. They also seldom own a large share of the company, which makes it difficult to make decisions on their own. Private equity firms have a more limited portfolio of companies that they can control, and can therefore, for example, decide on the company's strategy or replace management teams that they think are underperforming. This is how private equity firms can implement growth-enhancing measures, which can have positive effects on the real economy.

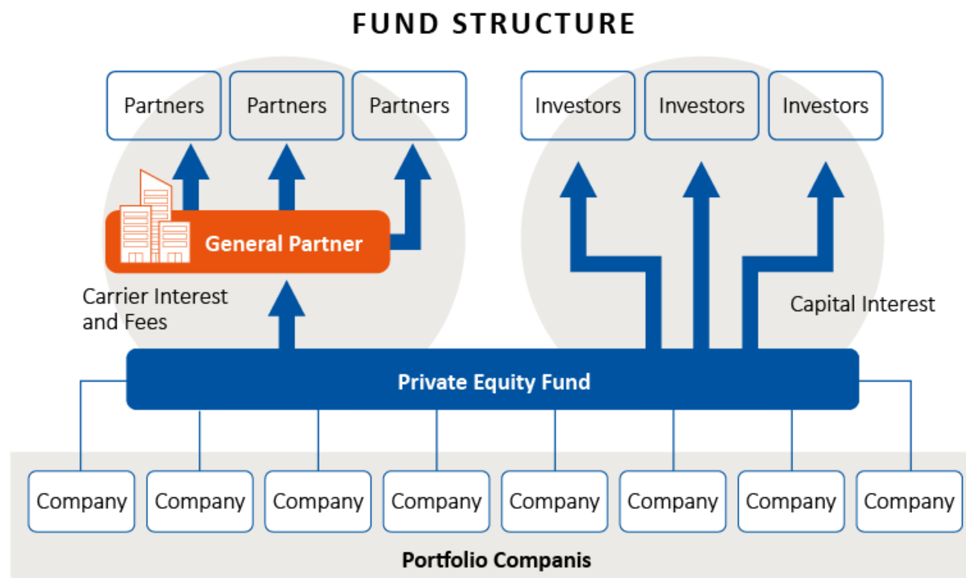
Private equity firms companies receive their capital from investors who invest in a private equity fund. The partners of the private equity firm normally invest in the same fund, which gives them strong incentives to increase the value of the fund's holdings. The private equity firm then uses the money in the fund to acquire and invest in private companies. The money that investors have agreed to invest is used as they find suitable companies to invest in. The difference between the amount an investor has committed to invest and what investors have actually invested is called 'dry powder', as it is a measure of the fund's ability to make further investments.

Private equity firms investing in new companies mainly use capital from their fund. Private equity firms that acquire more mature companies instead often use a combination of the fund's money and loans from one or more creditors. This method is known as a leveraged buyout (LBO). The loans are charged to the balance sheet of the portfolio company, resulting in higher interest and amortisation costs for the portfolio company. Companies owned by private equity firms are typically more indebted than other companies, which can increase the risk of bankruptcy and creditor losses. Research based on US data has shown that private equity-owned companies are adept at managing their high levels of debt and therefore do not need to be liquidated to the same extent as other highly indebted companies.[71] However, that research was based on data from a period of low interest rates and good access to capital. The higher interest rates of recent years may have made it more difficult for highly indebted portfolio companies to service their debt, which could lead to an increase in bankruptcies. This, in turn, could cause losses for creditors and investors in private equity funds. This business model has been profitable for private equity firms during this period, with low interest rates and good opportunities to list companies at high valuations. With higher interest rates and lower valuations on new listings of portfolio companies, it is likely that their business model is less profitable than before.

[71] Hotchkiss, E. S., Smith, D. C., & Strömberg, P. (2021). Private equity and the resolution of financial distress. The Review of Corporate Finance Studies, 10(4), 694-747.

Figure 1 shows a typical relationship between investors, private equity firms and portfolio companies.[72] Private equity firms charge their investors a fee, often two per cent of their invested capital, and they receive a share of the profits when the fund is wound up, usually 20 per cent (carried interest).

**Figure 1: Typical structure of a private equity firm**




Note. Investors, or limited partners, invest together with the private equity company, the general partner, in a fund. This fund, in turn, buys a number of portfolio companies governed by the private equity firm. Portfolio companies receive additional investments to improve their productivity and pay a regular fee to the fund. After a set period of time, the fund is wound up, the portfolio companies are sold and the surplus is distributed to investors.

## The financing of private equity firms has changed and diversified

Private equity firms have historically borrowed primarily from banks to finance their portfolio companies. However, in recent years, they have also increasingly borrowed from other financial actors, so-called non-banks such as private credit funds.[73] Market funding is also common, where the portfolio company itself issues bonds, for example.[74] Chart 38 shows both how the number of European private credit funds and the

[72] A private equity firm uses capital from the fund for its investments. However, it does not contain cash and investors need to inject these when they receive a request, which poses a liquidity risk for the fund and thus for the portfolio companies. Here, banks often offer the funds bridging loans, which are a kind of standing credit facility, that the funds can draw on to get the cash they need. Investors who do not pay in the contracted capital may lose their entire stake in the fund, and thus have strong incentives to pay. According to PE actors, it is very unusual for investors not to deliver as agreed.

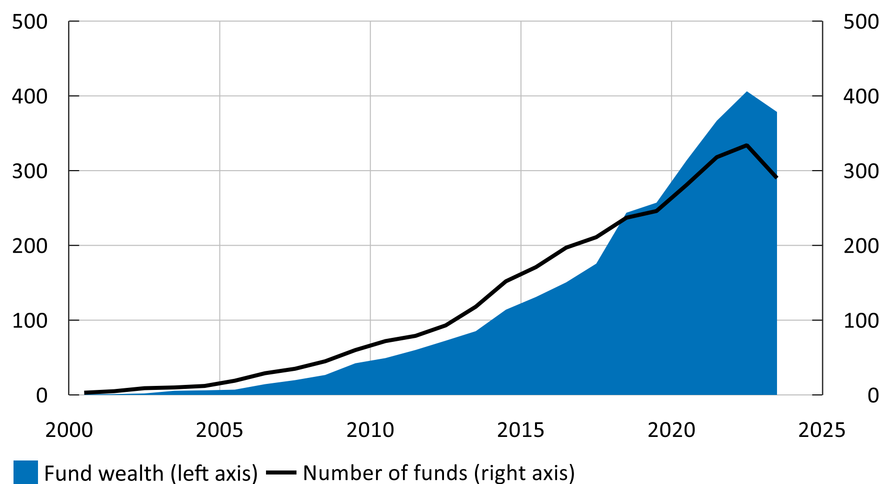
[73] Private credit funds can lend directly to private companies or buy loans for these companies that other actors, such as banks, have securitised. Unlike private equity, private credit funds do not take control of the companies they lend to.

[74] Funds sometimes also take loans with all portfolio companies as security, known as net asset value (NAV) loans. These are often used to make additional investments in portfolio companies when there is not enough capital in the fund. They can also be used to deliver returns to investors if selling the portfolio companies is considered unfavourable.

size of their funds have increased in recent years[75]. There are several reasons why private equity firms have increasingly borrowed from non-banks or via the bond market in recent years, even though this is often more expensive than borrowing from banks. Non-banks can often offer larger loans than an individual bank can, and for the private equity firm, it is desirable to have a larger credit from one lender rather than several smaller ones that need to be negotiated with different banks. It also seems that non-banks are more willing to relax loan conditions linked to the performance of the portfolio company (covenants) in return for being able to charge more for the loans. At the same time, banks have become somewhat less willing to lend to private equity firms as banks have been required to have higher capital adequacy for risky loans. Non-banks have not been subject to any such requirements.

**Chart 38. European private credit funds**

USD billion, number




Note. Fund wealth includes capital that has not yet been used, known as dry powder. Based on the domicile of the fund manager.

Source: PitchBook Data, Inc.

## Swedish private equity firms have a significant international presence

Private equity firms in Sweden are major international players in terms of both how they are financed and the portfolio companies they invest in. For example, the Swedish private equity firm EQT is the world's third largest in terms of the size of assets under management in its funds, approximately EUR 119 billion. Other major Swedish private equity firms include Nordic Capital, which manages EUR 25 billion, and Altor, which manages EUR 4.5 billion.[76] A private equity firm based in Sweden typically has its investment and advisory activities here. However, private equity funds themselves are rarely legally based in Sweden, but are often located in countries such as Malta,

[75] Private credit funds lend money not only to portfolio companies but also to other companies, primarily medium-sized enterprises.

[76] However, not all of the capital managed is necessarily in the funds, but instead represents claims on the investors, known as dry powder. The private equity firm calls on this capital as it has projects to invest in. Usually, not 100 per cent of all capital is invested, but a small reserve is kept to be used if crises arise in a portfolio company.

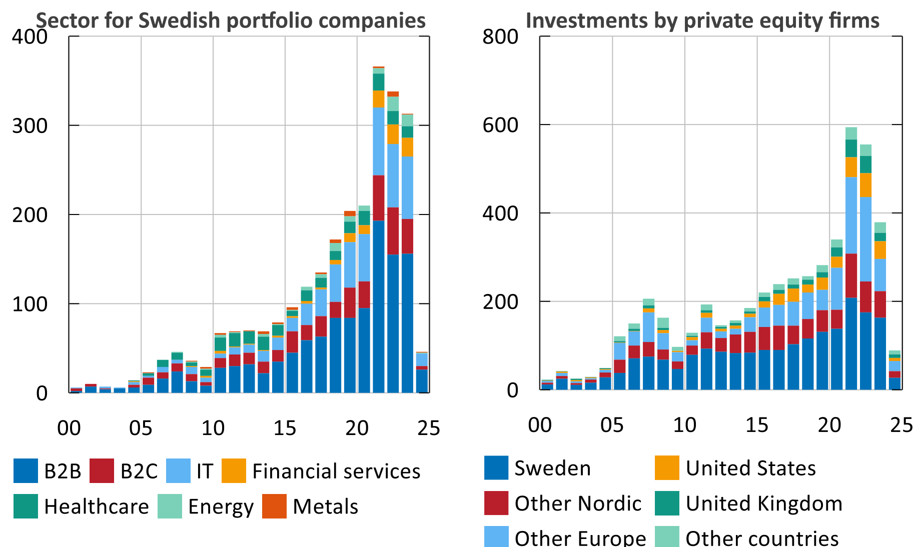
Ireland and Luxembourg. Investors in private equity funds are often drawn from a global market. For example, pension funds in other countries are common investors in the private equity funds managed by Swedish private equity firms. Other major investors include sovereign wealth funds and large institutional managers. The portfolio companies in which Swedish private equity firms invest are also located in several different countries, although Swedish private equity firms invest in Nordic companies to a greater extent than might be expected given the economic size of the Nordic countries.

The fact that large private equity firms are based in Sweden does not necessarily mean that there are large Swedish exposures in the funds. Investors in the funds and lenders to the portfolio companies, as well as the portfolio companies themselves, can be and often are foreign. In these cases, the link to Sweden is mainly that the investment decisions and the subsequent corporate governance of the portfolio companies take place from here.

The left-hand side of Chart 39 shows the Swedish sectors in which private equity firms invest. The most common category is business services (B2B), followed by IT and consumer services. The right-hand side of Chart 39 shows the number of investments made by Swedish private equity firms broken down by the geographies in which they have invested. It shows that Swedish private equity firms usually invest in the Nordic countries and the rest of Europe.

**Chart 39. Investments in Swedish portfolio companies by company sector and investments by Swedish private equity firms by geographical area**

Number




Note. Investments include acquisitions and additional investments. B2B menas business-to-business services, B2C means business-to-consumer services.

Source: PitchBook Data, Inc.

## Private equity poses various risks to the financial system

There is an ongoing international debate on the risks associated with private equity and their potential impact on the financial system. For example, the increased role of non-banks as creditors to private equity firms, and the resulting reduction in the role of banks, makes it more difficult to assess the credit risks. Non-banks, such as private credit funds, are less transparent and not as strictly supervised as banks. However, a potential benefit of the increased role of private credit funds is that credit risks will be less concentrated than if banks had been responsible for all lending. In a situation where many companies go bankrupt, both private equity-owned and others, loan losses are spread over more actors, which can be positive for financial stability. Investors in private credit funds, like those in private equity funds, agree to lock in their capital for a longer period. This means that, unlike banks, private credit funds run a small risk of being exposed to liquidity crises, as investors typically cannot recover their investments early.

Private credit funds have similar investors to private equity funds, which means that bankruptcies among portfolio companies would concentrate losses in the same type of investors. If the portfolio companies had been financed by bank loans instead, investors would share the losses with the banks. However, the lack of available information from the private credit funds makes it difficult to assess the risks in Sweden. As private credit funds are a relatively new form of corporate lending, there is also no previous experience that can be used to assess risks.

Private equity firms may face problems if several of their portfolio companies go bankrupt, or if it becomes difficult to sell them without making a loss. Moreover, as it has not been financially favourable to list companies on the stock exchange in recent years, many private equity firms have several companies that need to be sold to generate a profit. The European Central Bank notes that it is not obvious that the historically high profits of private equity firms are possible with today's high interest rates and difficulties in selling companies. For example, if private equity firms are unable to deliver the returns investors expect, this could, for example, make it difficult for pension funds to pay out the high pensions they have promised. This has been recognised in the United States, where large pension funds have invested in private equity funds. In Sweden, pension funds invest significantly less in private equity funds as a proportion of their total assets: just over 4 per cent. Therefore, these risks are lower here than in other countries.[77]

The business model of private equity firms has benefited from low interest rates and high valuations of the stock prices of those companies that have gone public. With higher interest rates and lower IPO valuations, it is not likely that private equity firms will be able to deliver the same returns and thus not attract the same volume of investment. As a result, portfolio companies may not be able to obtain the capital injection they need to develop in a desirable direction.

[77] They also invest in funds that focus on other alternative asset classes, such as property and infrastructure funds. The size of their holdings of alternative fund assets amounts to almost 10 per cent of their total assets, according to data from the European Insurance and Occupational Pensions Authority (EIOPA).

Another aspect is that the holdings of private equity funds are not constantly marked-to-market, which distinguishes them from equities and bonds. Their book value is therefore relatively stable and has been one reason why institutional investors, such as pension funds, have favoured investing in private equity funds. But it also means that it is harder for investors to know what the actual market value of their assets is.

## Important to continue to analyse the private equity market

Sweden has both large private equity firms and many private equity-owned portfolio companies. That said, the financing for private equity firms comes largely from foreign investors. Swedish banks also have substantial lending to private equity firms, but this has declined over time. The fact that such a large proportion of the Swedish private equity industry's financing comes from abroad means that any crisis for private equity firms should have limited direct effects on the Swedish financial system, but the indirect effects are difficult to assess. The increasing importance of private credit funds in the provision of credit to companies, both private equity-owned ones and others, needs to be further analysed. Therefore, greater access to data from international non-banks is needed to better analyse whether they pose a stability risk to Sweden.