

2007-2016: THE ITALIAN PRIVATE EQUITY MARKET A DECADE AFTER THE BEGINNING OF THE CRISIS: FULLY RECOVERED, BUT NEEDS TO STAY FIT

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2007-2016

**The Italian Private Equity market
a decade after the beginning
of the crisis: fully recovered,
but needs to stay fit**

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PREVIEW

IN THE LAST TWO-THREE YEARS, THERE HAS BEEN A STRONG FLOW OF PRIVATE EQUITY TRANSACTIONS IN ITALY WHILE M&A ADVISORS AND PE FIRMS DECLARE THEMSELVES BUSY CHASING OR ARRANGING DEALS.

IT SEEMS A NEW GOLDEN MOMENT FOR PE INVESTMENTS HAS ARRIVED, LIKE IN 2004-2007 PERIOD. TO UNDERSTAND IF THIS IS REALLY THE CASE AND WHETHER THERE ARE ANY HIDDEN ISSUES IN THIS “MOMENTUM”, WE HAD A LOOK AT BOTH HOW THE THE 2007’S CRISIS AFFECTED THE ITALIAN PE INDUSTRY AND THE CURRENT MARKET SITUATION.

The economic crisis, which shocked the global economy after 2007 and which has only recently ended, rocked the Italian PE world, especially LBOs, due to the lower availability of investment capital and the weaker popularity of the Italy-based assets. Anyway, as the economic conditions have improved, also the deal volume has recovered and is now almost back to pre-crisis levels.

THE IMPACT OF THE 2007'S CRISIS ON PE INVESTMENTS

The economic crisis, which shocked the global economy after 2007 and which has only recently ended, rocked the Italian PE world, especially LBOs, due to the lower availability of investment capital and the weaker popularity of the Italy-based assets. Anyway, as the economic conditions have improved, also the **deal volume has recovered and is now almost back to pre-crisis levels** (see Exhibit 1).

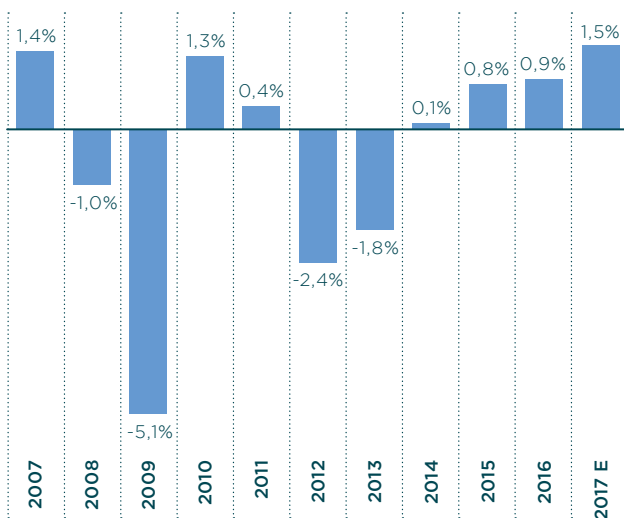
Domestic investors have not substantially changed over the years the volume of funds allocated to Italy based PE funds, differently from what foreign investors did (see Exhibit 2 next page).

Especially in the aftermath of the Euro-debt crisis (2010-2011), Italy entered the “black list” of important international institutional investors (such as pension funds, insurance companies or sovereign funds). This is mirrored by the fall in the resources invested by international PE funds in Italian deals (see Exhibit 3 next page).

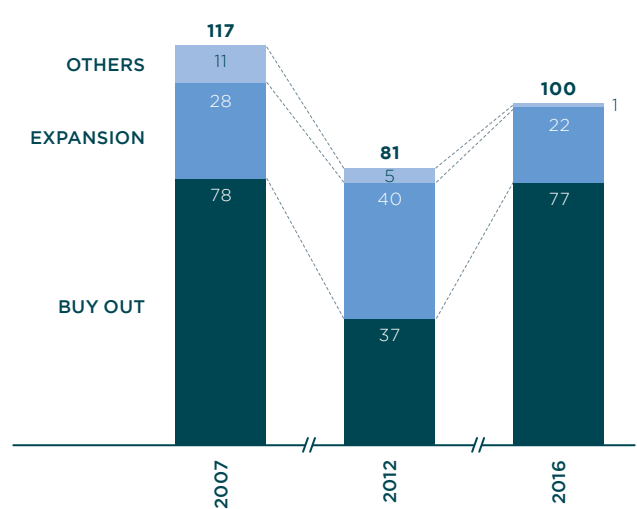
For several years, international PE funds were willing to avoid the Italian risk and were only interested in companies based in Italy but with a strong percentage of their revenues coming from abroad. Actually, after 2009, several foreign funds entirely left the Italian market and/or closed their local offices.

EXHIBIT 1
Italian GDP real growth rate and evolution of the number of private equity deals in Italy by deal typology

ITALIAN GDP REAL GROWTH RATE



NUMBER OF PE DEALS IN ITALY



Source: PEM reports.

EXHIBIT 2
Evolution of fundraising by national private equity players in Italy by source of funds (Mln €, %)

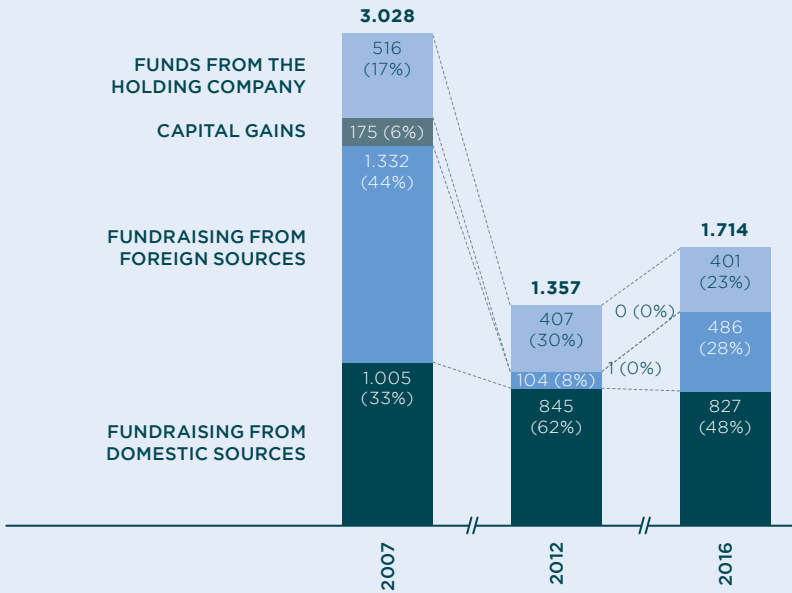


EXHIBIT 3
Equity capital invested by international firms in Italian PE deals (Mln €)

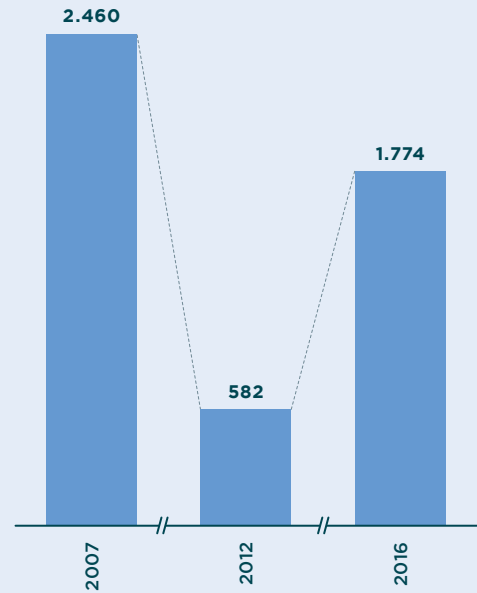
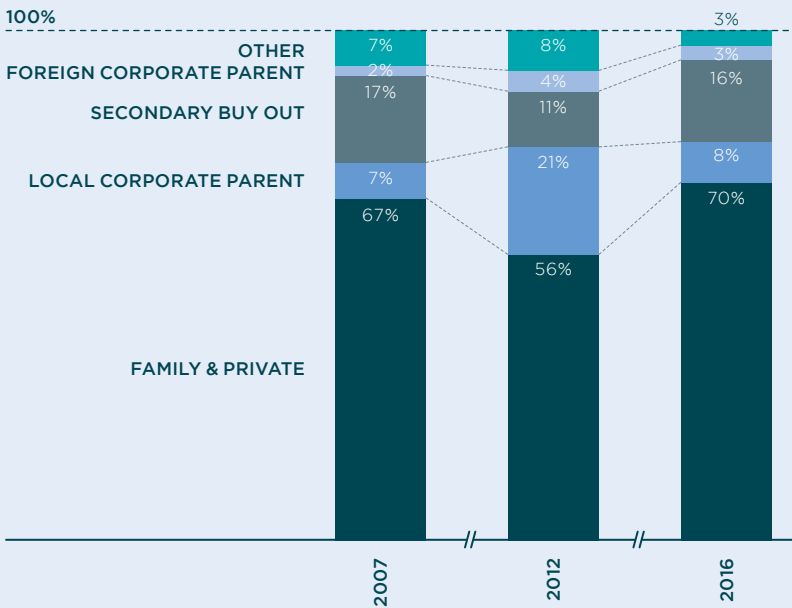


EXHIBIT 4
Breakdown of PE deals in Italy by origination (%)



Sources: AIFI reports, PEM reports.

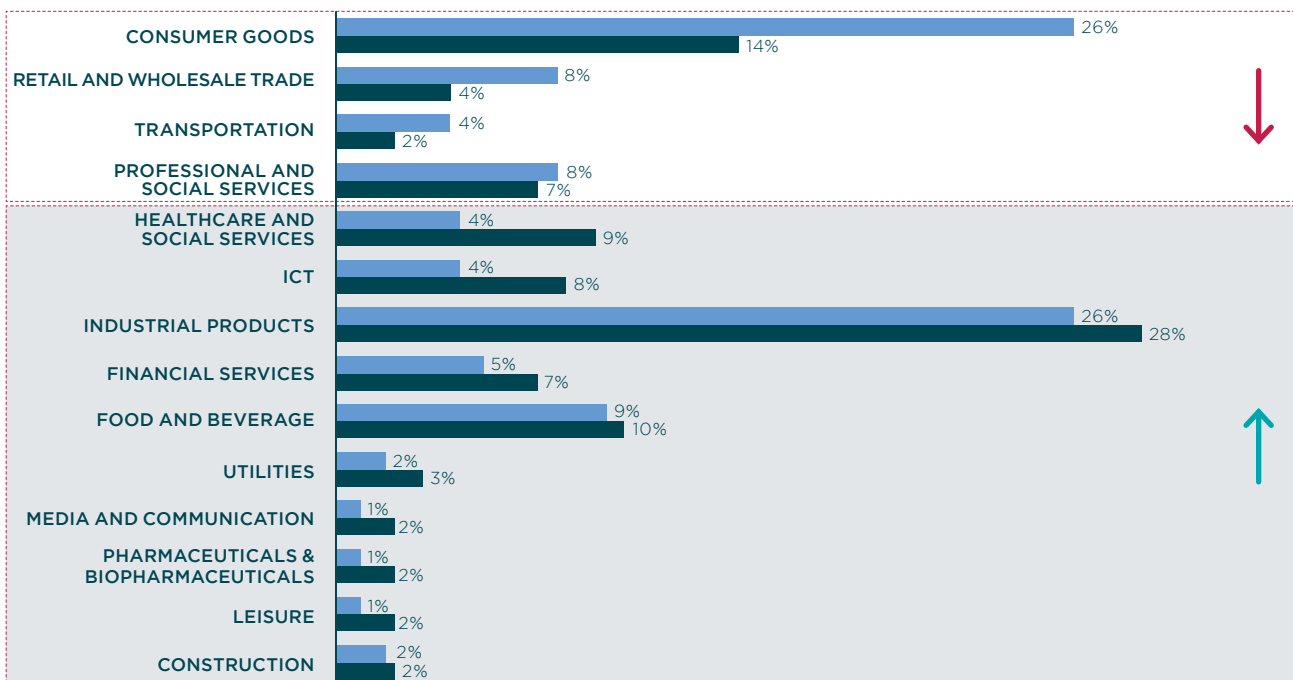
This exit was only partially offset by the progressively increasing activity of a number of PE firms running Italian deals directly from other office locations (e.g. Bain Capital, Charterhouse, Blackstone). Foreign capital seems anyway to be making a comeback (see Exhibit 3) as international investors are looking more favorably at Italian companies.

As the prospects of the Italian economy improve and other European countries enjoy highly competitive PE markets (e.g. France) or are characterized by political/economic uncertainty (e.g. the UK due to Brexit), **the presence of foreign PE funds in Italy will likely strengthen**, above all for mid to large deals (similarly to what already happened in the 2004-2007 period).

The magnitude of the financial problems suffered by Italian companies and their impact on the PE market are well highlighted by the rise between 2007 and 2012 of the **weight of deals originated by the local corporate-parent on all PE deals** (see Exhibit 4). This must be interpreted as a clear evidence of the need for funds which prompted the disposal of assets no longer regarded as core. Some significant changes also took place from 2007 to 2016 in terms of deal origination by industry (see Exhibit 5). Compared to 2007, 2016 highlights a lower weight of those industries more affected by the fall in national consumptions or by technological evolution (e.g. retail, due to the online channel boom) and a higher weight of those industries which are supported by long run demographic or business trends (e.g. health-care & social services, ICT) or which traditionally represent Italian excellence (e.g. industrial machinery and products or food and beverage).

EXHIBIT 5
PE deal breakdown by target industry

■ 2007 ■ 2016



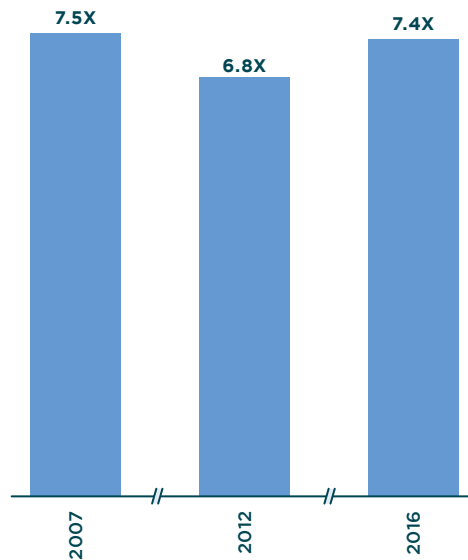
PE DEAL MULTIPLES 2016 VS 2007: BUBBLING UP AGAIN, IN LINE WITH GLOBAL TRENDS

In spite of the substantial fall in the PE deal volumes (and of the general Italian M&A market), **transaction multiples posted just a limited decrease from 2007 until 2012** (see [Exhibit 7](#)).

If on the one hand, multiples were under pressure due to the reduced number of bidders (especially for companies with most sales coming from the national market or in industries exposed to recession), they benefited from the contemporary generalized drop in interest rates across the Euro area.

Now, as competition increases, **transaction multiples are on the rise again** (see [Exhibit 6](#)) and are close to 2007 levels. Some recent deals were closed at very high multiples (EV/EBITDA ratios greater than 10X) which can be justified only by excellent growth expectations, especially in a scenario of interest rate hike.

EXHIBIT 6
PE deals: EV/ EBITDA multiple evolution
Focus on LBO deals with available information



Source: PEM reports.

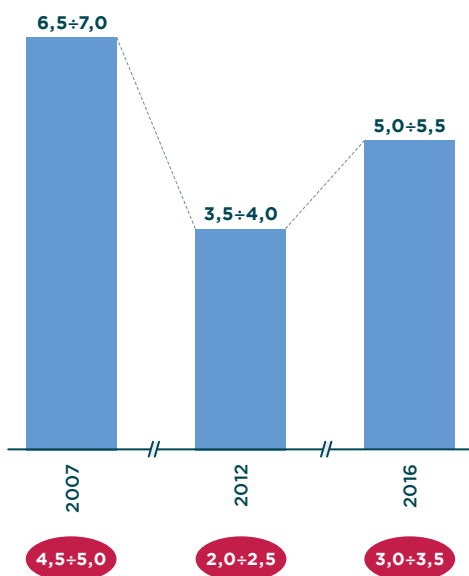
LBO DEBT/EBITDA MULTIPLES UP AGAIN

The years between 2003 and 2008 saw an increase in LBO Debt/EBITDA multiples and financing structures reached stunning levels of complexity with several layers of debt: multi-tranche (A, B, C and D) loans, mezzanine debt and/or PIK notes (Payment In Kind notes, that is zero coupon deeply subordinated notes). The economic crisis and its consequences (e.g. the collapse of the Collateralised Loan Obligation market) led to a **sharp decline in financing availability** for both large and small deals and in the Debt/EBITDA multiples (see Exhibit 7).

The **situation has progressively improved** due to the better conditions of the Italian economy and international capital markets. Moreover, the “Crescita” decree in 2012 eliminated the quantitative limits to the issue of bonds by unlisted companies (such as the companies object of a LBO) and the differences in terms of fiscal treatment between these bonds and those issued by listed companies. This prompted a large flow of high yield bond issues by Italian companies used to finance or re-finance LBO deals. Moreover, the development of national and – above all – international private debt funds has created a new source of funds for PE transactions (e.g. the acquisition of the tyre distributor Fintyre by Bain Capital financed by the private debt fund GSO).

EXHIBIT 7
Evolution of the average Debt/EBITDA multiples in Italian LBOs (Acquisition Debt/EBITDA)

● Multiples on small sized deals (EV<100 Mln €)



Sources: AIFI reports, PEM reports, interviews with industry experts, Value Partners analysis.

At present, LBO financial packages for medium-large transactions appear favorable to PE investors, with **Debt/EBITDA multiples equal to 5.0-5.5X**, and debt packages composed of **7 years bullet covenant lite loans** (supported by Revolving Credit Facilities of the same maturity). For deals on companies with EBITDA greater than 50 mln €, the issue of bonds has become more common. The use of bullet only debt with no financial maintenance tests (such as the once widespread EBITDA/interest cost cover covenant) allows PE houses greater flexibility in both structuring the investment and managing the target company after the acquisition.

NEW COMPETITORS FOR PE FIRMS: THE CROWD IS GROWING

The favorable evolution – for PE houses – of the economic and financial conditions has been accompanied by the progressive development of **new sources of funding available to small and medium companies to raise equity capital** and which – de facto – represent an alternative to PE investors. Among these, at least two are noteworthy:

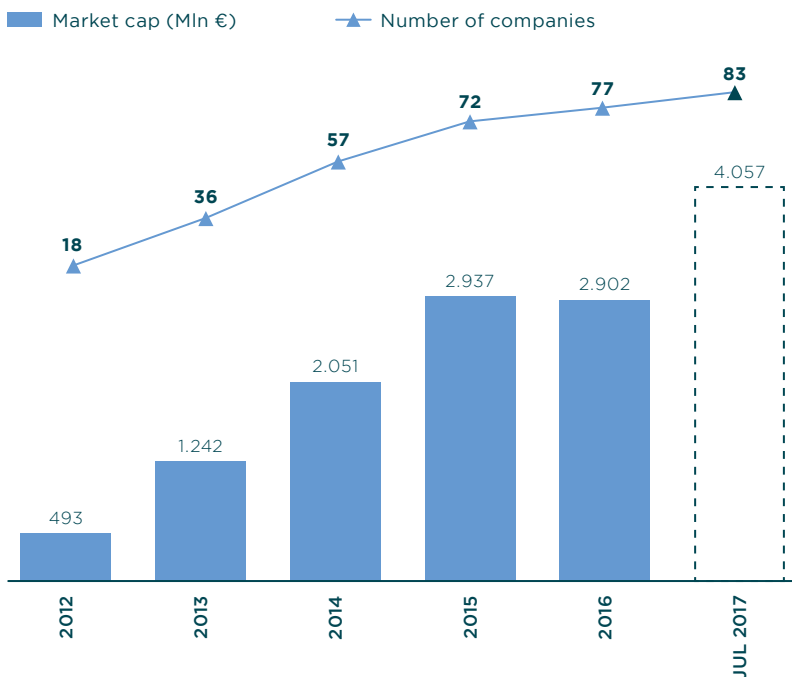
- **AIM or Alternative Investment Market**
- **SPAC or Special Purpose Acquisition Company**

Focus on the AIM or Alternative Investment Market

The AIM is a **Stock Market specifically designed for small companies** with lower requirements in terms of IPO, corporate governance, information to investors (e.g. no quarterly reports) than the MTA (Mercato Telematico Azionario). The AIM has fast grown in terms of number of listed companies and overall market capitalization (see Exhibit 8). Moreover, the 2018's Budget Law includes some tax advantages related to the deductibility of IPO costs which will make AIM more appealing to small and medium sized companies.

The companies listed on the AIM appear to be extremely dynamic. Between January 2016 and the end of May 2017, 40 companies (that is 48% of all AIM listed companies) closed M&A or JV transactions.

EXHIBIT 8
Growth of the number of companies listed on the AIM and of their cumulated market capitalization



At present, the average size of the company listed on the AIM is still limited: both the average market capitalization and revenues amount to ~50 mln €. As the AIM develops in terms of overall capitalization, number of active investors and number of listed companies, it will increasingly become an attractive source of equity capital for companies which would otherwise go to PE firms.

Focus on SPACs or Special Purpose Acquisition Companies

SPACs are **blank-check companies** with no operations at the moment of their listing but which go public with the intention of acquiring a company with the proceeds of the SPAC's initial public offering (IPO) and subsequently merging with it (the so called "business combination"). Thanks to the merger with the SPAC, the target company will be listed on the stock market. SPACs are promoted by senior teams of professionals ("promoters") with a consolidated track record in Private Equity, Business Management and Corporate Finance who also invest in the SPAC itself.

SPAC promoters have typically **24 months to invest the money collected through the IPO** otherwise the SPAC will be liquidated. So far this has not happened in Italy but in the US market, where this instrument was developed, 80 out of the 278 SPACs (~30%) launched since 1/1/2003 were liquidated because they were not able to find an acquisition target. SPACs **focus on companies with an investment profile similar to that sought after by PE funds** (stable business companies with good cash flow generation and growth potential) and allows public stock market investors to invest in private equity-type transactions.

SPACs were introduced in Italy for the first time in 2011 and are listed on a dedicated segment (MIV) of the AIM. So far, they have encountered a remarkable success, as is proven by their share price dynamics (see Exhibit 9). This has prompted investors to dedicate more attention and capital to these new investment vehicles and has recently resulted in a rising number of IPOs of SPACs (see Exhibit 10 next page).

EXHIBIT 9 Share performances of Italian SPACs

NAME	RAISED CAPITAL (MLN €)	ACQUIRED COMPANY	% CHANGE IN SHARE PRICE FROM 1/1/2017	% CHANGE IN SHARE PRICE FROM IPO
ITALY 1 INVESTMENTS	150	IVS SPA	43.76%	36.16%
MADE IN ITALY 1 S	50	SESA SPA	39.91%	152.55%
SPACE	130	FILA SPA	37.92%	147.22%
GLENITALIA FOOD	80	GRUPPO ORSERO	37.05%	45.89%
IPO CHALLENGER	52	ITALIAN WINE BRANDS SPA	29.43%	4.16%
SPACE 2	155	AVIO SPA	28.22%	36.17%
INDUSTRIAL STARS OF ITALY	50	LU-VE SPA	18.30%	17.66%
CAPITAL FOR PROGRESS 1	51	GPI	10.91%	12.52%
GREENITALY SPA	35	ZEPHYRO SPA	-9.86%	-27.61%

(1) Beginning of the first quarter of 2017.

For an entrepreneur seeking additional equity capital/new investors to either:

- Support a new development phase
- Solve problems of succession and/or related to other family shareholders
- Reduce his/her stake in the company to diversify personal holdings

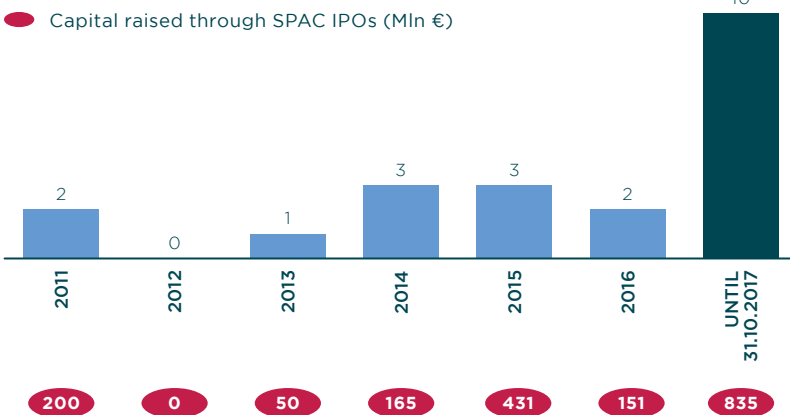
a **SPAC offers several advantages** such as:

- Keeping the majority control of the company (most SPACs have bought a minority stake in the target company)
- Lower return rates required by SPAC investors compared to traditional PE investors
- No high debt burden to live with (differently from a LBO). Some SPACs have used some debt to finance their acquisitions but have kept low leverage levels.
- Fast and simple listing on the Stock Market

A recent event is enhancing SPACs and in general equity capital markets (AIM and MTA too) competitiveness vis-à-vis alternative tools available to entrepreneurs to raise equity capital, that is the recent **PIR reform**. PIRs (in English Investment Saving Plans) are investment products (such as open investment funds) which can invest in bonds, shares and other funds. They can be underwritten exclusively by individual investors and are subject to some constraints: at least 70% of the funds must be invested in securities issued by Italian companies and 30% of these funds must invest in securities issued by companies different from those included in the FTSE Mib (the index composed of the 40 largest companies listed on the Italian Stock Exchange). PIRs offer significant tax benefits since if the underwriters keep the investment in their PIR for at least 5 years, they will not be subject to the taxes on capital gains.

The PIR reform was **designed to channel additional funds into small and medium sized companies** and promote the development of the Italian Stock market. Market forecasts point at a total of 10 bln € raised by PIRs by the end of 2017. Industry practitioners attribute the recent strong flows of capital into the AIM and SPACs as a consequence of the money raised by PIRs.

EXHIBIT 10
Evolution of the number of Italian SPAC IPOs
Number of IPOs



Sources: BeBeez, Bloomberg.

IMPLICATIONS: OUTLOOK STILL ROSY, BUT NEEDS TO STAY FIT

The PE business seems to be in a recovery phase, and as the economy improves, Italy and Italian companies are getting more popular among international investors. Despite the length and magnitude of the crisis, industry competition has not anyway decreased. Some PE players left the Italian market but others have entered the fray. At the same time, PE funds are now facing competition from capital market tools such as SPACs and the AIM which did not exist in 2017 (not to mention Family Offices, Club-Deals, Corporate Venturing, and others). The PE investors that are active in Italy will have to fight fiercely to close deals and generate adequate returns.

In this context, to **gain an edge over competitors**, a PE firm should:

- **Develop their operating performance improvement skills and specific industry expertise** to be able to faster assess the opportunities to improve profitability of the possible investment targets and support/monitor the management more effectively. Most PE funds are actually characterized by management teams with predominantly financial or investment banking background. Their skill mix will have to change if they want to extract more operating value from their investments.
- **Have a more proactive approach** and enhance the networking efforts with entrepreneurs and above all the traditional entrepreneurs' advisers - such as "commercialisti" (tax consultants), private bankers, lawyers and so on - to generate a flow of proprietary or almost proprietary deals. This was the typical approach adopted by PE funds in the late 80's but many PE funds have progressively shifted their focus on the deal flow provided by investment banks. Even if they are the main channel for large deals, they almost inevitably lead to regular auctions with several bidders and intensive price competition

Sources: AIFI, PE Monitor, SPAC Analytics, Ir Top, Milano Finanza, Borsa Italiana, interviews to corporate finance professionals, Value Partners analysis.

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An area of focus in developing countries across the Middle East, Asia and South America is also “financial inclusion”, helping universal banks and other industry payers to target the unbanked population at the bottom of the pyramid, through mobile financial services or more traditional community lending business models.

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