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SMES IN ITALY

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HOW PE INVESTORS CAN SOLVE THE CONUNDRUM

VALUE PARTNERS

SMEs in Italy:
how PE investors can solve
the conundrum

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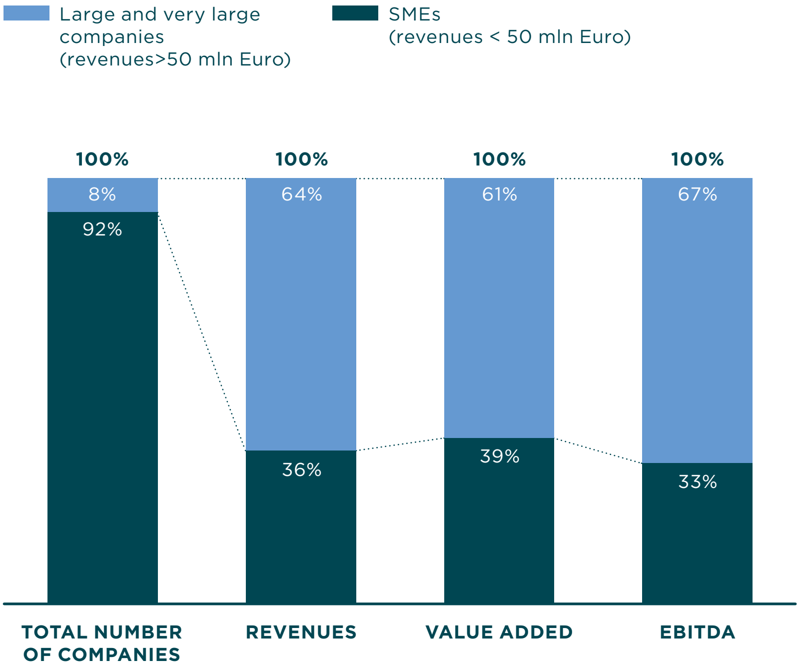
ITALY, LAND OF SMALL ENTERPRISES

SMEs, that is companies with a turnover between 2 and 50 mln €, have traditionally been – and still are– the backbone of the Italian economy. Their weight is particularly significant in manufacturing activities and non-financial services, where they represent ~90% of all companies and generate ~35% of the overall revenues and EBITDA (Exhibit 1).

Their presence is relevant in "traditional" manufacturing activities such as, just to mention a few, fashion & textiles, food & spirits, mechanical equipment, furniture and design, as well high tech sectors like pharmaceuticals, medical devices and ICT.

For a long time, this huge basin of SMEs has been depicted as – potentially – an important source of opportunities for PE investments. Such drivers as family succession issues or need for capital to fund external growth and/or internationalization strategies have often been cited to explain the logical attractiveness of Italian SMEs for investors.

EXHIBIT 1
Weight of SMEs on Italian Economy
Manufacturing and non-financial services companies, 2014



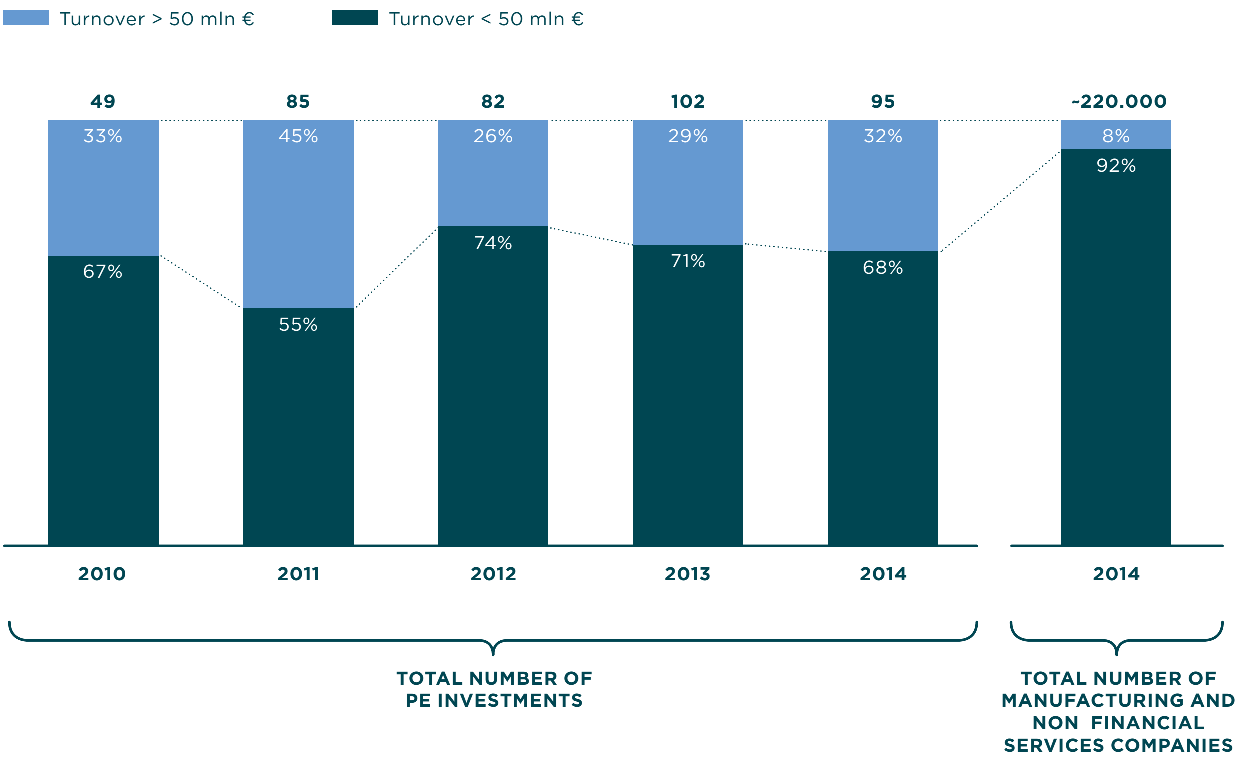
SMES, STILL A DIFFICULT "UNDERWORLD" FOR PE INVESTORS

However, the PE industry in Italy has traditionally looked at SMEs with mixed feelings: on the one hand, intrigued by the interesting value-generation to be captured in this pool, but at the same time, very sceptical – or at least incapable – to systematically address the peculiar characteristics of SMEs entrepreneurs when crafting effective deal structures.

As a matter of fact, and for many different reasons, the PE here is relatively underdeveloped compared to the size of the national economy and certainly the number of investments in SMEs, in both value and number, is still very low with respect to the economic structure of the Italian economy (Exhibits 2 and 3).

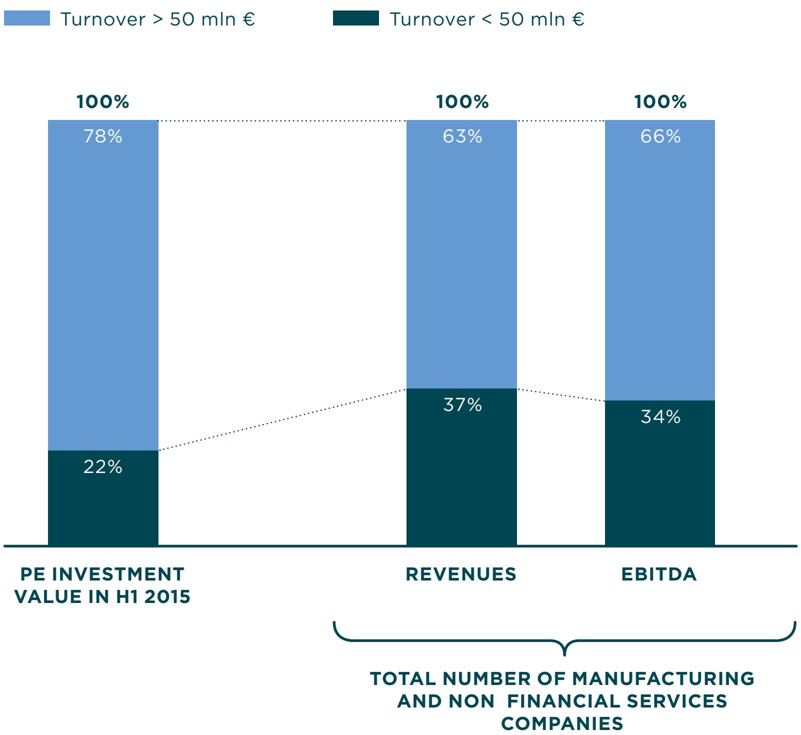
We looked at IRRs generated by PE investments by the turnover classes of the target companies over the last 10 years (Exhibit 4, page 6).

EXHIBIT 2
Comparison between the number of PE investments involving SMEs and the weight of SMEs on the total number of companies
Manufacturing and non-financial services companies



The outcome offers some tangible evidence of this reality. Returns posted by PE investments in very large companies (turnover > 250 mln €) are higher than the ones generated by SMEs in seven of the last ten years. Capital deals into very large companies underperformed significantly those into SMEs only through 2008-2010 (the aftermath of the global financial crisis) when large companies LBOs closed between late 2005 and 2007 underwent substantial write-offs due to their abnormally high indebtedness level, which proved unsustainable in the new economic situation.

EXHIBIT 3
Comparison between the weight of PE investments involving SMEs and the weight of SMEs on the economics of the manufacturing and non financial services sectors

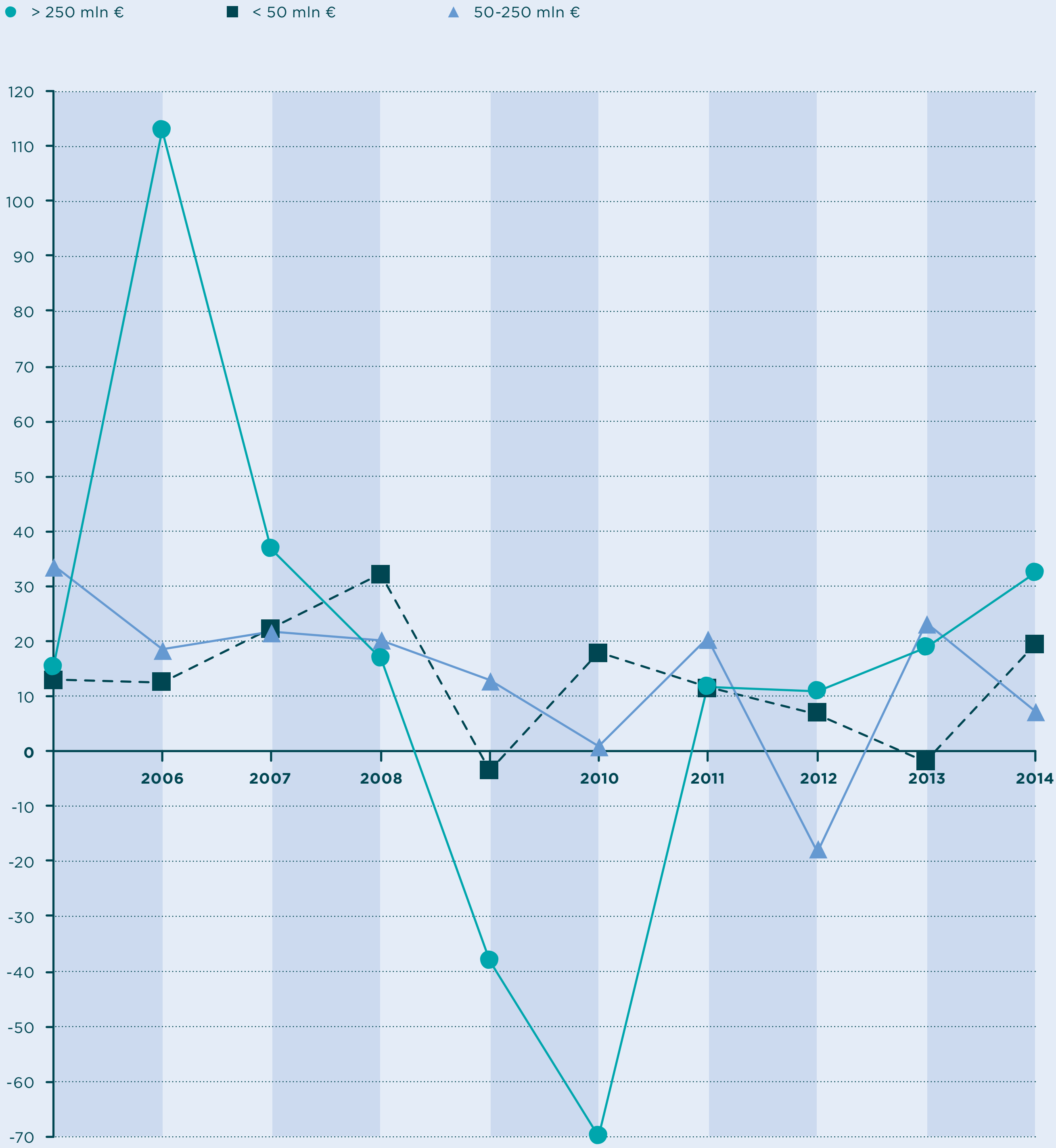


Several phenomena typical of Italian SMEs can offer valuable help in explaining why they have proved a difficult ground for PE investors:

- Murky tax-oriented accounting, often characterised by the:
  - confusion between the assets of the companies and those of shareholders
  - absence of adequate information about the profitability of the business.

  This reduces the capability of PE investors to assess the real profit-making capability of the target and define a correct pricing for the investment
- Presence in niche businesses with limited publicly available information (e.g. specialized B2B products) and not covered by industry analysts. Very often “corporate investors” have demonstrated a lack of common business dynamics which are typical of SMEs
- Concentration of the managerial talent in the shareholders’ team. This often represents a constraint to the implementation of major development and internationalization strategies
- Shareholders not accustomed to sharing the decision making responsibility with other investors
- Lack of experience in operating under substantial levels of indebtedness (typical of LBOs)

EXHIBIT 4
IRR of PE investiments by target company turnover and non financial services sectors



HOW TO FIX IT

The supply of large PE deals in Italy is not going to increase in the next 4-5 years, given the limited number of very large companies and the current lower-than-ideal credit rating, now just BBB- for S&P. This actually reduces the availability of debt capital for large levered transactions (especially for companies which realize most of their revenues on the domestic market), favouring, on the contrary, trade buyers.

Therefore, PE investors will have to devote more attention to the selection of SMEs in order to generate a reliable flow of deals.

Some deals completed at Italian SMEs have anyway proved highly profitable (think for example of the investment by Syntegra Capital Advisors in the luxury notebook and paper product manufacturer Moleskine, which generated a 20X return on the equity capital).

In such deals, PE investors are instrumental to the rollout of aggressive development strategies (with yearly turnover growth rates well exceeding 10%) carried out through both organic growth (e.g.: entry in new markets and enhancement of distribution platforms), often in parallel, to add-on acquisitions.

They act as real partners of the shareholders, bringing in capital together with capabilities, connections and financial discipline while respecting the day-to-day autonomy of managers.

SMEs will be a fundamental component of the Italian economy. Some deals involving SMEs have proved extremely profitable but an investment style enabling PE investors to manage the issues and risks associated with this type of companies requires knowhow and skills difficult to develop

According to Value Partners, PE investors can increase substantially the probability of success of their investments in SMEs through a mix of:

- Strong discipline in enforcing pricing structures (earn-outs, deferred payments, escrow accounts, …), consistently with the financial profile of SMEs (opaqueness and lower availability of accounting data and higher growth expectations)

- In-depth understanding of the competitive positioning of the target companies. Here, insights offered by clients and competitors can provide very useful inputs

- Assessment of the quality of the managerial talent pool inside the target company and its adequacy with the development plans

- Availability, at the PE house management team or its advisers, of the industrial capabilities to monitor and above all support the investment. The hands-off approach typically adopted by several PE houses with investments in very large companies is a very risky one here, and should be replaced by a continuous interaction with company's management

- Design, since the very first days of the negotiation process, of a suitable development and exit strategy in terms of:

    - Key actions (e.g. internationalization, product portfolio integration or pruning, salesforce enhancement, …)

    - Required resources (new managerial talents, capital), prerequisites (e.g. actual presence of potentially viable acquisition targets) and execution times.

- Assessment of the actual capability/willingness of the SME shareholders to share the decision making power with financial investors (here the professional history of the shareholders can provide useful hints) and definition of precise and strict corporate governance agreements (including dispute resolution clauses)

Certainly, an investment style suitable for SMEs (to weather the risks and issues they normally bring with them) requires know-how and capabilities difficult to develop. Only a few PE funds have proved able so far to acquire them but the returns, as previously indicated, can definitely be very rewarding.

Sources: AIFI, Cerved, Eurostat, Value Partners analysis

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ABOUT VALUE PARTNERS

Value Partners is a global management consulting firm that works with multinational corporations Value Partners is a global management consulting firm, founded in Milan in 1993. Value Partners grows fast with 30 global partners and more than 250 professional consultants from 23 countries. It has offices in Milan, London, Istanbul, Dubai, São Paulo, Buenos Aires, Beijing, Shanghai, Hong Kong and Singapore.

Value Partners has systematic methodology and professional tools combined with a wealth of industry knowledge. The project execution and delivery capabilities in telecom, media, financial services, energy, manufacturing and high tech are outstanding.

Value Partners has extensive know-how in assisting financial investors in both advanced economies and emerging markets and has advised PE firms on acquisitions totalling more than 10 bln €.

For more information on the issues raised in this note please contact the authors.

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