A most appetising private equity market

Italy's economy is characterised by small and medium-sized family businesses, offering huge potential for private equity. David Lane reports from Rome

Few stamps of approval are worth more in Italy than those of its central bank. So it is easy to imagine the private equity community's pleasure when, earlier this year, Mario Draghi, the Bank of Italy's governor, described private equity's role in financial markets as positive. More than one-third of initial public offerings (IPOs) over the past decade came from private equity portfolios, he said.

Mr Draghi neatly summed up why private equity is good for Italy: "Specialist intermediaries in risk capital can help small and medium-sized firms to grow, contribute to the strengthening of management, encourage access to the stockmarket and smooth generational change."

More than any large western European economy, Italy's is characterised by small and medium-sized family businesses, offering huge potential for private equity. A recent study by the Bank of Italy looked at a sample of more than 4000 firms and found that about 40% considered themselves too small and had missed opportunities for growth over the past decade, and that firms that tackle the question of generational change do best.

Mario Draghi: Bank of Italy governor has described private equity's role in financial markets as positive

Virgin territory

With Italian competitiveness slipping behind its neighbours, private equity has a clear role. "Even so, compared with the UK, Germany and France, there have been relatively few deals here. Italy is virgin territory," says Anna Gervasoni, general manager of AIFI, the Italian private equity and venture capital association.

"There are thousands of suitable firms that enjoy good market positions, in some cases internationally. Many are in traditional manufacturing sectors, some with technologically advanced products or processes," noted Ms Gervasoni, who is also a professor of management and economics at the Castellanza University.

How the AIFI has grown suggests that investors are aware of Italy's potential. From 77 in 2002, the association's membership has risen steadily to reach 113 earlier this year; 10 years ago it was less than 50. Mainly engaged in buy-out and expansion operations, rather than start-up or distressed concerns, Italy's funds have few problems in raising money but hit difficulties in closing deals at digestible prices.

According to the AIFI, more than €5bn was available for new investments at the end of last year (excluding pan-European funds, captive investors and public players), against their existing holdings of just under 1100 companies of about €11bn. This shows how much money is chasing targets who are playing hard to get.

An example comes from Alto

Partners, which last year closed its Alto Capital II fund, having raised €150m from about 60 subscribers that include major Italian insurers, banks in northern and north-east Italy, some 20 Italian businessmen and about 10 foreign investors. Stefano Scarpis, who spent 15 years at Mediobanca before helping to set up Alto Partners in 2000, notes that Alto Capital II has faced "non-sustainable prices" since it started seeking investments.

"The availability of targets is the problem. We have completed four deals but so far used very little of our fund. There is pressure to invest, and that is what foreign investors particularly want," he says.

That same pressure may soon be exerted on 21 Investimenti, part of the Benetton family's empire. It currently manages two Italian funds: the €75m Gladia Equity, which manages money raised from the Benettons themselves and others, and the €100m Idea Industria, whose money comes from wealthy clients of UniCredit. "We are now raising about €250m for investing in Italy, about half from Italian institutions and the rest from international investors," says Stefano Tanzi, who joined 21 Investimenti three years ago after 22 years with KPMG.

Family firms

The fresh money that Mr Tanzi and his team have been raising will be competing for family-owned firms that "lack objectives and need modernisation and strategy" with the swelling coffers of the growing ranks of private equity funds. And the competition for targets is not confined to Italian funds but also comes from pan-European funds such as that managed by Argan Capital Advisors. "Mid-cap firms in Italy are our core market along with mid-cap firms in France and Scandinavia," says Carlo Mammola, partner at Argan Capital Advisors.

By searching for small, medium-to-low technology targets, Cimino & Associati Private Equity (Cape) avoids going head-to-head with fund managers such as Alto Partners, 21 Investimenti and Argan Capital Advisors. "We are looking at a huge market of more than 23,000 firms that other funds generally ignore," says Simone Cimino, Cape's managing partner. His team has done about 40 deals over recent years with "an average equity ticket of €4m per deal". An example of the size of company that Cape approaches is its investment in May in a dental equipment business with sales of less than €4m last year.

John Andrew, Eidos Partners

'Most private equity funds say that they don't participate in auctions, but often they have no choice'

Cape's track record has attracted money from high net worth individuals. More than 100 wealthy Italians added their money to that of institutional investors in the €120m fund that the Bank of Italy approved in 2004. Many of the investors who put money into this fund also invested in the €195m fund approved in June this year.

Northern magnet

With rare exceptions, private equity money flows towards Italy's industrial heart in the north, particularly the regions of Lombardy, the Veneto and Emilia Romagna, where the manufacturing fabric spans clothing, footwear, leather goods, food, furniture, building materials, chemicals, jewellery, components, electrical goods, machinery of every conceivable type and much more. Industrial reconstruction after the Second World War, Italian flair, the Italian family and plain hard work led to the economic miracle of the 1960s that provides the foundations for today's business successes.

However, as firms that were founded in the 1950s, 1960s and 1970s begin to involve family members of the second, third and even fourth generation, so the question of generational change arises, explaining private equity's focus on such firms. "There are very good companies that are not exploiting their potential. Young members of the family have Porsches sitting in the garage and believe that is enough. Many firms have grown fat, rich and complacent," remarks Mr Tanzi.

Even so, convincing owners and members of their families that change is needed can be tricky. Managers of private equity funds need to deal with the emotional attachment to the business and loyalty towards the family that owners have, but everyone has a price and money is often the key to close deals. Indeed, excessively high prices are a common lament in private equity circles and, without doubt, the use of the auction has contributed.

"Most private equity funds say that they don't participate in auctions, but often they have no choice," says John Andrew, chairman of Eidos Partners, a boutique investment bank in Milan, for whom private equity deals now >>

ITALIAN PRIVATE EQUITY – INVESTMENT ACTIVITY

	2002	2003	2004	2005	2006
Amount (€m)	2626	3034	1480	3065	3731
Number of deals	301	336	248	281	292
Number of target companies	254	266	208	241	245
Fundraising (€m)*	1996	1937	1663	345	2275

* Does not include regional, public investors and pan-European funds

Source: **AIFI & PwC**

MONTEZEMOLO FAMILY IN THE DRIVING SEAT

LUXURY ARMCHAIRS AND fast cars; apparently worlds apart, they are close together in the centre of Rome where Poltrona Frau's showroom and Ferrari's shop stand side-by-side in Via Tomacelli.

But they are more than simply Roman neighbours and there is more to the relationship than Poltrona Frau's elegant leather seats that help Ferrari drivers feel comfortable behind the wheel. Luca di Montezemolo, Ferrari's chairman, is the man behind Charme Investments, the private equity fund that controls Poltrona Frau.

Generation game: Matteo (left) and Luca di Montezemolo

In December 2003, almost a year and a half after the fund was established, Charme's first deal was the acquisition of 30% of Poltrona Frau. "I was working with Goldman Sachs in London when we talked in 2002 about what we might develop as a family business. My father has been successful in running companies for other people but had never created a business himself," remembers Matteo di Montezemolo, Mr Montezemolo's son. Charme's advisory company, Montezemolo & Partners, is now the family business, with Matteo its chairman and CEO.

The Montezemolo family was joined by Diego della Valle, the boss of Tods, the up-market footwear maker; Vittorio Merloni, which controls Indesit, the white goods firm; and Alessandro Profumo, the CEO of UniCredit, in putting €150m into Charme. "All the equity investment has come from family offices," says Matteo Montezemolo. That may provide even more incentive than usual to generate good returns. Indeed, Charme has done better than just keeping on track. "Making money is obviously the first rule," he says.

Charme later took its interest in Poltrona Frau to 75% and brought two other manufacturers of luxury furniture (Cappellini in December 2004 and Cassina in June 2005) to create a group. This was floated in November last year.

"Twenty-times oversubscribed, the offering was hugely successful," says Matteo di Montezemolo. Poltrona Frau's flotation completely repaid Charme's investment while leaving the fund with a 52% stake worth about €190m.

Soon after buying its initial interest in Poltrona Frau, Charme acquired 70% of Ballantyne, a British luxury fashion business, a deal that used about €20m of the fund's cash.

"Ballantyne's turnover has since doubled to about €30m and over the next year or two we will decide on our best strategy for this investment," says Matteo di Montezemolo.

Meanwhile, he is preparing to launch a second fund. "This will be bigger than the first," he says. Understandably, with the name Montezemolo, Matteo wants to keep the family business racing ahead.

account for around one-third of business.

Eidos Partners was financial adviser earlier this year in Permira's tender offer for Valentino, the largest private equity acquisition in the luxury sector worldwide. Among its deals last year were advising Modo & Modo on the sale of Moleskine, the famous notebooks used by Van Gogh, Picasso and Hemingway, to SG Capital and Motovario, a power transmission firm, on its sale to BS Private Equity.

"Private equity buyers must either arrive early at their targets or face an auction. But even if they arrive early, nowadays they find that the target has a financial adviser and the pressure is on them all the same," explains Mr Andrew. He thinks, however, that prices will ease as a result of this summer's financial turbulence and that there will be a slowdown in deals as sellers adapt to lower prices. "An important factor is the tightening of credit. Lenders are more careful. Debt has become harder to obtain and costs more," he adds.

Figures from AIFI-PwC show that last year the debt-equity ratio in private equity buy-outs (in which funds invested €2.4bn of the €3.7bn total) was 1.8, putting the amount of debt in those deals at about €4.4bn. In 2005, the debt-equity ratio in private equity buy-outs was 1.5. "The credit crunch should help us close more deals," says Mr Scarpis of Alto Partners, who expects prices to fall from about five -times gross operating profit to a multiple of between 3.5 and four.

Banking opportunity

And Italy's banks? Private equity is good business for them in several ways. To begin with, they invest in private equity funds, allowing them to participate in internal rates of return of more than 20%. Then, they provide advice on deals and, of course, earn interest on the debt lever that private equity funds use. In addition, they can count on arrangement fees for bridge finance and re-financing.

Banks also earn money from various sources when funds exit from their investments. Divestments from 151 companies generated €1.8bn last year: by value and number, trade sales accounted for about one-third; sales within the private equity community for about one half by value and one-fifth by number; and divestments through IPOs and sales post-IPO for about one-tenth, by both value and number.

Banks' re-assessment of risk and adaptation to lower expectations by target firms may cause a minor drop in Italian private equity deals, but that is all. As Mr Andrew observes: "Private equity fund managers have knowledge, skills and grit, and the firms needing them have not disappeared." Whether owner of a family firm, adviser, banker, fund manager or investor in a private equity fund, the future in Italy still looks rosy. TB