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September 2024

The strategic repositioning of Private Equity funds

Expert's opinion

The evolution of Private Equity operators in the next digital evolution

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Partner - CEO of Grant Thornton FAS & Head of Advisory

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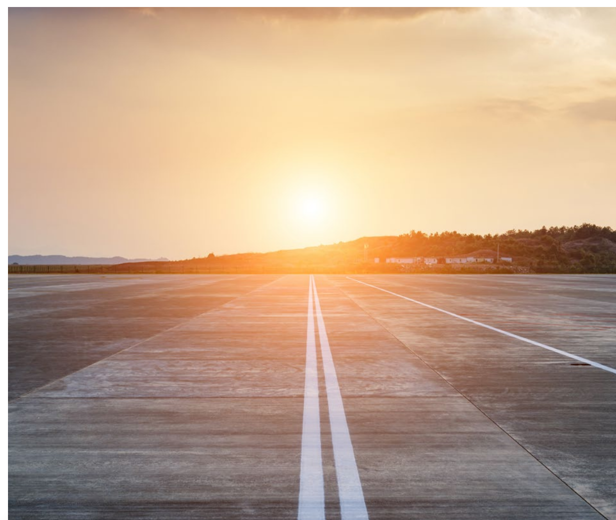

Overview

Approaches to market positioning of Private Equity firms in Italy

Edoardo Craviolo

Senior Consultant Grant Thornton FAS

The term Private Equity indicates, on a global level, "the investment activity in the risk capital of unlisted companies, with the aim of valorising them and then divest them in the medium-long term". Typically, this activity is carried out through the typical operational structure of so-called Funds. The involvement of Funds goes beyond simple financing; in fact, their function is that of implementing previously defined growth strategies, improving operational efficiency, increasing turnover, diversifying the product/service portfolio and penetrating new markets. Through this partnership, investee companies can undertake a growth path and therefore improve their operational efficiency and strengthen their competitive position. To valorise the acquired companies...

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Focus on

Positioning strategies of Private Equity funds in Italy

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In the ten-year period 2013-2023, the number of Small sized operators has decreased dramatically. At the same time, there was a growth trend for both Mid and Large funds. This trend clearly reflects the resilience of medium and large funds and their ability to adapt to complex and changing economic and financial dynamics. Their ability to cope with volatility and uncertainty periods, quickly adapting to market changes, underlines the strength of their investment strategies. Furthermore, this resilience not only demonstrates the robustness of the funds, but also their flexibility in responding to various external factors...

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The term Private Equity indicates, on a global level, "the investment activity in the risk capital of unlisted companies, with the aim of valorising them and then divest them in the medium-long term". Typically, this activity is carried out through the typical operational structure of so-called Funds.

The involvement of Funds goes beyond simple financing; in fact, their function is that of implementing previously defined growth strategies, improving operational efficiency, increasing turnover, diversifying the product/service portfolio and penetrating new markets. Through this partnership, investee companies can undertake a growth path and therefore improve their operational efficiency and strengthen their competitive position. To valorise the acquired companies, Private Equity funds now implement consolidated development strategies such as, for example, working closely with the management of the companies involved, contributing not only specific skills and know-how in the reference industry, but also a vast range of financial resources.

The principles described above represent the general guidelines that are common to the different types of Private Equity Funds, although each of them has a specific investment strategy, normally defined as "IC - Investment Criteria" and a specific orientation in each of the following areas (briefly summarized by way of example):

- the maximum amount of investments, i.e. the fund's equity contribution to investment operations (Ticket);
- the development stage of the target companies (Stage);
- the geographical location (Geography);
- the reference industry (Industry).

Generally, although each fund has unique characteristics, based on the type of investment (majority/minority), the investment ticket (small/mid/large cap), and the maturity of the targets (growth/value) there are common criteria for each tier of the matrix. For example, in the Italian market, approx. 70% of PE operations (by number of operations and not by cumulative value of the same and/or by level of AuM of the Funds) target small-mid cap companies (which is quite logical, since 95% of enterprises are SMEs). Therefore, the funds operating in this segment have common ICs, such as preferring majority investments, targets with stable/growing cash flows (representative of countercyclical sectors), MBO (management buy-out) operations - also meant as re-investment of the founding members, etc. Likewise, the rationales also have common features, such as the structuring of an efficient managerial line, the internationalization of the business and the inorganic growth of the target, through a build-up process.

However, despite the common criteria of the different Fund tiers (listed above) as well as the common rationales (improving operational efficiency, increasing turnover, diversifying the product/service portfolio and penetrating new markets), in recent years, there has been a change in the specific ICs that characterize the tiers, bringing the methods, forms and investment criteria of all Funds closer together, regardless of the ticket and other factors. In fact, considering the Italian situation, from 2012 to 2019, there was an increase in Leverage Buy Out (LBO) and Expansion (investments in growth companies) operations compared to the past, which had previously suffered a sharp slowdown in the post-2008 global financial crisis – given the significantly high implicit risk. In fact, the contraction of the ECB reference rates, as well as the quantity of money issued in the ten-year period, have, among other things, encouraged the financial economy linked to M&A operations, allowing PE Funds to leverage a smaller use of own capital in their acquisitions and, consequently, make investments with a higher risk/return ratio (growth investments). As regards LBO operations, prior to 2008, we could see 80-90% financial leverage (especially in the US), while, in subsequent years, leverage was almost nil due to the psychological shock of the American banking crisis and pessimism in the market outlook. In the years following 2012, although there was a re-integration of leverage into market practices for PE operations, it did not exceed 50-60%.

Furthermore, in Italy, LBO operations established only from 2003 onwards and did not represent the most used structure until 2011-2012. In recent years, the market situation (consequences of the 2008 crisis) together with a complex socio-political situation in Italy, have implied that Italian companies, due to the implicit risk, be essentially "economical" to the eyes of foreign investors, who have imported more sophisticated financial structures based on a constant use of financial leverage (but also mezzanine financing, preferred equity, etc.). Therefore, in the years from 2012 to 2020, Italy experienced a segmentation of funds into different tiers (based on ICs), due to the progressive increase in M&A operations and specialization of the funds themselves.
In 2020, following COVID-19, we experienced an unpredictable event linked to causes external to the market, i.e., the pandemic.
In fact, the lockdown marked a transversal slowdown of the economy, which translated into declining (in many cases, negative) cash flows. Furthermore, following a period – which lasted for approx. 8-10 years – characterized by an easy access to credit and an economic expansion, many SMEs showed "distorted" cash flows due to these factors and not directly attributable to real growth of the business. Therefore, COIVD-19 had a catalytic effect on the crisis of many companies, which were already in a precarious economic and financial situation. The result has been an extremely volatile market regarding corporate cash flows, which has led the various Funds to investigate their own ICs and subsidiaries.

The ultimate consequence was the review of investment criteria by financial players, opting for counter-cyclical businesses with extremely solid fundamentals (paradoxically, 2020 has become an extremely relevant reference year for understanding whether a target is based on a solid business model and whether it has concrete market penetration or not). Therefore, the Funds that invest in Italy today are always partially divided based on investment tickets, target maturity, reference industry, etc., although, at the same time, there are common requirements for finalizing an investment (for example, in the pre-pandemic years, Funds usually concentrated investments in one or few close industries, focusing on geographically close companies and with similar business models, while, today, there is a search for portfolio diversification and, in any case, for solid companies, as well as highly developed industry expertise to be able to understand the quality of a business).

Essentially, on the one hand, Funds have started to look for common characteristics in companies across different industries, diversifying the geographical risk, since there is no longer a limit of investment in a very small specific area, and the trend of specialization of Funds has continued compared to the post-financial crisis years, albeit in a different way (not as concentration in few industries, but rather relying on industry experts to better analyse the reference industry as well as the positioning of the company in the same). Compared to a market in which easy access to credit, together with complex financial architectures – based on the LBO archetype – has generally favoured investments in companies with a high level of risk/return, now the trend has returned to be that of a more detailed analysis of the underlying assets (research of solidity in the fundamentals) of the targets, as well as of stable markets in different economic situations (defensive and, generally, anti-cyclical markets).

The change in ICs, in many cases, has led operators to implement a new organizational structure, dismantling the traditional closed-end Fund and moving to less rigid forms, with variable perimeter, and with the fundamental possibility of involving not only institutional investors (typically: banks, insurance companies, pension funds and funds of funds) but also individual investors whose contribution can be not only a capital contribution but also a contribution of intangibles, such as: industry skills, operational, organizational and commercial networking, credibility, in order to be able to better evaluate the fundamentals of companies.

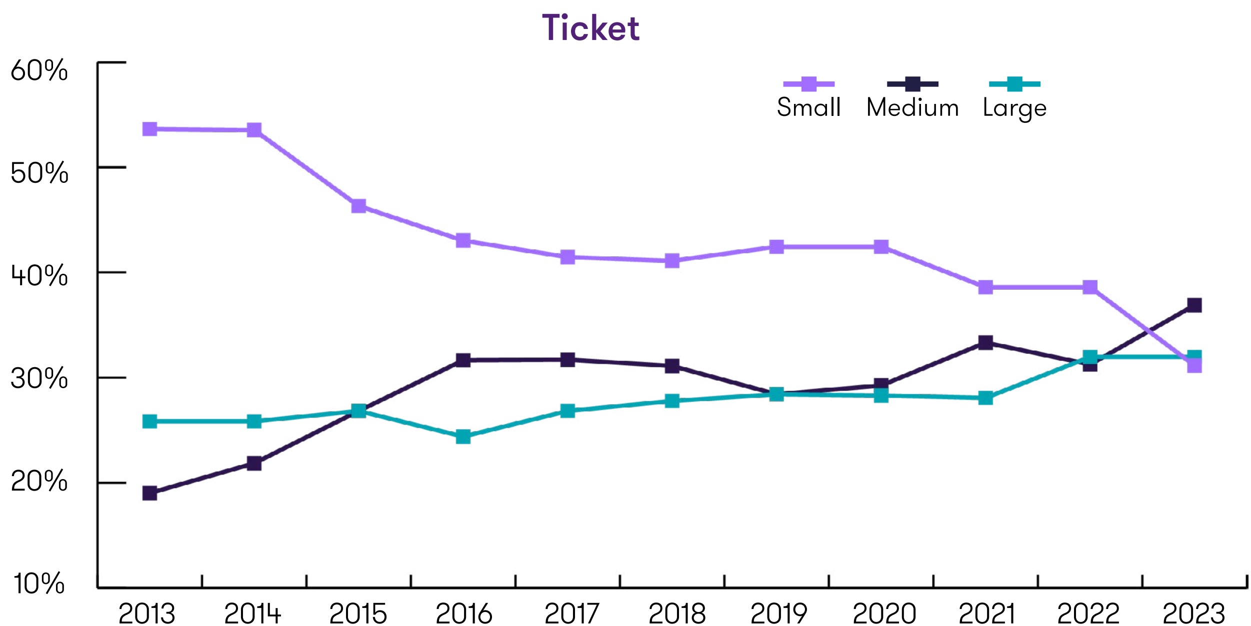
Finally, Investment Clubs, Continuation Funds, Search Funds, Permanent Capitals, etc. are also being introduced into the Italian market, not only amplifying the number of available operators, but also providing companies with a considerably wider range of solutions, which can better adapt to their strategic needs.

The analysis and data presented in the ***“Expert’s opinion”*** and in the ***“Focus on”*** articles are the result of the research ***“Analysis of the evolution of the positioning strategies of Private Equity funds in Italy from 2013 to 2023”*** by Sante Maiolica and Lorenzo Bocchieri.

Focus on

Positioning strategies of Private Equity funds in Italy

***Lorenzo Bocchieri**, graduated from Università Cattolica del Sacro Cuore*



In the ten-year period 2013-2023, the number of Small sized operators has decreased dramatically. At the same time, there was a growth trend for both Mid and Large funds. This trend clearly reflects the resilience of medium and large funds and their ability to adapt to complex and changing economic and financial dynamics. Their ability to cope with volatility and uncertainty periods, quickly adapting to market changes, underlines the strength of their investment strategies. Furthermore, this resilience not only demonstrates the robustness of the funds, but also their flexibility in responding to various external factors, ensuring a constant and sustainable performance over time.

Over the years, there has been a marked increase in competitiveness, fuelled by the

accelerated development of technological innovations useful for competing in many industries. These innovations, which are increasingly advanced and revolutionary, require significant investments. The rapid and constant evolution of technologies has forced operators to adapt quickly and invest massively to ensure that investments bring competitive results on the market.

The trend of Small operations has been progressively decreasing, since it has become clearer that the implicit cost of a small operation, as well as its risk, is not optimal for either the fund or its investors. The cost of completing an investment transaction is substantially the same, regardless of the size of the transaction itself. Moreover, over the years it has been observed that the failure rate of small companies is higher than that of large companies, mainly due to different economic circumstances.

Increasing the size of the investment leads to benefits related to economies of scale and, above all, reduces the intrinsic risk of the company and the operation. Considering the above, the MID segment represents the most widespread ticket, precisely to mitigate risk and take advantage of the economies of scale.

As regards the performance of Large funds, it must be considered that they are very limited. The large funds capable of implementing Mega Deals or Large Buyouts represent a limited number and are mainly US-based. The funds that operate with such investments are always the same over the years and it is difficult for new ones to be formed. Furthermore, large funds have difficulties in selling portfolio companies as they are too large to sell. The only solution would be to sell them to other private equity funds of equal size.

Until 2021, investments were more focused on Expansion and Buy out. In recent years, however, many operators have decided to focus almost exclusively on buyout-type investment activities.

This strategic shift can be attributed to several factors. Buyouts offer greater opportunities for corporate control and restructuring, allowing investors to quickly implement operational and strategic improvements. This positioning may also be fostered by the changing trends caused by the pandemic.

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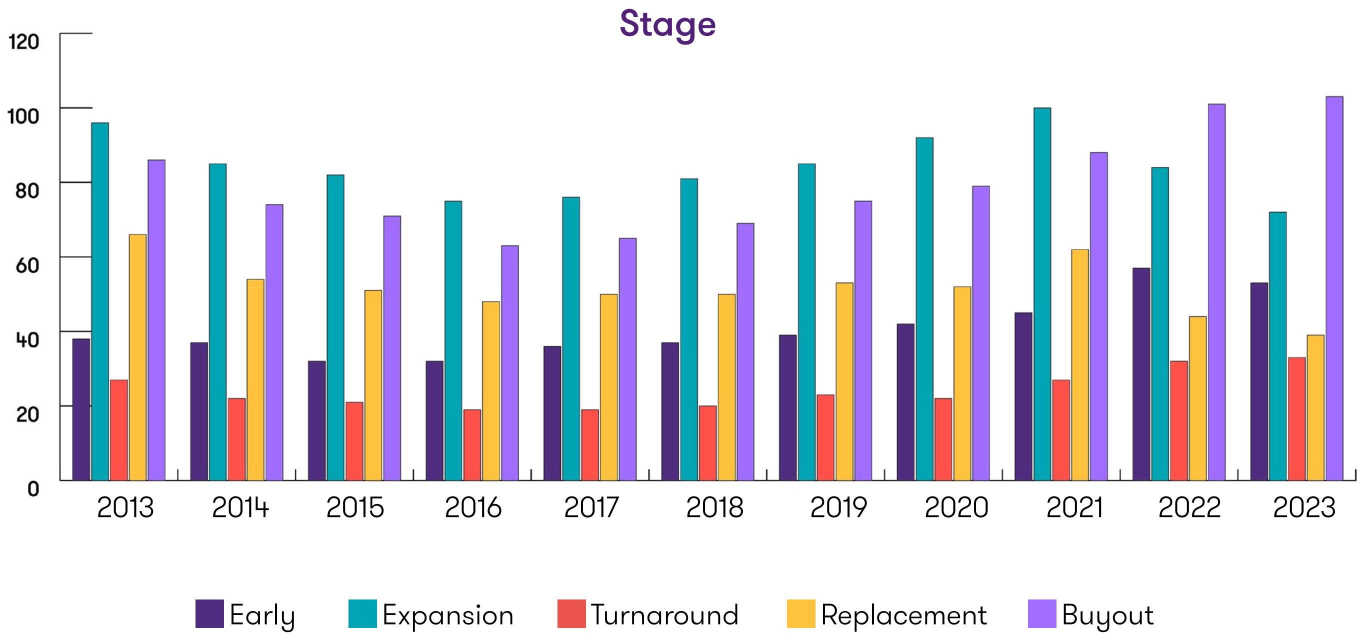
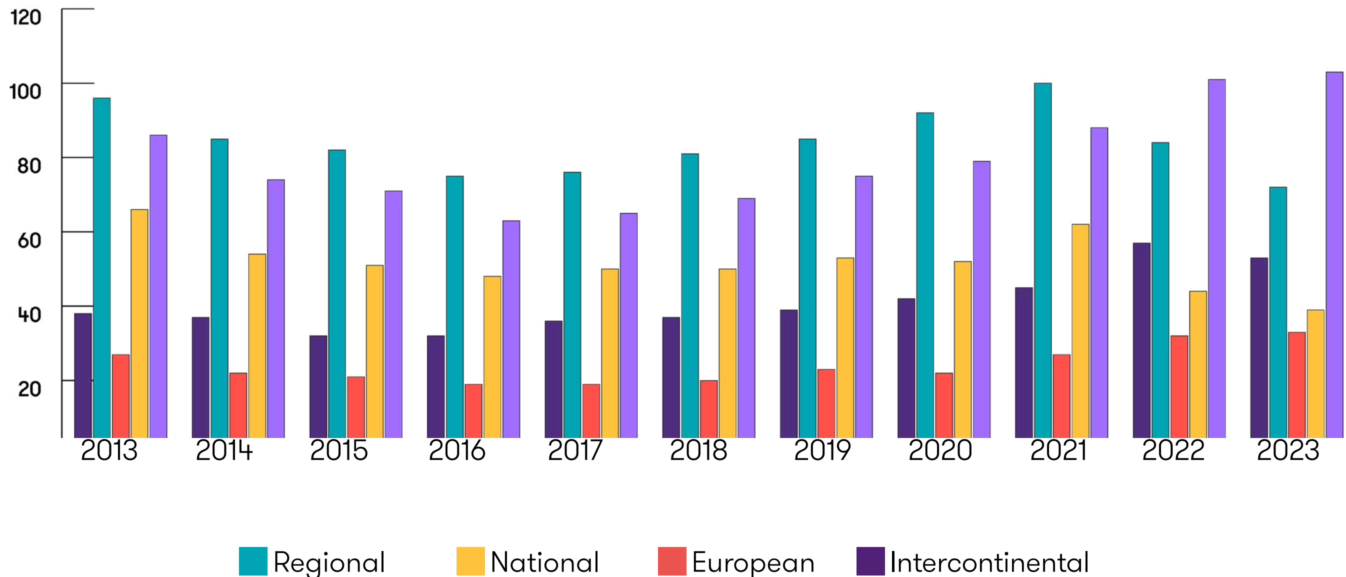


Private equity funds have preferred Buy out as their main strategy, considering it as a safer and more profitable approach than Expansion, which can involve greater risks in an uncertain market environment. Furthermore, during the extraordinary crisis period due to Covid and the pandemic, entrepreneurs have shown deficiencies in management and business strategy, leading funds to intervene to avoid the collapse of companies and leading them beyond the difficult situation. This highlighted the importance of having full control of corporate governance, in order to be able to overcome crisis situations. In fact, funds that did not have majorities suffered significant losses.

In the investment landscape, the domestic sector continues to be preferred by a significant number of operators, which choose it as the heart of their investment strategies, thanks to their experience and in-depth knowledge of the Italian economic system. Numerous funds invest on projects aimed at the development of Italian SMEs in all stages of growth. However, over the years, there has been a constant decrease in the number of operators active at a regional level. This decreasing trend reflects a substantial transformation in the sector's investment strategies. Regional funds are highly specialized in investing in small companies. Therefore, the decreasing trend over the years is a consequence of the decrease in Small-type funds. In fact, the cost of small investments at regional level in small businesses is not optimal, as it is comparable to the cost of a larger investment.



Private equity funds are progressively shifting their attention towards diversification on a domestic and international scale. This decision is driven by a series of strategic and economic reasons. Diversification towards a broader geographic scope allows, first and foremost, to mitigate the risks associated with specific local markets, offering greater resilience to events that can affect a single region. During the period, there has been a globalization of information and technologies which has allowed many investments to increase the value and competitiveness of companies within their investment portfolio. Furthermore, over the years, investments have allowed small Italian SMEs to grow by adopting an international perspective and turning into small multinationals.

The growing phenomenon of European investments reflects the evolution of a European culture and a single market over the years. This has fostered relationships between companies and facilitated the business aggregation process.

Geographical expansion was also possible thanks to the constant analysis of the market and trends for each industry, which allow companies to adapt and compete beyond the domestic territory.

As for the breakdown of investments by industry, the investment strategies implemented in the last decade were diversified, involving different industries over various years. The decrease in the number of industries covered by the investments shows how PE funds have rethought their positioning and generalist strategies over the years to try and specialize on specific sectors, in line with international trends, especially in the Anglo-Saxon world.

Some sectors have been under attention for a few years and then abandoned. On the contrary, some other sectors have been in the limelight of investment strategies during the whole decade.

The Healthcare, Industrial Products and Services, Manufacturing and Food and Beverage industries are among the most coveted by private equity funds, for various reasons:

- the healthcare industry is characterized by a constant demand driven by continuous medical and technological progress. The growing innovation offers significant high-yield investment opportunities;
- the industrial products and services industry is broad and diversified in nature. The continuous modernization of the various industrial sectors provides opportunities for a diversification of investments;
- the manufacturing industry plays a key strategic role as the pillar of the global economy which provides essential goods to various other industries;
- the food and beverage industry responds to a universal and continuous demand, as it deals with goods that meet primary needs, thus guaranteeing a constant demand and a stable and long-term investment opportunity.

Over the last few years, a significant increase in the interest towards the Energy and Environmental sector was also recorded, driven by various factors, the main one being the growing awareness towards sustainability and the development of renewable and sustainable energy.

The growing concern towards climate change and the environmental impact of human activities led to an increased awareness of the challenges related to the supply and use of energy sources. As a result, investors are increasingly focusing their attention on cleaner and more sustainable energy solutions. Alongside with the increased attention towards renewable energy, there is a growing interest in technology and solutions aimed at improving energy efficiency and reducing waste.
This includes investments in technology for energy efficiency in buildings, transportation and industry, as well as solution for waste management and recycling.

Expert's opinion

The evolution of Private Equity operators in the next digital evolution

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PE funds, therefore, were searching for companies operating in traditional industries, capable of producing large cash flows without excessive efforts to defend their competitive positioning.

Today, also based on the results of previous research, the aforementioned paradigms seem to have radically changed.

From tangible to intangible; Is it true that PE operators no longer look at short-term cash flow but at other elements, even intangible ones?

If ten years ago someone had told me that during my professional career, I would have dealt with a Private Equity operator interested in investing in companies with negative operating margins, whose structures are made up of very few people, whose business model is based on totally digital infrastructures, I would never have believed it. However, this is exactly what is happening today; even the more traditional operators are looking forward to investing in technological, innovative industries, which are very often completely dematerialized.

Are we reviving what happened in 2000, then giving rise to the so-called "dot-com bubble"?

Absolutely not, when I talk about technology, digital, dematerialized industries, I am not referring to the generic concept of "online", software or apps. I am referring to old and new industries, whose structure has changed profoundly, or is destined to change profoundly, thanks to the use of technology.

Where technology can reinvent the rules of the game, financial operators from all over the world see an interesting opportunity for creating value.

Can you make a concrete example?

Think about the medical sector: once, we were used to physically going to our doctors, for example the psychologist, for a consultation. Now, it is possible to do this not only in a totally virtual way, but also by benefitting from a series of previously unthinkable possibilities:

- choose the psychologist you prefer (through prior viewing of the CV, video presentation and, above all, independent references);
- rely on very powerful tools based on artificial intelligence, capable of carrying out more accurate and predictive diagnoses;
- put together a vast portfolio of psychologists and overcome geographical barriers;
- connect an excellent training system, including university ones, to these platforms, to guarantee the quality of the service offered.

Each of the above points is an advantage for the user, for the supplier, and for the investor.

In conclusion?

First of all, I could mention the above example just because PE funds made it possible. This new sector, in fact, was born thanks to Private Equity. But the thing that strikes me most is that previously a Private Equity operator would never have thought of being able to invest in a psychologist's office. Today, it is one of the many asset classes that have top priority for financial operators around the world.

Previously, we were used to having hundreds of thousands of small independent professionals spread across the country, while today we have national-level organizations that group these professionals in an organized and structured way, guaranteeing them training, visibility and operational stability.

And tomorrow? These organizations will probably become international networks and maybe they will be even listed on the stock exchange.

Go beyond business as usual

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