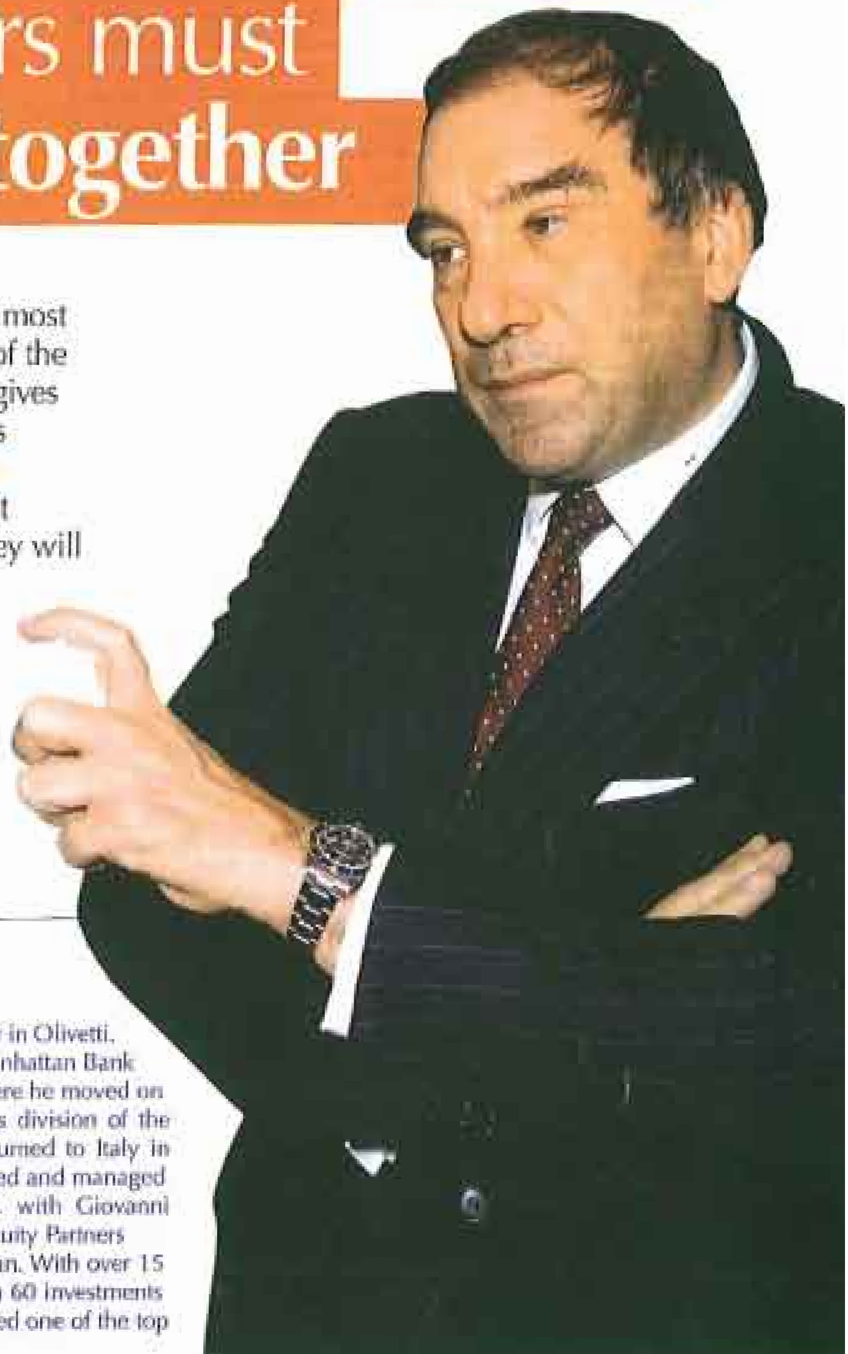
Industrial and financial investors must act together

Fabio Sattin, one of the most experienced managers of the Private Equity industry, gives his view on the business challenge: **players' time horizons** and investment patterns will change, they will adopt a **longer term view** and pay greater attention to the needs of all **stakeholders**



PROFILE

Fabio Sattin (50) began his career in Olivetti. In 1985 he joined the Chase Manhattan Bank NA (now JP Morgan Chase), where he moved on to the Mergers and Acquisitions division of the New York headquarters. He returned to Italy in 1987 and, in 1988, he established and managed Chase Gemina Italia. In 1993, with Giovanni Campolo, he founded Private Equity Partners (PEP) of which he is the Chairman. With over 15 years' experience and more than 60 investments completed in Italy, PEP has earned one of the top IRRs on the market.

A general economic downturn; credit restrictions; excessive use of leverage; increasing competition from industrial buyers and Sovereign Wealth Funds; controversial image; decreasing returns: those are only some of the issues that may have a negative impact on the development of private equity (PE) activity in the next years according to many observers. Consequently, many are wondering what the future of PE will hold and if new development patterns will emerge.

The reality is that private equity, due to its increased dimension and deeper social and economic impact, will probably suffer as all other economic and financial activities will. Just like the rest of them, it is now exposed to the general deterioration of the economic climate, at least as far as the US and Western European Markets are concerned.

This consequently calls for a significant fundamental strategic repositioning that takes into account the long term structural changes the world economy is facing.

But what are the key fundamental changes that private equity may need to make to face such a complicate situation?

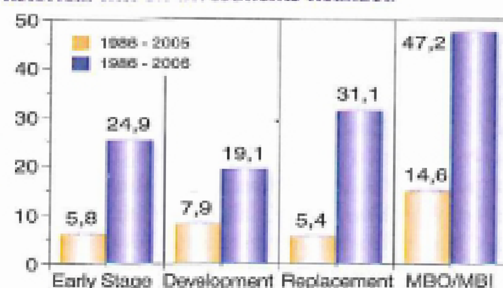
A first important consideration is that private equity is somehow facing the consequences of its increased success, dimension and social exposure. It is now acknowledged as a fundamental element of today's economy and all PE investors, especially the largest ones, are now required to pay much more attention to the social consequences of their activities. Although returns and profitability must always be the key objective of their action, to consolidate those returns in the long run, they must pay greater attention to the economic and social impact of the investments made and take into account a wider range of interests. Social responsibility, transparency, long term stability, flexibility, relations with governments and regulators, attention to all stakeholders' needs and investment criteria driven by real added value will probably be the key elements on which the future development of all leading PE investors will be based.

> "Private equity is facing the consequences of its success, dimension and social exposure. It is now acknowledged as a fundamental element of the economy"

Another possible evolution might be an increased joint-investment activity that brings together PE and industrial investors as partners, and not only as competitors, as many observers expect. The complicated economic scenario and increased internationalization of M&A activity will probably generate a higher number of investments in which PE investors will join forces and experience with industrialists or entrepreneurs in order to maximize the success potential of their investments. As an example just take the increased number of industrial groups, perhaps based in China, India or other developing countries, that need to expand internationally. For that kind of international acquirer, having a PE investor with consolidated investment experience on the market in which investments are to be carried out as a partner can be very helpful. In the meantime, the presence of a "local" PE investor may ensure a better consideration of the company's specific needs and interests, maintaining a higher level of independence also at the management level. On the other end, the industrial partner may be able to provide the PE investor with specific know how, synergies and expertise that might prove very useful in maximizing investment returns. This type of partnership will benefit all parties involved, including the company's management and employees. The well-known problem of a possible different strategic orientation that has traditionally represented the key impediment for the realization of those "joint" transactions is now less

The graph shows the trend of investments and exits for private equity funds operating on the Italian market. 2007 was a record year for the Italian market

Historical IRR on Investments Realized



Source: KPMG - AIFI Survey

evident than in the past. "Industrial" and "financial" investors are starting to increasingly resemble one another and it is really becoming harder to identify significant differences in terms of business action, governance or development strategy. Actually, they both act in a similar way, especially as far as listed public companies are concerned. The most difficult issue to be addressed and solved is PE investors' need for a clear way out in a pre-defined time frame. Normally, the industrial investor does not need to have an exit strategy and his objective, in most cases, is to consolidate business in order to exploit synergies. These differing needs can create a significant misalignment of interests between the two partners. But with the increased experience gained by the most professional PE players, helped by the development of a more articulated financial market, this problem can now be successfully addressed, as it has been in many cases, by structuring well designed put/call options, earn-outs agreements or other similar "way out" mechanisms (IPO's, buy-backs, etc.). The advantages of such partnerships for all parties involved, first of all the invested company, can be significant and being more flexible and finding creative solutions to this problem may be worth the effort.

Another possible development for PE activity could be partnerships between PE investors and public institutions and governments. The support of professional and financially powerful PE investors may be of significant help in solving critical situations or within privatization processes, bringing together all necessary resources, including financial ones, in order to better address and solve those situations whilst curbing the use of public resources. This is particularly evident in the case of PE funds investing in infrastructure projects but this concept can also be expanded to many other sectors such as: health-care, transportation, energy or others.

In this regard, we also need to mention **the role of Sovereign Wealth Funds (SVF)** and the dynamics of their relationship with the PE sector and, on a wider scale, with local governments. SVFs have been and will be a fundamental element in the development of the PE sector. All major PE funds have had SVFs as important investors for many years and have established long standing, mutually satisfactory relationships with them, based on mutual trust and fruitful cooperation. This experience may probably help mitigate the controversial perception of SVFs. In a global market, SVFs will certainly play a key role and the fact that they are mainly based Asia, Russia, Emirates or other developing countries should not be seen as a threat. Their increasing role is only the natural consequence of the global changes taking place in the world distribution of economic powers. Consequently, the challenge is putting their financial strength to the best use to enhance the competitiveness of our "less developing" western economies. Up to now, SVFs have maintained a correct and professional approach, using their power carefully and keeping a great level of respect and autonomy when investing. In many cases, they do not even ask for a seat on the board when investing in companies and their attitude has been very cooperative and friendly. And there are no signs of change in this positive attitude. Certainly, their power and influence will grow, but no laws, restrictions or protectionist processes can change the world dynamics. This may help in the short term but not in the long run. If well structured and developed (and PE investors could be of significant help with this) the activity of SVFs can be very fruitful and important also for the development of western European or US companies, even allowing some of them to survive, as we have seen in the recent investments carried out by SVFs in some large banking groups.

> "This process may be difficult to manage for some players, especially the smallest ones, and a selection process will probably take place"

In conclusion: PE players will face significant changes in the coming years and their role and importance will continue to grow. In Europe, their activity will probably expand in many sectors (banking, insurance, infrastructure, real estate, transports, energy, healthcare, media and financial services). They will also closely cooperate with industrial companies, entrepreneurs, SVFs, governments and public institutions, carefully managing the social and economic impact of their investment activity and developing a positive image. Even relations with their investors will develop further. More transparency and information and increased attention to reputational issues will be required to establish a long term partnership with all fund providers and to avoid problems with local governments, regulators and unions. This process may be difficult to manage for some players, especially the smallest ones, and a selection process will probably take place.