Gatti Pavesi Bianchi

Back in fashion

The Italian private equity market in 2018

Unquote
An Acuris company

Contents

Record Q1 2018

7 deals over €100m

The highest Q1 large-deal volume on record

€4.7bn

The highest Q1 total value on record

34 deals

The strongest Q1 volume on record

Q1

Sector watch

- Largest sectors by volume 2016-17
- Largest sectors by value 2016-17

Largest sectors by volume 2016-17

- 30% Industrials
- 27% Consumer
- 14% Technology

Largest sectors by value 2016-17

- 25% Financials
- 18% Industrials
- 16% Consumer Goods

Private equity in focus

In this first edition of Gatti Pavesi Bianchi's new series on the M&A and private equity markets, partners **Gianni Martoglia, Carlo Pavesi** and **Stefano Valerio** explore how family businesses, foreign interest and fertile fundraising are boosting Italian private equity

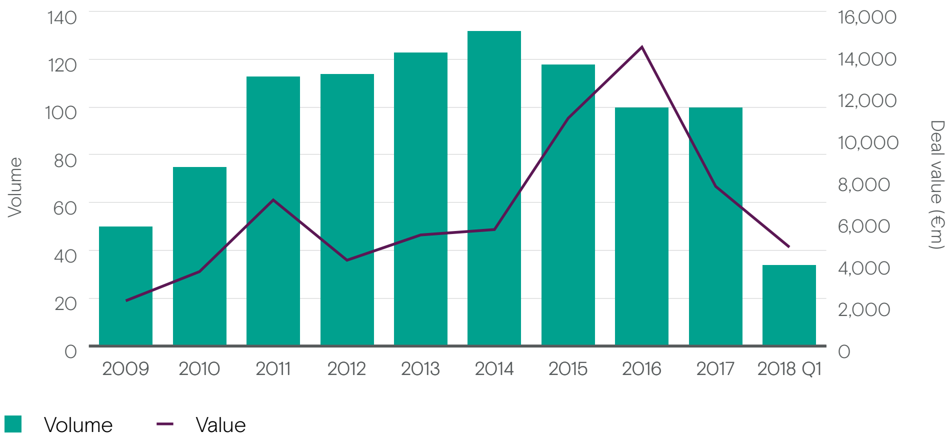
The Italian private equity industry had to negotiate a volatile period in 2017. Although the number of private equity-backed deals in Italy held steady, matching 2016's total of 100 deals, value was down 47% year on year to €7.6 billion, according to data compiled by Unquote.

The fall in deal value last year, however, obscures the fact that the Italian private equity market is actually in a healthy position. Despite the drop-off in 2017, total value last year is still almost double that of the €4.1 billion worth of deals closed in 2012. Total Italian private equity deal value has in fact climbed every year between 2012 and 2016, when a record €14.3 billion of private equity-backed deals were done. It is also notable that the €7.6 billion posted last year represents the third best year since the financial crisis.

The outlook is certainly positive after a strong start to the year for Italian private equity in 2018. The first quarter of 2018 ranks as the strongest Q1 for Italian private equity deal activity in terms of both deal volume and value since Unquote records began. Notably, by the end of Q1, total deal value had already surpassed the halfway mark of 2017's total deal value and matched a third of 2017's total deal volume.

A further sign of private equity's confidence in Italy is the fact that firms have been willing to deploy larger sums into bigger deals. There was a higher volume of larger-scale private equity-backed deals than in any previous year and relatively fewer smaller-scale deals.

ITALIAN PRIVATE EQUITY DEAL ACTIVITY 2009–Q1 2018



100

The total number of private equity deals in both 2016 and 2017

€7.6B

The value total for private equity-backed deals in 2017 – the third highest total since the financial crisis

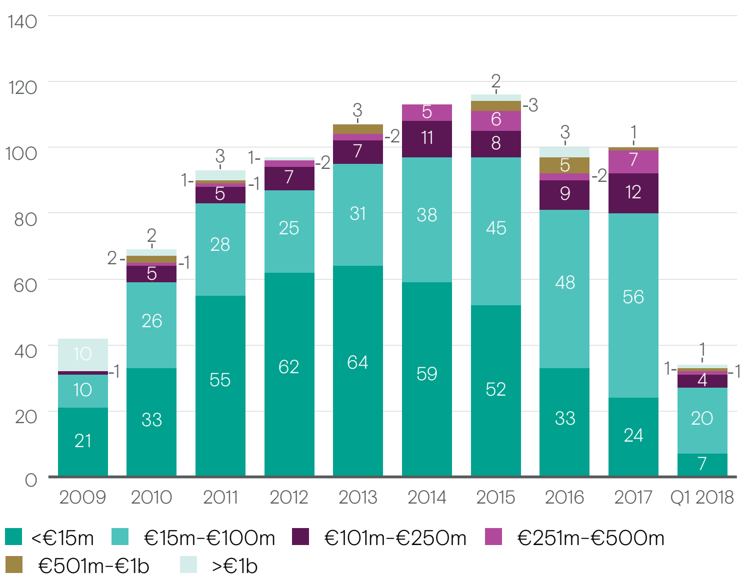
Overall, it seems that the upward trend that started in 2016 and 2017 has continued into 2018 and a slowdown seems unlikely. However, it is worth noting that, despite the formation of a government, the political uncertainty that remains in the country could mean that foreign backers begin to reduce their investments in Italy. Nevertheless, a combination of factors have supported private equity's strong performance in Italy.

FAMILY MATTERS

The question of succession within Italy's family-owned companies has been among the main drivers for private equity deal flow. According to AIDAF, the Italian Association of Family Businesses, there are an estimated 784,000 family businesses in Italy, accounting for 85% of all companies in the country. Two thirds of these companies are still fully managed by family members, whereas in other European countries such as France (26%) and the UK (10%), the proportion is much lower. According to a study led by FABUSS, an EU-funded project focused on facilitating succession within family companies, and consultancy TUCEP, these family business leaders are now approaching retirement. The average age of a business leader in Italy is 57.5 years, with the average age of company boards sitting at 58.1 years.

Many of these business leaders have turned to private equity as they prepare to hand over the running of their companies. Unlike a corporate acquisition, where a family business is subsumed into the parent company, the private equity model's flexibility allows outgoing family business leaders to secure the independence of their businesses, retain a share of the company and continue participating in the running of the business as the transition to new management is implemented.

ITALIAN PRIVATE EQUITY DEAL ACTIVITY SPLIT BY DEAL SIZE, 2009–Q1 2018



Private equity ownership also avoids some of the tensions that can emerge when one family-backed company attempts to acquire a rival.

In addition, private equity plays a fundamental role for a family-backed company because not only does it provide capital and expertise for development and growth, but also acts as an accelerator for the modernisation of the business in terms of corporate governance and best management practices.

In the case of IRCA Group, for example, the largest Italian private equity deal of 2017 that saw the Carlyle Group acquire the company in a secondary buyout from Ardian, private equity investment was a key part of the succession process. Owned by the Nobili family, IRCA, a producer of ice cream and a supplier of ingredients to bakeries, was acquired by private equity house Ardian in 2015. Run by brothers Renato and Roberto Nobili, the Ardian investment provided an exit for Renato and allowed Roberto to stay on with the company and retain a shareholding before making his final exit in the subsequent Carlyle deal.

Family-backed companies have also turned to private equity to help them grow exports. With domestic demand in Italy lagging behind the rest of Europe (the OECD projects that GDP growth in Italy will edge lower to 1.5% in 2018 and 1.3% in 2019), family companies have recognised the importance of broadening their product lines and moving into new markets.

CEME Group, bought for €280m by Investindustrial from Investcorp in the fifth largest Italian private equity deal of 2017, has entered the US market and increased its presence in China since first coming under private equity ownership in 2005. Initially focused on the single serve coffee market, CEME has expanded into temperature control, medical devices and water dispensing after taking on private equity investment.

85%

Of all companies in Italy are family-owned businesses

25%

The percentage of total private equity deal value accounted for by the financial services sector in 2016-2017

From private equity's point of view, Italy also boasts large numbers of small- to medium-sized enterprises (SME) that produce high-quality products in sectors as diverse as fashion, engineering and food. Companies such as bicycle-maker Pinarello, coffee group Segafredo, steel construction business Cimol and Artsana, the maker of Chicco baby strollers, are just some of the household names that have emerged from Italian industry.

Italy has earned a well-deserved reputation for manufacturing and craftsmanship of the highest order, and there are large numbers of Italian SMEs that produce great products and have strong revenues. A study of more than 15,000 Italian companies by the AUB Observatory, which tracks the performance of Italian family companies, found that 60% of family businesses have revenues of between €20 million and €50 million. These kinds of businesses are ideal private equity targets, with their steady cashflow and scope for international growth.

FOREIGN INTEREST

Given these dynamics, it is not surprising that international and pan-European private equity firms have been among the most active in the Italian market. Of the ten largest deals in 2017, nine involved either a global or pan-European private equity house.

International private equity houses have also been encouraged by a package of regulatory measures designed to attract investment into Italy. Those firms have been especially welcoming of new rules that came into force last year that allow for carried interest (the money paid to private equity firms when return hurdle rates are cleared) to be taxed at the lower capital gains tax rate of 23% rather than the personal income tax rate of up to 46%. Italy has also set up a guarantee fund for SMEs taking on bank debt, introduced tax breaks for research costs and income from intellectual property and launched a new "non-dom" tax scheme to draw wealthy individuals with Italian links back into the country.

FUNDRAISING FUNDAMENTALS

Investors have noted the potential for private equity in Italy, which has supported strong fundraising for firms targeting deals in the country. According to figures compiled by Italy's private equity trade association AIFI and consultancy firm PwC, fundraising in Italy increased almost five-fold in 2017 to €5 billion, up from €1.3 billion in 2016. Investor appetite was particularly strong for managers raising large funds targeting the region. F2i and new special situations firm QuattroR were among the firms who enjoyed strong investor support. Fundraising has also benefitted from the hugely popular introduction of personal savings accounts called PIRs. The individual savings accounts receive tax advantages and PIR assets can be invested in private equity funds (see *The rise of SPACs*, page 10, for more details). Returns from private equity funds, meanwhile, have been decent. AIFI and KPMG calculated that exits in Italy in 2017 recorded an average gross IRR of 12.5%. This was above the ten-year average of 10%.

FEAR FACTORS

Investing in Italy, however, is not without its obstacles. Corruption continues to be a problem, with Italy ranked as the third most corrupt country in the European Union, according to Transparency International's most recent World Corruption Index. General partners have raised concerns that tax decisions in the country can be unpredictable. There are also concerns that investment is heavily concentrated in the north of the country, with AIFI and PwC figures showing that only 1% of private equity investment in 2017 went to the south.

The early March general election, meanwhile, only managed to deliver a government in the second week of May, which created uncertainty for the local business community and overseas investors. The fact that the Five Star Movement won the most votes, with the right-wing Lega Nord taking more votes than coalition partner Forza Italia, the party of former Italian president Silvio Berlusconi, has prompted further unease. Deal activity does not appear to have been affected by the election results, but there is a risk that some dealmakers, especially those from abroad, may put transactions on hold until the nature of the coalition government and its policies are clearer.

Perhaps an even bigger challenge facing private equity in Italy is the weakness of the country's banks. Lenders have been bogged down by more than €340 billion of non-performing loans following the financial crisis, one third of Europe's total. The state has been forced to bail out Italy's oldest bank, Monte de Paschi, and put guarantees in place to prevent contagion. Morgan Stanley believes it could take as long as a decade to clear the backlog, while data compiled by consultancy Oliver Wyman for Reuters shows that in the first half of 2017 the return on equity for Italian banks was just 2.3%. This was less than half the European average and well shy of their 12.8% cost of equity.

The plight of the banks has not been all bad news for private equity, which has sourced deals by stepping into the funding gap left by these institutions. However, the plight of lenders has drained resources and hampered growth, as well as making it difficult for private equity to raise acquisition finance domestically.


RIZZO

Sector watch

Italy's two most consistent sectors continue to provide private equity firms with the majority of deals. But, for value, it is a different matter entirely

In terms of volume, the industrials and consumer goods sectors made up more than half of all deals between 2016 and 2017, a big shift from 2014, where technology was the most dominant sector by some margin.

Technology was still the third most popular sector for Italian private equity deals in 2017, but its share of total deal volume fell from 35% in 2014/2015 to 14% in 2016/2017.

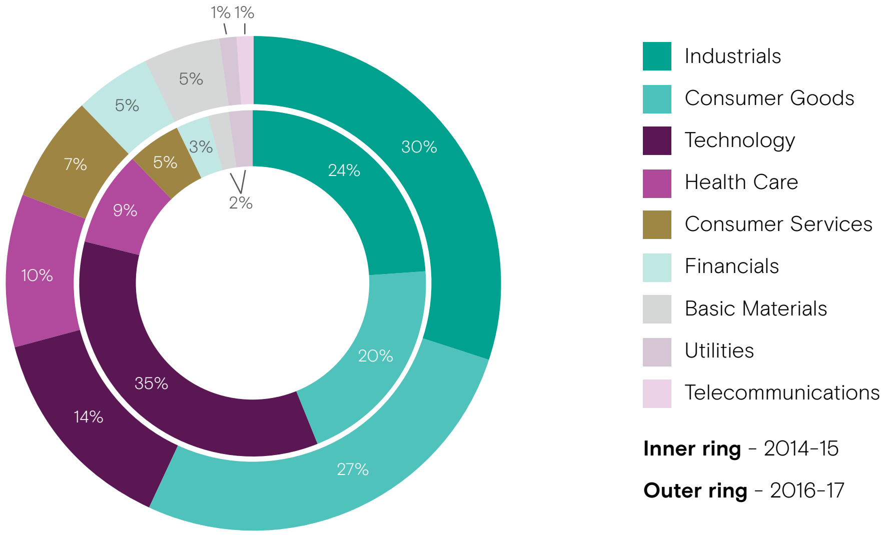
FINANCE OUT IN FRONT

When looking at deals by value, however, the financial sector was the largest, accounting for 25% of overall deal value between 2016 and 2017.

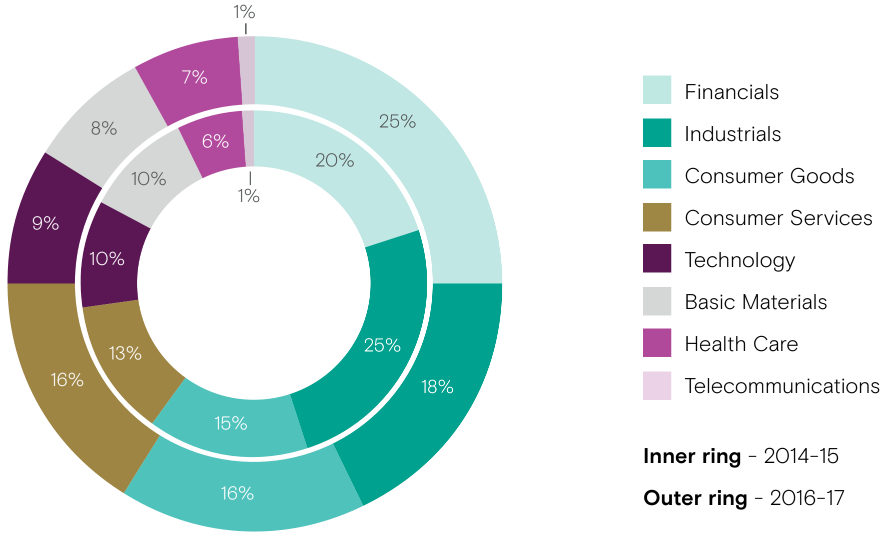
The large deal values in financial services can be explained by the banking crisis in Italy, which has seen investors come in to acquire portfolios of non-performing loans and distressed assets at reduced prices. Firms including Idea Capital, HIG and AnaCap have all raised money for investment in Italian non-performing loans.

Financial services deals also offer growth plays, with private equity firms open to opportunities to invest at attractive prices as the sector bottoms out. Cinven's purchase of Gruppo Flavia, for example, is part of a strategy to consolidate the Italian life insurance industry. There are also opportunities to find growth through digitalising Italy's banks, which lag behind the rest of Europe in this regard but could enjoy strong upside from investing in their online product and account offerings.

PRIVATE EQUITY DEAL VOLUME, SPLIT BY SECTOR



PRIVATE EQUITY DEAL VALUE, SPLIT BY SECTOR



Announced date	Target company	Target Dominant Sector	Bidder company	Deal value EUR(m)
Jun-2017	IRCA Group	Consumer Goods	Carlyle Group	520
Feb-2017	Golden Goose	Consumer Goods	Carlyle Group	440-460 (estimated)
May-2017	DentalPro	Health Care	BC Partners	365-385 (estimated)
Jun-2017	Pasubio	Consumer Services	CVC Capital Partners	275-295 (estimated)
Dec-2017	CEME Group	Industrials	Investindustrial	280
Dec-2017	La Piadineria	Consumer Services	Permira	240-260 (estimated)
Aug-2017	Biolchim	Basic Materials	zManagement, Chequers Capital, NB Renaissance Partners	190-210 (estimated)
Apr-2017	Gruppo Flavia	Financials	Cinven	170-190 (estimated)
Jun-2017	Dynamic Technologies	Consumer Goods	Ardian	130-150 (estimated)
Jun-2017	Infracom SpA	Telecommunications	Fondi Italiani per le Infrastrutture (F2i)	120-140 (estimated)

FOOD BEATS FINANCE IN 2017

However, when it came to the top ten deals of 2017, there was only one financial private equity deal (the aforementioned Gruppo Flavia purchase). Most private equity firms chose to focus their resources on the consumer industry. Half of the ten largest private equity-backed deals in Italy in 2017 had a consumer angle. The high quality of Italian consumer goods, which are hugely popular across world markets, have attracted interest from private equity firms, which see huge scope for taking the Italian “brand” international.

Permira’s acquisition of Italian piada sandwich chain La Piadineria, the sixth largest private equity deal in Italy last year, is an example of why private equity firms are so keen on Italian consumer businesses. Permira paid Idea Taste of Italy, an Italian fund specialising in food deals, between an estimated €240m and €260m for the company, which serves a range of Italian flatbreads. La Piadineria was the first investment from the Taste of Italy fund, which was set up in 2015 by Idea to invest in Italy’s high-end food industry. The business, which still produces all its dough from its Montrione base, has doubled its store network and tripled annual turnover to around €60m over the last four years. During Idea’s hold, the business opened its first two sites in France. Permira plans to support further store roll-outs across Europe and grow La Piadineria’s customer base.

Italian private equity house Clessidra further illustrated the appeal of Italian food brands with its sale of balsamic vinegar maker Acetum to large trade buyer Associated British Foods. Clessidra only held the business for two years before it received an offer from the British group that was too good to refuse.

The rise of SPACs

Special purpose acquisition companies (SPACs), blind pool vehicles that raise capital via IPOs for investment in private M&A deals, have proven incredibly popular with stock market investors in Italy over the last 12 months

The first SPAC was launched in 2011 and, by the end of last year, there were 23 SPACs trading on the Italian stock exchange. At least ten of those had come to market during 2017.

Momentum has carried on into 2018, with former Intesa Sanpaolo head and Industry Minister Corrado Passera securing €600 million for SPAXS, a SPAC set up to invest in the banking sector.

However, SPACs have not always been popular with investors, who were concerned with their relatively low transparency, illiquidity and weak safeguards in the event of poor management and underperformance. This is particularly true of the US market. But over the last 24 months, these investment vehicles have been making a comeback.

One of the main drivers of the SPAC renaissance is the fact that Italy's family-run SMEs, which make up the backbone of its economy, have had to look for new sources of finance. Traditionally, these businesses relied on the country's banks for their capital needs, but with Reuters' figures estimating that there are still more than €300 billion of impaired loans sitting on the balance sheets of Italian banks, SMEs have had to look elsewhere for funding. SPACs, which are often relatively passive investors, have offered a credible alternative for owner-managers and families who do not want to cede control of their companies in a trade sale but need funding. From the entrepreneurs' perspective, SPACs are also seen as providing easy access to listings (thanks to the intermediate transition to AIM, the Italian Alternative Market organised and managed by Borsa Italiana).

SPACs have also benefitted from the government's introduction of individual investment savings accounts called PIRs that receive beneficial tax breaks. These accounts have to invest 70% of their capital into Italian companies, with a minimum of 30% of that allocation going into SMEs. PIRs have proved incredibly popular with savers and broker Intermonte has forecast that €12.4bn will flow into these accounts in 2018. This forecast comes after more than €10bn was secured last year, exceeding all expectations. This huge inflow of new capital has boosted investor interest in SPACs.

Finally, SPACs are quickly shedding any legacy reputation for poor management. The more recent SPAC listings have had some of Italy's best-known business leaders and investors behind them. In addition to former Intesa boss Passera, other well-known SPAC sponsors include investment bank Equita and well-known entrepreneur Maurizio Borletti. With this kind of experience behind them, SPACs have been able to afford investors more comfort than was previously the case and offer target companies skills and networks in addition to capital. Limited restrictions also mean SPACs have been able to provide investors with a diverse range of investment strategies.

With capital continuing to flow into stock market funds thanks to the ever-popular PIR accounts, increasingly impressive business figures participating and the balance sheet issues faced by banks unlikely to unwind in the short-to-medium term, the outlook for growth in the SPAC space is bright.

Success against the odds

Despite a number of hurdles – both economic and political – private equity is thriving in Italy. Can the strong start to 2018 be sustained?

Tepid economic growth, a weak banking sector, political uncertainty and corruption are not usually a combination of factors that attract private equity investment.

Yet despite having to navigate all of these challenges, Italy's private equity market appears to be in a very strong position after the first quarter of 2018.

The high concentration of family-owned companies in the country, many of which are fast approaching a succession event as the founding generation of entrepreneurs approach retirement, is a long-term structural shift that will have to be addressed irrespective of political and macro-economic machinations. Private equity is perfectly placed to provide these family-run companies with succession options.

Even though these SMEs produce goods to the highest standards, many still have not taken full advantage of the opportunity to grow sales beyond domestic markets. Again, private equity is in a good position to partner with these companies and provide funding and expertise to support international growth.

Regulators and politicians, meanwhile, appear to have recognised the role that private equity can play in supporting succession and growth. The taxation of carried interest is more favourable after rule changes, support for R&D is strong and guarantees for SMEs taking on bank debt generous.

Fundraising has also picked up, almost doubling over the last 12 months, as investors note the opportunity that private equity firms in Italy have in front of them. Investment from the new personal PIR savings accounts has brought another source of capital into private equity vehicles.

Italy is also serving up opportunities for private equity houses across a range of sectors, with consumer, food, industrials and financial services all producing a steady supply of interesting investment targets.

Unpredictable politics and a banking sector that is still under intensive care do pose risks, but for firms that are capable of managing those challenges, underlying M&A fundamentals make Italy a good place to be for private equity at present.

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