Private Equity and Venture Capital in Europe

Markets, Techniques, and Deals

Stefano Caselli

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To Elisa and Lorenzo

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Foreword

The private equity industry, dominated since 1988 by Kolhberg Kravis Roberts & Co., architects of the famed $30 billion LBO of RJR Nabisco in 1988, stood in awe in June 2007 after the initial public offering of The Blackstone Group, a diversified alternative asset investment manager with $88 billion of assets under management was successfully launched and traded to a premium. The offering, which included a non-voting $3 billion investment by the State Investment Company of China, was priced at $31 per share, and opened for trading at $36.45 per share just two days after two Bear Stearns hedge funds collapsed, ushering in the beginning of the 2007–2008 mortgage securities crisis. The offering valued Blackstone at about $38 billion, and revealed that CEO Steve Schwartzman would take out $677 million in cash while retaining a 24% interest in the firm, valued at $10 billion. His co-founding partner, Peter Peterson, 80, would withdraw $1.9 billion and retain a 4% interest valued at $1.6 billion.

No wonder private equity had been the hottest thing in the market for the past three years!

Peterson and Schwartzman founded Blackstone in 1985, soon after Peterson retired from Lehman Brothers, which he had headed since 1973. Peterson, a former CEO of Bausch and Lomb, an industrial company, and Secretary of Commerce in the Nixon administration, was able to negotiate an investment by Lehman in a new firm he planned to form with an initial investment of $400,000. He invited Schwartzman, then a 38-year-old merger specialist, to join him, and the two set out to see what they could do. Peterson was very well liked by his many friends and clients among corporate CEOs, and he attracted merger and other advisory business, which Schwartzman was good at executing. But they looked around after a while, especially at KKR, and decided to shift their focus from corporate advisory work to investing money on behalf of institutional clients in LBOs and real estate deals. In 1987 (more than ten years after KKR) they began to raise their first investment funds, which required a 2% management fee and a 20% share of profits. Their investors included university and other endowments and a few pension funds. In the 20 years since it was founded, Blackstone's funds have taken control of 112 companies with a combined market value of $200 billion, and provided returns on investment 10 to 20% higher than the S&P500 stock market index. Earlier in the year, it had completed the purchase of Equity Office Properties for $39 billion — the largest private equity buyout ever (at least for a few months), topping the RJR Nabisco record. By the end of 2007, Blackstone managed over $100 billion of real estate, corporate private equity, and hedge funds. Revenues for 2007 were $3.1 billion

and net income (after many adjustments to convert from a private partnership to a public limited partnership that distributes the bulk of its income directly to its investors) was $1.6 billion, down from a record income in 2006 of $2.3 billion. Peterson and Schwartzman, in modeling themselves after KKR, twenty years later, had passed it by.

"We raise money to provide alternative asset opportunities for institutions that know us," they might have said.

> *"We charge hedge fund fees and use the money we raise, plus a lot of leverage from banks and the junk bond market, to acquire companies we can improve and re-sell. We hire the industrial management skills we need, use our many connections to build a deal flow, and sit back and watch the money flow in, which is then taxed predominantly at capital gains rates. We keep the game going by selling new funds every couple of years, hopefully in ever-larger amounts. We avoid investing much of our own money in the funds, and therefore take much less risk than our investors. We also avoid hostile deals, conflicts of interest, and areas of heavy business regulation, which further lowers risks, and can stick to the morally defensible 'high road' because the nature of the business makes it relatively easy to do so. We can do all this with only a small staff of experienced professionals for whom we provide a friendly, supportive environment to work in. We don't need to retain a lot of capital in our management company, or borrow money or subject ourselves to trading risks. Ours is a high margin business that is very different from cut-throat investment banking, competing for business with endlessly demanding clients against powerful competitors with huge balance sheets, or, as traders, subjecting ourselves to a lot of market and other risks."*

No wonder so many stars from Wall Street and the City of London had decided to leave the investment banks that had recruited, trained, and nurtured them — the grass in private equity land had never appeared to be so much greener.

Blackstone's post-IPO share price valued the firm at about 10 times book value, and 24 times earnings, as compared to an average of about 1.5 to 2.5 times book and 8 or 9 times earnings for the best of the investment banks. The IPO was a breakthrough for the secretive private equity industry that had prized its ability to avoid regulation and public scrutiny. The high valuations provided by the Blackstone IPO would surely attract others among the leading figures of this powerful, fascinating but shadowy industry. Everyone would want to be public now.

In fact, some other fund management companies had already gone public by the time the Blackstone deal came along. KKR had sold shares in a specialty finance company, KKR Financial Holdings in London in June 2005, and followed up with an IPO of KKK Private Equity Investors on the Amsterdam market a

year later. These funds were designed to allow small investors to invest in KKR's deals alongside the big guys and were sold in Europe where they didn't have to be registered with the SEC, which took a dim view of complex LBO funds luring unsophisticated investors into risky investments. Neither of these companies fared well in the markets, though, and KKR had to inject additional capital into Financial Holdings, which had been hurt by the mortgage crisis. There were also some hedge fund managers — Off-Ziff Capital Management, Fortress Investment Management, and GLG Partners — that had established public trading markets in their firms. In July 2007, just after the Blackstone IPO, KKR announced it too was going to sell $1.25 billion in shares in an IPO scheduled for the fall, all the money was retained in the firm and none of the firm's founders were selling any of their shares. The initiative would signify a major shift in strategy for the firm, which now saw itself branching out into a more comprehensive, multi-platform financial firm like Blackstone.

Blackstone's IPO, however, came at the same time as the market meltdown that began in the summer of 2007 and lasted for nearly two years. Blackstone had no exposure to the mortgage-backed securities business, and its exposure to real estate was limited to commercial real estate, which did not suffer too badly initially in the residential sector. Its principal exposure, of course, was to private equity investments, most of which were fully financed. Some deals in process were cancelled or renegotiated without any harm to Blackstone. The problems lay in the virtual halting of all new deals (the banks, suffering as they were from major write-offs did not want to make any new leveraged loans, which were also falling sharply in value), and the need to apply fair value accounting to the positions they did have. Soon after the IPO, however, the share price began to drop, and continued to do so for most of the rest of the year and the next, reaching a low of $3.55 per share in February 2009, a 91% decline from its high of $38.

For the year 2008, Blackstone announced a net loss of $1.16 billion, as compared to a profit of $1.62 billion for 2007 (almost all of which had been earned in the first half). The loss was attributable to restating the value of investment positions held and reduction in the amount of performance fees due on them. "We hold our assets for the long term," said Tony James, President and Chief Operating Officer, "and expect their value will rise as we come out of the cycle."

Building the cycle

The cycle Tony James was referring to was the third one since LBOs became active in capital markets in the mid-1980s. The first one ended in 1990 when the junk bond market collapsed. There was an active, but smaller scale LBO business from 1993–2000 that was halted by the collapse of the technology and telecommunications sectors and the record levels of bankruptcies that ensued.

In 2003 the third cycle began and peaked in mid-2007, just as the Blackstone deal was brought to market, when private equity fundraising reached the $250 billion per year record level it had achieved in 2000 and then slightly exceeded it. During the four and a half years of this cycle, one now that comprised as much activity in Europe as in the United States, over a trillion dollars was raised for private equity investments. During the first half of 2007, nearly one out of four US and European acquisitions was in the form of an LBO, including a $45 billion transaction for the Texas public utility, TXU, arranged by KKR and Texas Pacific Group, and later a record-smashing $52 billion deal for the Canadian phone giant, BCE led by Providence Equity Partners. There was also a $100 billion buyout of the ABN Amro Bank by a consortium of European banks intending to break it up that, though technically not a private equity transactions, was considered by many European observers to be one and the same.

Most of the funds raised for private equity investments end up financing the equity component of LBO acquisitions, which are supplemented by substantial amounts of debt financing provided by banks or subordinated lenders. Private equity funds also exist to provide venture capital, mezzanine debt, financing for distressed company work-outs or turnarounds, and to fund portfolios of private equity investments of various types acquired in the secondary market from original investors wanting to sell their positions before the termination of their funds. They also exist to finance real estate investments of various kinds. All of these different forms of private equity investments now operate globally — in Europe, Japan, and in many emerging market countries.

During the most recent cycle, activity was accelerated by low interest rates and extremely easy borrowing conditions. Whereas the buyout firms have argued that their investment activity improves companies, creates growth and jobs, and meaningfully contributes to the economy, and academic studies support this claim, their critics say that the success of the LBO firms is due to the use of leverage, and because of the scale of the industry now, these firms subjected the economy to serious credit and liquidity risks. After 2003, LBOs of large, worn-out, difficult to improve companies (like Burger King, Hertz, and K-mart) occurred with little prospect for intrinsic value enhancement. But because of the ability to borrow cheap money, and to borrow more later to pay special dividends, the LBO operators could make a good and quick return.

Leverage ratios of buyout companies increased after 2003, and credit quality standards deteriorated to what came to be known as *covenant light* loans that required hardly any of the restrictive covenants that are usually demanded by lenders to keep the companies under financial control, because the loans were going to be repackaged into collateralized loan obligations (CLOs) and sold as asset-backed securities, in the same manner as mortgage-backed securities were

then being created and sold. Banks making these kinds of corporate loans were also eager to get themselves into the group of investment banks advising the private equity firms on their deals so they could share in the fees and the credit to be reflected in league tables. These banks, especially Citigroup and JP Morgan Chase, became so competitive with their credit facilities that the investment banks were forced to meet them by offering credit facilities of their own. By the spring of 2007, with the market roaring along, the advantages in negotiating financing were all with the LBO fund managers.

But all of this changed suddenly as the crisis in mortgage-backed securities widened and spread from a few hedge funds to infect major banks. After the collapse of two Bear Stearns hedge funds in June of 2007, despite the positive momentum of the Blackstone IPO, the market for LBOs came to a halt. By August 2007, the mortgaged-backed securities market was nearly in free fall, and had affected the market for collateralized debt securities, into which many LBO loans had been sold. Banks were unwilling to lend for new deals and were struggling to meet their commitments for deals arranged a few months earlier at very generous terms. The problem only worsened as the banks began to report huge losses in the third and fourth quarters of 2008.

Without access to the debt market and the high levels of leverage the LBOs require, the industry was forced to look to other investment possibilities. Texas Pacific organized a $7 billion investment in Washington Mutual, only to see the whole thing lost as the bank had to be taken over by its regulators a few months later. Some, like Goldman Sachs, took over the portfolios held by others, especially ailing banks such as Wachovia that were forced to undergo top to bottom restructuring as part of a merger arrangement. Investors led by Harvard University said they might increase sales of their private equity positions in the secondary market to more than $100 billion in 2009. Some private equity managers like Black Rock prospered by acquiring distressed portfolios of mortgage securities from others. Some others intended to use their capital like hedge funds to arbitrage the low prices of mortgage-backed securities against their supposedly higher intrinsic value.

The entire industry felt the pain of the market meltdown. Their funds declined by 30 to 50%. They received no performance fees, and some were required to return fees earned in earlier periods. There were very few new deals on which fees might be earned, no existing deals ready to be refloated to the market could be sold in the non-existent IPO market. And, several deals that had been agreed upon, but not yet closed, faced serious financing risk if the banks that were committed decided to pull out or wanted to renegotiate the terms. Many highly leveraged companies previously acquired through LBOs would find the global recession too difficult for them and be forced into bankruptcy. The private equity

industry had never experienced such a storm of difficulty and hostile markets before. All private equity firms suffered large losses. KKR abandoned its plans for a public offering. Several large investors threatened to avoid future capital calls by assembling a majority of fund investors to vote to reduce the principal amount of the funds. New funding was extremely difficult, although Carlyle managed to raise some additional equity.

Not all was entirely gloomy, however. Most private equity finds were of a ten-year duration, with several years more to go before having to wind up. As markets recover, some of the write downs will be reversed. Many private equity managers were also pointing out that they would be able to take advantage of the market declines by acquiring new investments at knock-down prices, often low enough to enable them to complete the deals with little if any leverage. As the recession entered its second year, a backlog of uncompleted restructurings in Europe, Asia, and America were just waiting to be done when they could be again. And, investors withdrawing their capital from private equity were not finding any other markets likely to provide healthy equity returns. They might as well stay where they were.

The industry will recover, and, indeed, return to the markets under more conservative, sensible terms and conditions. When it does it will find this detailed and wide ranging book by Stefano Caselli, who teaches finance and private equity at Bocconi University in Milan and consults widely throughout Europe, to be a useful handbook to guide investors and corporate practitioners, large and small, through the processes of arranging finance for private equity transactions. Students, too, will find this exacting description of all of the steps and practices involved in completing successful deals to be of great value.

There are still risks of the sort that Blackstone experienced after going public, but those risks are atypical, reflecting a sudden halt to new deals and an abrupt devaluation of existing holdings. Blackstone and KKR both experienced similar erosion to their stock prices as did the average large investment bank from 2007 to 2008. Over a longer term, private equity activity may prove to be less risky and worthy of higher price-to-book and price-earnings ratios than the traditional form of investment banking, in which current income from fees and proprietary trading is entirely dependent on current market conditions. But that may take some time to happen while the memory of the sharp write-offs of values in their investment portfolios caused by the 2007–2008 market conditions still lingers.

Roy C. Smith
Kenneth Langone
Professor of Entrepreneurship and Finance
NYU Stern School of Business
New York, March 2009

Preface

About the Book

I started studying and writing about corporate banking and the issue of financing companies in 1994. In those days the European Banking System was coming out from a big turnaround involving a unique legal framework based on the concept of the Universal Bank and its governance. The focus of the banking system (as well as researchers, consultants, and practitioners) was devoted to analyzing the different financing companies moving from a vision mostly bank-based to financial markets as a complementary/competitive source of funding for big companies and SMEs. With the exception of the UK, where the tradition of merchant banking was quite deep and old, the private equity (and the specific cluster of venture capital) was quite new and innovative in the rest of Europe. Because of the strong relationship between the European banking system and European companies, private equity started to be one of the tools used in old and new finance the companies. This was (and this is) a fundamental difference between the concept of private equity in its mother country (i.e., the United States) and the EU.

Private equity is an extraordinary source of creating new ventures and stimulating research projects with a seed investor approach, but it is also a very powerful instrument with which to gain leverage value and multiply company size, even with a pure speculative approach. This showed its negative side during the big financial turmoil in 2001–2002 and, especially, in 2007–2009. Multiples, debt, and a majority shareholding strategy are the common roots of a private equity system that works along with the financial system as a whole, playing a relevant (even leading) role in economic development.

Private equity is a part of the financial system and, for this reason, is supervised in many European countries. Private equity is seen and used mostly as a tool to integrate the debt and to finance companies who want to expand and are in the mature stages to launch acquisitions or run new investments. Big buyouts, pushed in many cases by privatization, are managed by investment banks and M&A boutiques, and rarely by private equity firms. Research projects and new ventures are not a typical target for private equity firms, but they survived because of State intervention (declining from the early 1990s because of deficit constraints) and the use of private money coming from families of entrepreneurs and high net worth individuals.

Even in the new financial environment of 2008–2009, American and European private equity perspectives remain disparate because of different traditions and

different legal and fiscal frameworks. Things are changing toward a new era of similar concepts and drivers between finance companies. The lesson of past crises is evident and relevant: the traditional blend of using multiples and leverage with a majority stake has ended and the right (and wise) use of money is, and will be, predominant. But an approach based only on a minority stake and a conservative use of money as a pure substitute of debt is not enough. Because of this, there is a need for private equity to play a prominent role as a competitor–partner of debt financing, with a clear focus on creating value through company growth and to give and share added value by transferring industrial and competitive knowledge.

It has been 15 years since I first worked with corporate banking and at that time private equity in Europe was for pioneers and quite distant from European culture, and meant to be studied in a laboratory with a pure theoretical mindset. Today, private equity stays in the debate not simply as a "tool" but as a way to develop companies and interact with the banking system to finance them, to promote knowledge, and to improve governance. These reasons, linked to my personal experience as a researcher, teacher, manager of executive education, and consultant drove me to write a book covering all topics relevant to understanding, applying, and managing private equity in the European market. I took on this very ambitious project not to promote conflict between an "American" and a "European" view of private equity, but only to contribute and identify the very different approaches to the same job. My personal story was a continuous work researching different sides, teaching both pre-experience and executive classes, and consulting and advising companies and financial institutions. It is my desire to give a very large audience a book that is useful for undergraduate and mostly graduate students attempting to understand the world of private equity with a very broad approach; executives and practitioners working both in the banking and private equity sectors to improve their technical skills along a wide spectrum of topics; MBA and Masters students desiring to understand the issues and links between entrepreneurship and management of companies with the difficult job of raising money from the banking system; and entrepreneurs willing to share their projects, their futures, and capital with a financial partner.

To give an exhaustive picture of private equity, this book is divided into three parts: General Framework, The Process and the Management to Invest, and Valuation and the "Art of Deal Making." Part One is devoted to building the pillars of knowledge through the analysis of private equity fundamentals (Chapter 1), the definition and understanding of the very different clusters that represent the private equity market throughout the world (Chapter 2), the understanding of the theoretical framework built by researchers (Chapter 3), the design of the

legal framework in Europe (Chapter 4), the design of the legal framework in the United States and the UK (Chapter 5), and analysis of the relevant mechanism involving taxation issues (Chapter 6). The general aim of Part One is not to simply cover the traditional topics such as venture capital, expansion financing, turnaround financing, distressed financing, etc., common in many handbooks, but to analyze the legal entities investors can use both in the European, American, and British context. Knowledge of the fiscal framework gives an additional advantage when combining legal issues and strategic choices with the understanding of a relevant driver of costs and revenues into legal entities.

Part Two analyzes the entire management cycle in a private equity world, crossing the whole spectrum of tools a private equity manager has to master within a private equity firm. Chapter 7 illustrates the map of the different life cycle phases involving relevant decisions, moving beyond fundraising, investing, managing, and monitoring, and the exit phase. Chapters 8 to 11 cover indepth the details and techniques for every phase. Fundraising is the main topic of Chapter 8, which demonstrates the actions of private equity firms relating to the creation of the business ideas to the negotiation with potential investors to obtaining the necessary commitments. In Chapter 9, through the perspective of company valuation (which is preliminary to investment decisions), the decision to invest as well as the corporate governance design issues to negotiate with the venture-backed company are explained. Managing and monitoring are the issues for Chapter 10 with the focus on formal and informal rules necessary to ensure peaceful dealings with the private equity investor by avoiding divergence of opinion and conflicts. Lastly, exiting is the topic of Chapter 11 where the pros and cons of the different exit strategies for private equity investors — IPO, buy back, sale to another private equity investor, trade sale, and the write-off — are analyzed.

Part Three faces the issue of creating and managing private equity deals into the different clusters (as seen in Chapter 2) and using different exit strategies. Real, detailed examples and cases are inserted in the appendices of many chapters to highlight and strengthen the techniques and patterns explained in the text. Part Three is focused on private equity deals with the last part divided into three different logical areas. First, Chapters 12 and 13 deal with the issue of company valuation starting from a general summary of the different techniques and moving to a very analytical application to private equity situations. Later, Chapters 14 to 18 cover every type of deal made with private equity. Chapter 14 reviews the topic of seed and start-up financing; Chapter 15 expands on growth financing (i.e., both early stage and expansion); Chapter 16 manages the topic of buyouts, which represents about half of the market in the world; Chapter 17 analyzes the

deal of turnaround and distressed financing; and Chapter 18 illustrates successful deal exiting represented by the IPO. Lastly, Chapter 19 explains the competitive strategy of private equity firms and creates a (visionary) futuristic picture of its destiny. In this sense, Chapter 19 is written to stimulate a debate about the role private equity plays in the future of the economic system. But this is a new gamble, and for the next 15 years we can analyze and build successful relationships between companies and the future financial system.

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