Preface

Small- and medium-sized enterprises represent the core of Italian industrial system, contributing to 71 % of Italian Added Value versus a European average of 60 %. The Italian industrial system is composed of about 15,000 companies, 10,000 of which are active in the manufacturing sector, with sales in the € 10–100 million range. In the last five years, best performances were realized by investments in companies with sales in the € 25–125 million range.

The small size of average Italian companies is one of the causes of the lower productivity of the national industrial system, if compared to Germany, France, and United Kingdom, as well as of their weaker competitive position in the global markets arena. As a consequence, the increase of the average size of Italian companies, both internal and through acquisitions, is a leading strategic issue as well as an opportunity.

Furthermore, small- and medium-sized businesses face an historical difficulty to raise appropriate financial resources to sustain medium and long-term projects. Their average debt-to-equity ratio is 4,17x. They make an excessive recourse to short-term bank lending, which is now more difficult to obtain due to the restrictions imposed by the new Basel III accord. They are characterized by a low level of equity capitalization if compared with the average of other European companies due to:

1. high amount of family owned firms;
2. negative performances caused by the enduring economic crisis;
3. difficult access to capital markets (stocks and corporate bonds).

Indeed, about 90 % of the Italian companies are family owned. Family succession is thus a strategic issue in the Italian business arena, also considering that about 43 % of senior management is represented by more than 60-years-old entrepreneurs (source: “Osservatorio AIDAF—Unicredit—Bocconi”). Just 24 % of the companies survive to the first family succession and only one-third are alive after five years from the first family succession.

As a consequence, the support of a private equity (PE) player could be an important boost for the managerialization of small- and medium-sized firms operating in Italy.

Over the past 20 years or so private equity has grown to become a sizable asset class at its peak, responsible for up to a quarter of global M&A activity and as much as half of the leveraged loan issues in the capital markets. Indeed, private equity is increasingly used around the world as a source of financing firms' growth and business expansion and as a mechanism to transfer know–how and managerial competences from investors to target companies. Private equity also contributes to enriching firms' capital structure decisions, which are a puzzle not yet fully resolved. The choice between internal equity capital (retained earnings), external equity capital, (e.g., private equity, VC, IPOs) and debt for financing positive-NPV investment projects has been widely investigated in the academic literature.

The private equity industry in Italy is relatively young and still faces some important market barriers that prevent it from growing at the pace experienced by other European countries. The high potential for Italian private equity is confirmed by the flourishing activity recorded in the country market since 2006. As most European markets decline, private equity investments in Italy increase by 30 % between 2007 and 2008 with an exceptional growth also in the number of companies invested and a steady rise in the size of the average investment. The pattern of yearly IRRs shows that the Italian private equity market performance has declined over the 2007–2009 period until it has turned into a negative one (−16.6 %; 2009) due to the global crisis. However, an historical 24-year IRR of 27.6 % (1986–2009) demonstrates that PE investments realized in the country may be highly profitable on average. As far as the sector's prospects are concerned, the Italian private equity market is estimated to be growing in the near future, as € 8.115 million is the amount of equity capital that the main houses have still available to invest. In this sense, private equity investments in Italy have steadily increased since 2006 representing 1.2 % of total worldwide market in 2010 with a +35 % growth compared to 2009.

This essay utilizes the *unique* information collected in four Surveys on Italian Manufacturing Firms (SIMFs; Unicredit Group) spanning the 1995–2006 period to investigate the characteristics of those companies that use internal equity as the only source of capital for financing their positive-NPV investments. While capital structure decisions of (especially) large-, medium- and, small-sized firms have been widely discussed in country studies, little is known about the use of the various forms of equity capital in Italy. Empirical evidence suggests that firms that are more likely to make an exclusive and pro-cyclical use of internal equity to finance their investments are mainly located in the Northern and Central part of the country and tend to be steadily profitable but not export-oriented, not innovative and R&D spenders. More interestingly, their prevailing family business model limits the use of external equity (to avoid ownership dilution and loss of control) and debt (to minimize bankruptcy costs), thus favoring the resort to internal equity. The resulting lack of resources for innovation makes it impossible for them to grow and sustain a competitive advantage. This is an economic disgrace as the total value added of our sample companies represents 0.75 % of the Italian GDP in 2006. By going beyond the mere assessment of the determinants of SMEs' preference for internal (vs. external) equity conducted in prior studies, we argue that the active involvement of private equity investors would bring most of these firms out of stagnation. We develop a framework that provides guidelines on how their entrepreneurial model and associated value creation would be positively impacted by PE's non-financial support.

The contributions of our study can be summarized as follows. First, we underline the business model of those Italian manufacturing firms that finance their new capital expenditures via internal equity. Second, we explore the role that the corporate governance style associated with the qualitative composition of the gearing ratio may play in fostering commitment, innovation, and growth as an internal, virtuous value creation process. What empirically emerges is that, because of a prevailing family-based business model, Italian firms are reluctant to implementing a proactive, value-oriented governance. The key policy implication is that a greater involvement of PE investors in the boards of (especially) small- and medium-sized, mature Italian firms could dismantle the conservatism with which they are governed and strategized. Stronger policy efforts should thus be directed toward promoting the growth of a private equity market in Italy by removing the major regulatory and fiscal barriers that still prevent it from having a positive, *real* impact on the *real* economy. Specific recommendations for advancing the use of external equity are provided to policymakers in Italy and in other European countries where the pace of private equity investments is still slow.

More importantly, we contribute to the strand of private equity literature on target company selection. Rather than examining data from actual deals executed by private equity funds or international aggregate industry-wide datasets, we focus on the empirical evidence arising from firms that could potentially become investment targets of private equity houses but they have not accessed such a capital so far. More specifically, our claim is that access to private equity has not yet happened for at least a fraction of them due to a lack of entrepreneurial culture for external equity financing, on the demand side, and a number of market barriers, on the supply side. To the extent that the activism of private equity investors would trigger a "wake-up call" for most of these dormant firms, we develop a normative framework providing guidelines on how their entrepreneurial model would be favorably influenced by conventional private equity actions.

The main research questions we aim to address here can be summarized as follows:

- Who are those firms resorting to internal equity only to finance investments with positive NPV?
- What would be the impact of external equity (PE) on their business operations in terms of what we can call the 3 Gs (Governance, Gearing, Growth)?
- How can private equity ownership expansion be expedited in Italy?

This study offers some important managerial insights. On one hand, our findings may assist general partners of private equity firms in exploring more investment opportunities in the Italian manufacturing sector as there are several small- and medium-sized enterprises that would gain from rejuvenating their business model through the value-oriented discipline imposed by a private equity ownership. On the other hand, this research should motivate owner-managers of family businesses to look at private equity as an excellent companion for getting out of the stagnation trap and engaging in a new, innovation-driven path. Private equity funds would provide such firms with financial and non-financial support thanks to their network connections with the outside business environment, being able to integrate such new resources without emotional ties to target companies' founding families. Missing growth opportunities due to a myopic financial strategy would represent a disgrace for the Italian economy.

However, the empirical analysis described above would be useless without obtaining some evidence on the *investment practices* of those private equity investors that operate in the Italian market. Can firms only backed by internal equity financing, as portrayed within our sample, become the real targets of private equity activity carried out in Italy?

Italian private equity investors currently hold 5.2 % of Italian small- and medium-sized companies in their portfolios, which represents 15 % of the country's GDP. More specifically, new private equity investments in Italy are made in the predominant form of acquisition of a 51 % stake of small-medium sized, family companies (< € 50 million sales) located in Lombardy and manufacturing industrial products (Private Equity Monitor, May 2010). Indeed, the characteristics of exclusive internal equity users in our sample seem to perfectly match those of the average portfolio company of private equity investors operating in the Italian market. How can we prove this *perfect match*?

To do so, we design the first survey ever conducted in Italy on investment habits of private equity investors. The survey is made of 20 questions aimed at capturing the way private equity investors build up their investment thesis around potential target companies. The questionnaire was delivered to 21 private equity houses that are mostly members of the Italian Association of Private Equity and Venture Capital (AIFI) and highly active in the market. One of these private equity houses is the industry leader in Southern Europe and another one mainly invests in firms operating in the South of Italy. A total of 29 % of responses was obtained.

In conclusion, our study aims to provide a *unique* view of the current state of the private equity industry in Italy supported by a straightforward empirical evidence demonstrating that business operations and financial strategy are intertwined. Although the focus is on Italian manufacturing firms, we believe that:

- the strategic framework for fostering the expansion of potential target companies;
- the analysis of those market barriers delaying the transformation of private equity investments into a sizable asset class;
- the provision of policy recommendations for removing such obstacles

may be extended to different emerging economic contexts (specially those of Eastern Europe countries).

More specifically, our study will be attractive to both academics and practitioners operating in the private equity and M&A industry because it complements existing monographic essays on private equity markets, techniques, and exit strategies recently published as a result of doctoral dissertations or research projects of specialized university centers. At the heart of our essay is the nature of those firms that may predominantly become targets of private equity investments rather than deal-making techniques. This will render it an accompaniment book for those who are interested in gaining insights into the process of creating an investment thesis in the private equity industry.

Rome, July 2012 Francesco Baldi