Hugo Mendes Domingos | Private Equity Transactions in Portugal

Policy Paper 10/03 | April 2010

Private Equity Transactions in Portugal

Hugo Mendes Domingos

Policy Paper 10/03
April 2010

Contraditório
www.contraditorio.pt

e-mail: info@contraditorio.pt

The analyses, opinions and findings expressed here are those of the author(s) and not necessarily those of Contraditório.

Contraditório is a non-profit, independent and non-partisan think tank whose mission is to set out a better way to deliver best practices and innovative solutions. We combine the scientific approach of our policy papers with the virtues of freedom and knowledge and the engagement in civic intervention.

Contraditório's Policy Papers are circulated to encourage discussion and to establish a distinctive mind mapping in the scrutiny of ideas and policies.

Citation: Hugo Mendes Domingos, Private Equity Transactions in Portugal, Policy Paper 10/03, April 2010, Contraditório, www.contraditorio.pt
Copyright: This is an open-access article distributed under the terms of the Creative Commons Attribution License (http://creativecommons.org/licenses/by-nc-nd/2.5/pt/deed.en)

ABSTRACT

We summarise the recent development of the private equity industry in Portugal and present an overview of the main types of funds. Based on a sample of transactions involving private equity funds from 1 January 2005 to 1 April 2010, we present and discuss the main acquisition strategies used, according to target company development stage and chosen sector. A large number of transactions consist in the acquisition of minority stakes and involve Government-sponsored funds. Most transaction volume is concentrated in buyouts.

We also review the main exit strategies used by private equity funds during the period and find that one of the most favoured routes for Portuguese buyout funds is to sell portfolio companies to international private equity funds.

We consider the economic effects of private equity investment and discuss some “myths” about the activity of private equity fund managers. We argue that private equity funds have strong incentives to invest during downturns and could fill a critical gap in providing equity financing to companies with limited or no access to public markets.

Finally, we try to anticipate possible scenarios for the development of the industry and find that there is certain inevitability about the development of private equity in Portugal. The country is heavily indebted at all levels: individuals, Government and companies. Perhaps the only way to re-establish equilibrium is to sell assets to foreign investors. Private equity funds with access to international investors effectively act as a gateway for foreign equity to enter the country.

Keywords: Private equity; venture capital

Author: Hugo Mendes Domingos

e-mail: hmd@contraditorio.pt

1. General context

Read the financial pages of any newspaper today and sooner or later you will find some reference to private equity. Ten or fifteen years ago, private equity was on the fringe of the market in Portugal. What is private equity and how have private equity fund managers become so successful that they are now increasingly playing a role in Mergers and Acquisitions (M&A) activity?

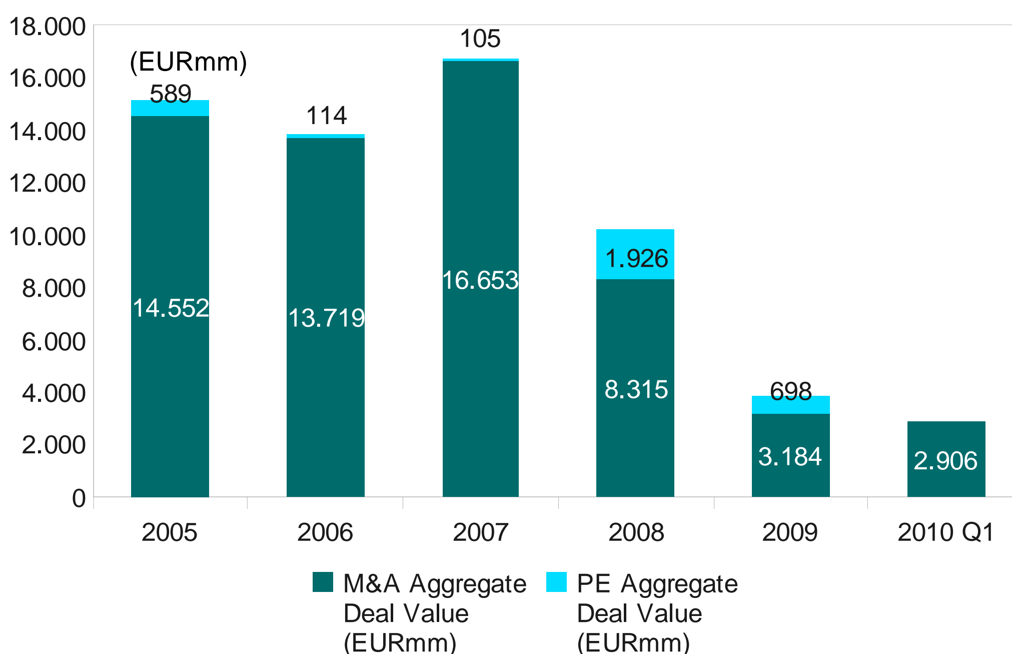
Private equity generally refers to equity financing of private companies and can take different forms according to the stage of development of a company. Seed Capital and Venture Capital refer to the financing of young companies whereas Expansion Capital or Buyouts apply to more established businesses.

The key elements of private equity investment can be summarised as follows:

- Investment in private companies;
- Targeting companies with stable cash flows and growth potential;
- Equity capital though other forms of financing are also used in some instances; and
- Medium to long term investors.

The following chart shows the value of all mergers and acquisitions transactions in Portugal[1] and the value of transactions where a private equity sponsor was involved:

Figure 1: Mergers and Acquisitions by Value and Private Equity Transactions by Value in Portugal, 2005-2008 (EUR in million – mm)



Source: Zephyr by BvD, April 2010

The chart shows a number of trends at work:

- Following a period of development, mergers and acquisitions activity fell off a cliff in 2008 and 2009. This is a direct consequence of the crisis which affected M&A globally;
- Private equity activity reached its peak in 2008 (this is partly the result of a single transaction, as we will see later). Private equity activity saw a

[1] Excluding transactions where a private equity fund was involved.

significant decline in 2009 when the mortgage-led debt crisis froze credit markets and the liquidity which fuelled activity in previous years dried out. However, private equity transactions in 2009 still reached a level above activity levels recorded from 2005 to 2007;

- With the exception of 2008, private equity activity is still relatively marginal, when compared with M&A activity.

2. How Do Private Equity Funds Work?

A private equity fund (also called a financial sponsor) works by raising capital from investors, called "Limited Partners" or "LPs". These investors participate in the fund by trusting the management of equity capital to a services company which is entitled to manage those funds on their behalf. The fund itself does not usually have any debt. The services company that manages the fund is usually called the "General Partner" or "GP". Once an LP has made a commitment, it will generally not be entitled to withdraw from a fund or transfer its partnership interest (unlike hedge funds). The investment is illiquid from the LP's point of view, during the term of the fund.

The objective of the GP is to produce returns on the capital invested by the LPs and will achieve this by investing in companies. Both sides establish the rules which govern their partnership, whether by restricting which type of company may be acquired, by limiting the amount of debt to be used, or agreeing on an investment policy.

Once funds are raised, the fund acquires stakes in the equity of a number of companies, after a notification is sent to the LPs by the fund manager. The GP will manage portfolio companies (usually for 5 to 6 years) and then sell them. During its period of ownership, the GP is supposed to improve the operations and strategy of the portfolio companies in order to create value and achieve capital

gains following the disposal. With a few exceptions, capital gains are distributed to investors shortly after realisation.

Investors run the risk that the GP does not choose the right investments or is unable to improve its portfolio companies. From the LP's perspective, private equity is by no means an investment that offers guaranteed returns.

We will get a better feel for the potential of private equity as an investment product if we say a few words on how private equity fund managers work internally and give more detail on the management of portfolio companies.

Private equity fund managers are usually small organisations which rely on outsourcing for non-core functions. GPs usually see fund-raising, investing, divesting, managing portfolio companies and the relationship with Limited Partners as core activities. All other aspects are seen as non-core. This includes fund custody and administration, usually run by external parties.

Acquiring companies involves intensive work, which often needs to be done in a relatively short period of time. The sponsor needs to examine a number of documents and ask key questions prior to the acquisition, in order to limit risks. This process is called due diligence. It is partly performed by the investment team working for the GP with another part usually outsourced to external consultants. Private equity funds rely on the work of lawyers, bankers and consultants to take on due diligence work.

Private equity fund managers have a significant involvement in the operations and strategy of their portfolio companies but their aim is not usually to replace management. The GP will rarely be involved in the company's day-to-day activities. Management is expected to continue running the business. Following the acquisition, the GP will retain the existing management teams or in some cases replace the existing team, the latter being less usual. The financial sponsor

will try to align its own interests with those of the management teams by providing certain incentives, notably in the form of equity ownership.

3. Market Development

Portugal's economy, like that of other countries in Southern Europe, does not have a history of private equity investing. In countries like the US and the UK, private equity emerged in the post-war period and has developed since, with the inevitable ups and downs. In Portugal, the industry started gaining more weight in 2001. At the time, a number of Portuguese and international investors were seeking alternative use for funds and aiming for geographic diversification.

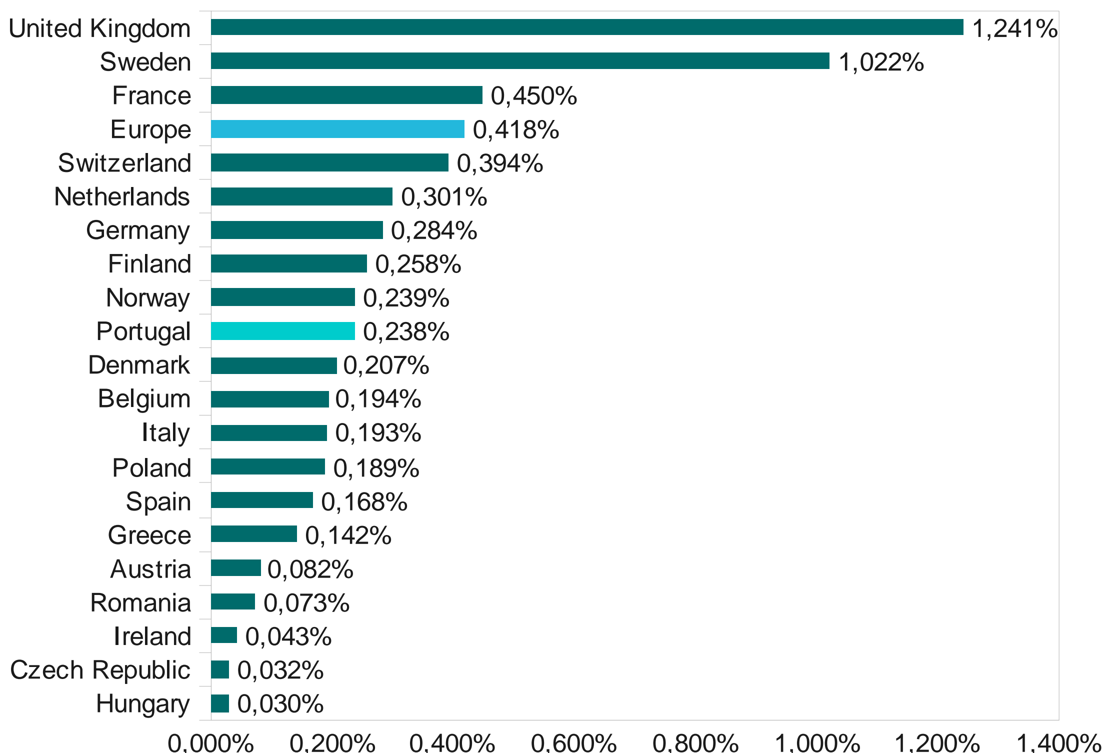
A possible explanation for the late emergence of private equity funds in Portugal is that countries in Northern Europe and the UK have mandatory or well-funded pension regimes and pension funds are willing to invest into private equity (an asset class which is reputed to yield higher returns compared to investments in quoted equity). Countries in Southern Europe rely mostly on Government-sponsored provision of retirement income. Governments tend to follow conservative strategies and are not significant contributors to private equity.

Moreover, most Portuguese companies are SMEs, many of which family-owned. In fact, SMEs account for 86% of employment in Portugal (against 50% in the US). The usual way to finance companies in Portugal consists in a mix of equity (provided by family and a network of business associates) and bank loans.

At present, there are 51 active private equity funds registered with CMVM (Comissão do Mercado de Valores Mobiliários, the regulator). These funds are managed by 27 GPs. In addition, some funds are active in Portugal and domiciled outside the country. We have taken into account Portuguese resident funds as well as funds domiciled abroad with significant activity in Portugal.

The following chart shows private equity investment as a percentage of GDP for different geographies:

Figure 2: Private Equity Investment as % of GDP by Geography, 2008

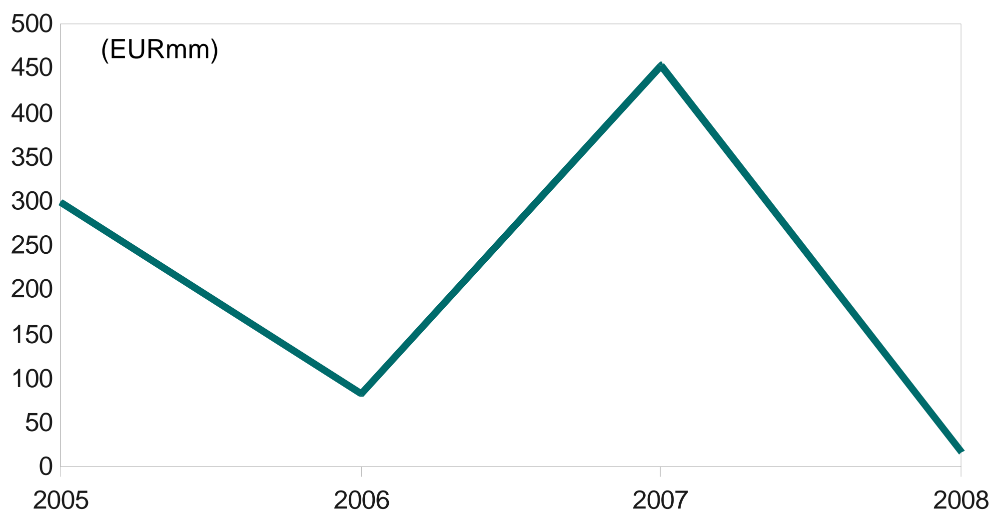


Source: European Venture Capital Association, Industry Statistics, 2008

Private equity investment is approaching levels comparable to larger and more developed economies in Northern European countries or Germany. The data above may be influenced by a single large transaction that took place in Portugal in 2008, the acquisition of Enersis by Magnum Industrial Partners.

The following chart shows fundraising activity for private equity funds:

Figure 3: Private Equity Fundraising in Portugal, 2005-2008 (EURmm)



Source: Portuguese private equity association (APCRI)

Following a peak in 2007, the crisis which started in 2008 had a dramatic effect on fund-raising. LPs witnessed a reduction of funds under management and reduced their investments into private equity funds. This was a global trend and Portuguese PE funds were affected. A number of funds were raising capital in 2008 and had to postpone their plans, with some reportedly still in the process in 2010. The reduction in fundraising and the fact that it now takes a longer period of time to close a fund will potentially result in a drop in private equity investment in coming years.

3.1. Types of Fund

From early development stages, Portuguese private equity funds have evolved into four leagues.

The first type of fund is government-sponsored. This includes funds such as Caixa Capital, the private equity fund manager of Caixa Geral de Depósitos, the state-owned bank. Another example is PME Investimentos, which is dedicated to investing in SMEs.

Government-sponsored funds tend to take minority shares in companies which are identified as strategic. Investment priorities may change with a change of Government. Selection criteria include fostering innovation, international expansion or creating jobs.

The second group of funds is run by independent managers which have access to capital from both domestic and international investors. These funds tend to be of a larger size and include names such as Magnum Industrial Partners, a fund based in Madrid with an office in Lisbon, Lisbon-based Explorer Investments and ECS Capital.

The third group is made up of funds related to financial institutions. There is a history of integrated banking in Portugal. Commercial banks have investment banking, insurance and private equity activities. Banco Português de Investimento (Banco BPI) has a stake in Inter-Risco while Banco Espírito Santo (BES) promotes Espírito Santo Capital and Espírito Santo Ventures, the latter being one of the few technology Venture Capital funds in the country.

The fourth group is made up of a large number of smaller funds. This is a mixed bag, with some being successful in their niche market while others are reportedly going through difficulties.

Only a limited number of international funds have offices in the country, which reflects the size of the market.

4. Investment Strategies

Private equity funds invest at different stages in a company's development. The Portuguese private equity association (APCRI) divides private equity investment into 4 categories.

In **Venture Capital** (or Start-Up), a number of funds will take minority stakes in a young company, to support its development while sharing risk.

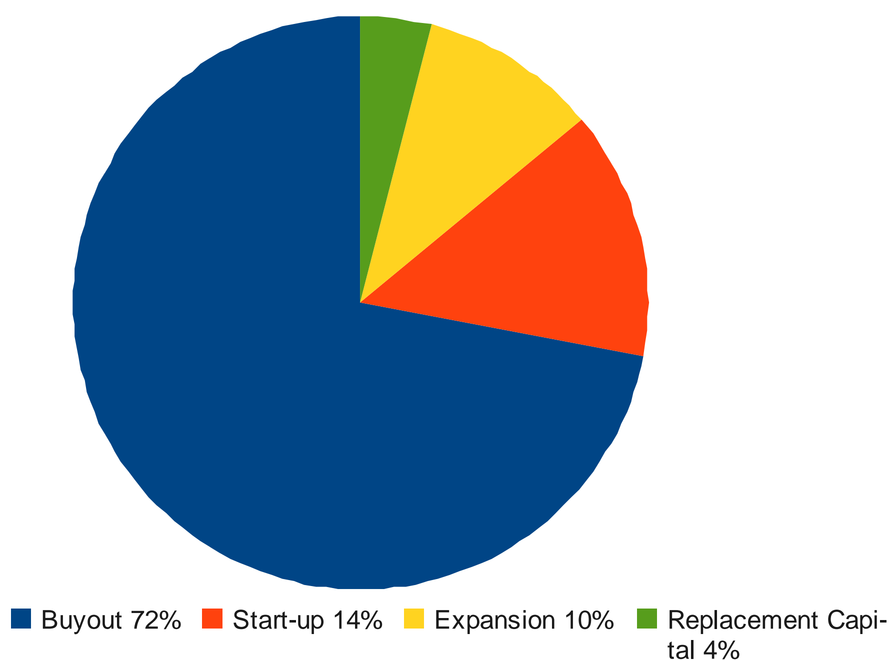
Through **Expansion Capital**, private equity funds provide healthy companies that had limited access to public markets with equity. Use of proceeds may include international expansion, launching new products or acquiring competitors.

In a number of cases, the fund acquires established companies operating in mature markets. The fund frequently takes a majority stake in the equity or becomes the sole shareholder. This is called a **Buyout**.

Replacement Capital transactions take place when private equity funds replace one of the shareholders or invest alongside existing shareholders for a certain period of time.

The following chart shows private equity investment by stage of development of the companies acquired. Transaction volume is largely concentrated in Buyouts:

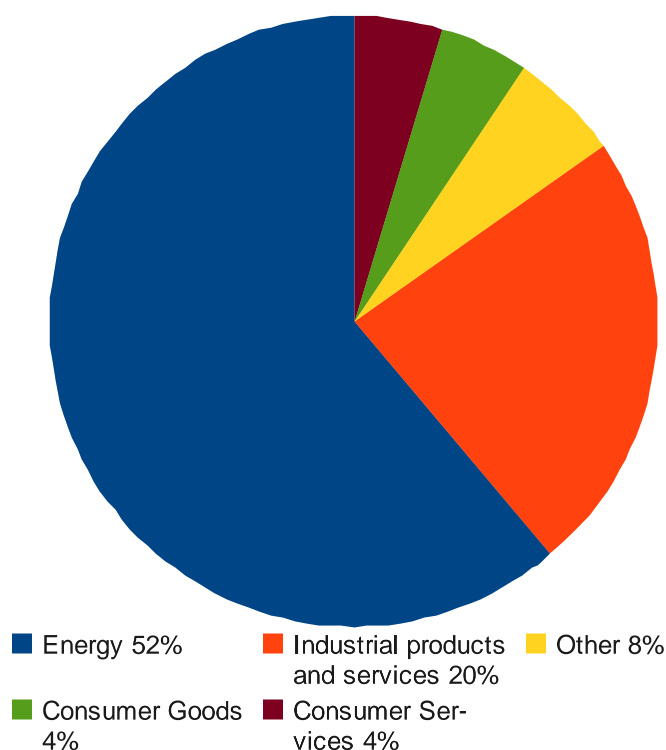
Figure 4: Private Equity Investment in Portugal by Stage, 2008 (%)



Source: Portuguese private equity association (APCRI), 2008/2009 report

Most Portuguese funds are generalists, investing in any sector of the economy. In 2008, the energy sector saw most activity, as shown in the following chart:

Figure 5: Private Equity Investment in Portugal by Sector, 2008 (%)



Source: Portuguese private equity association (APCRI), 2008/2009 report

The energy sector was of particular importance in 2008 as a result of a single investment, the acquisition of Enersis by Magnum Industrial Partners, as mentioned earlier. Energy is not a usual investment sector for private equity funds; however its popularity has been growing in recent years.

In general, sectors chosen by Portuguese funds are broadly in line with the rest of Europe. However, whereas technology has long been an area of interest for PE funds globally, the near absence of investment in technology in Portugal (at least

in 2008) is noteworthy. Government-sponsored funds and two independent funds (Espírito Santo Ventures and Change Partners) are largely responsible for investments in technology. Average transactions size for these investments is low and as a result, total transaction value is comparatively small.

In order to describe the investment strategies followed by PE funds in more detail, we analyse a sample of 144 acquisitions and 23 divestitures in which financial sponsors were involved, from 1 January 2005 to 1 April 2010. The selection criteria for this sample, which is based solely on public information (Standard & Poor's CapitalIQ database and press reports) is for acquisitions and divestitures of companies based in Portugal in which financial sponsors were involved.

In general, there is limited disclosure on private equity transactions in Europe, which makes numerical analysis difficult. The sample used has certain shortcomings and does not capture all transactions however we believe that it is reasonably thorough.

Based on the sample, investment strategies can be divided into 8 types according to both the type of transaction and the type of fund involved. Focusing on acquisitions (equivalent categories apply to divestitures):

- **Acquisition of Minority Stakes, Venture Capital and Expansion Capital.** A broad category, which includes transactions in which a minority stake is acquired. We have seen that Venture Capital is a type of private equity investment which relates to the early stages of development of a company or investment into a high-growth business. Expansion Capital refers to a minority investment into a company to support its development, the launch of a new product or international expansion. Given the information available, it was not feasible to further analyse these investments, which would have been preferable, given that Venture Capital is different from Expansion Capital.

- **Government-sponsored funds' transactions.** Refers to the acquisition of a stake in a company's equity by a Government-sponsored fund where there is no co-investment with a privately-owned fund;
- **Buyout Trade Transaction.** Transactions in which private equity funds acquire companies from shareholders and the majority of the equity is acquired. The seller is a group of institutional or private shareholders i.e. not a single entrepreneur nor a single family;
- **Buyout Fund Acquires Entrepreneur's Equity.** The private equity fund acquires the majority of the equity from an entrepreneur or a family;
- **Secondary Buyouts.** The buyer and the seller are private equity funds. The majority of the equity is acquired;
- **PIPE (Private Investment in Public Equity)** refers to the acquisition of a minority stake of a quoted company by a private equity fund. This is frequently associated with the acquirer obtaining some influence over the management of the company;
- **Distressed** refers to the acquisition of troubled companies, often facing bankruptcy;
- **Other**: those instances where not enough information was available to place the transaction into a single category.

It is worth noting that the following transactions were excluded from the analysis:

- Acquisitions and divestitures involving pure infrastructure companies or projects[2]. The view is that investors in infrastructure often deal with longer periods of time and that this is a market with its own dynamics;

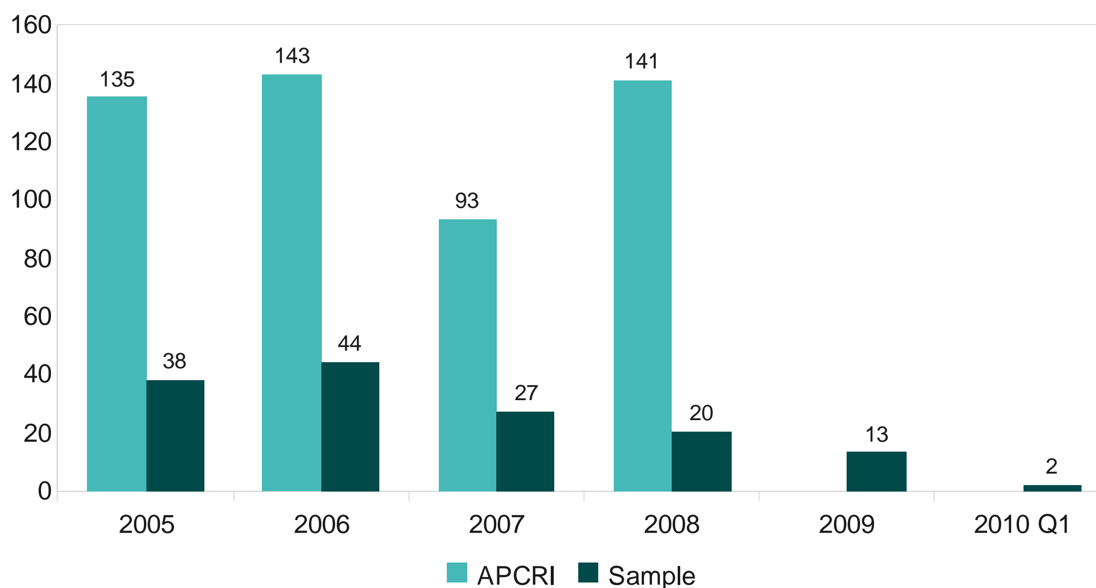
[2] Enersis is an integrated renewable energy company with investments in hydro and wind projects as well as bio-fuel and wave technology projects. Enersis was not treated as a pure infrastructure company.

- Acquisitions or divestitures made by family offices or individual entrepreneurs. Private equity investments are made by structured funds. Family offices and entrepreneurs usually have different time horizons and return objectives;
- Real estate transactions were left out due to the specific nature of these investments;
- Some seed capital and start-up capital transactions. The database used, CapitalIQ, does not usually capture these transactions as M&A activity. Terms are frequently not disclosed;
- Acquisitions and divestitures made by Portuguese funds where the target is located outside the country; and
- Minority or financial investments made by corporates e.g. the activities of Sonae Capital. These investments are usually made in areas where the corporate finds some type of synergy with its existing activities and are not strictly comparable to private equity investments. Corporates may also have different return objectives.

Inclusion criteria in the sample differ from those of APCRI. As an example, APCRI considers both Seed Capital and investments into Start-Ups in its analysis. For that reason, the number of transactions per year in the sample tends to be lower than that presented by APCRI. We chose to base the analysis on data provided by CapitalIQ since APCRI provides a global analysis of the private equity market but does not make detailed transaction data available, whereas CapitalIQ provides data on a transaction basis.

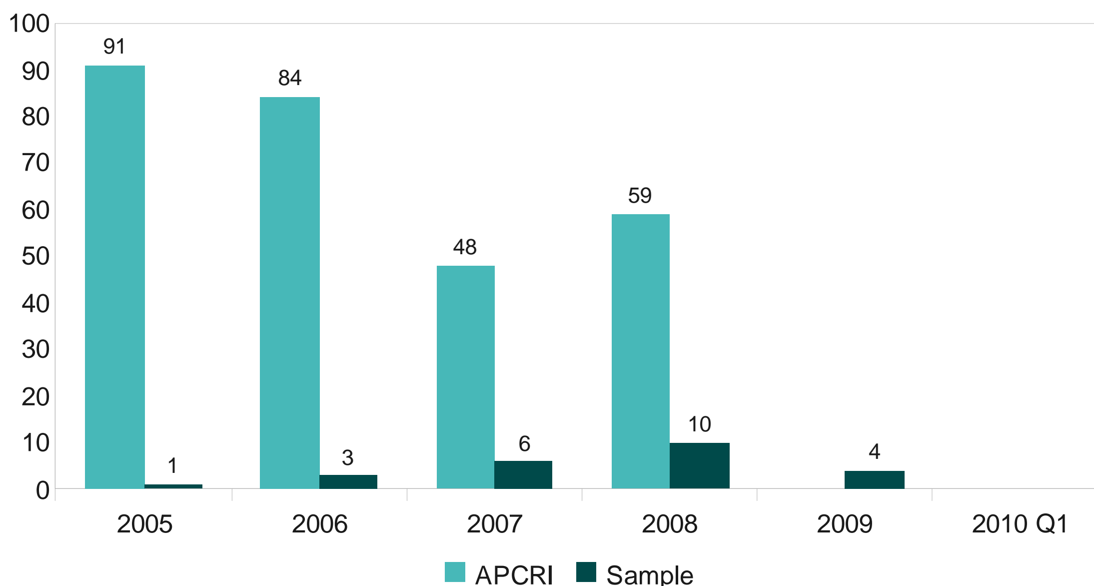
The following charts present a comparison between the number of transactions for acquisitions and divestitures respectively:

Figure 6: Private Equity Acquisitions in Portugal, 2005-2010 Q1



Source: Portuguese private equity association (APCRI), CapitalIQ, own calculations

Figure 7: Private Equity Divestitures in Portugal, 2005-2010 Q1



Source: Portuguese private equity association (APCRI), CapitalIQ, own calculations

4.2. Acquisition Strategies

We tried to capture the main acquisition strategies evidenced from the sample. Perhaps the most surprising result is that a reduced number of deals (6%) represent transactions in which the private equity fund acquires a company previously owned by an entrepreneur or a family. We saw how family-owned companies are a major feature of the Portuguese economy and we would expect private equity funds to be actively trying to acquire successful entrepreneur-owned and family-owned businesses, improve their productivity and increase capital efficiency. The evidence seems to point out in another direction as most of the activity is related to the acquisition of minority stakes.

4.2.1. Minority Stakes, Venture Capital and Expansion Capital

This is the largest category in the sample by number of transactions, representing 44% of acquisitions. A number of these investments are made into technology companies including Biotech, Software or Internet-type businesses. Some names were publicised as success stories of Portuguese technology. Transaction sizes are small; on average EUR7.5 mm (there was no information about deal sizes for 14% of transactions in this group).

In various instances, privately-owned venture capital funds invest alongside Government-sponsored funds such as InovCapital, PME Investimentos or Caixa Capital. We conclude that Government-sponsored funds follow the policy of co-investing and taking minority stakes.

The relatively small average investment sizes are evidence, in our view, of the ground still to be covered by Portuguese companies in order to compete internationally.

4.2.2. Government-sponsored Funds' Transactions

In the sample, acquisitions made solely by Government-sponsored funds are generally minority investments (with one minor exception). This reflects government policy of not seeking control but instead supporting companies which are seen to offer growth prospects. Transactions made by Government-sponsored funds represent 22% of acquisitions in the sample.

Investments cover a wide range of sectors, usually technology companies although investments in industrial sectors and retail also occur. Government's

investment criteria reportedly include the prospect of international expansion, technological or brand development.

Average deal size, according to public information, equals EUR1.4mm. In an increasingly global marketplace, with Portuguese companies facing large international competitors, one can question the effectiveness of these investments and their ability to provide an incentive to the economy.

Another question regards accountability. According to a list from the Ministry of the Economy, Government-sponsored funds appeared to be invested in 218 companies[3], as of 2009. To what extent Government-sponsored funds have enough resources to actively monitor these companies remains to be seen.

4.2.3. Buyout Trade Acquisitions

These represent 13% of acquisitions in the sample. Acquirers are larger funds including Magnum Industrial Partners, Explorer Investments, ECS Capital and Inter-Risco. One notable exception is the acquisition of Compal by Caixa Desenvolvimento and Sumolis in 2005, which involves a Government-sponsored fund (Caixa Desenvolvimento is a subsidiary of Caixa Geral de Depósitos) and a trade buyer.

Transaction sizes are not usually available as most funds disclose limited information. For those transactions where information was available, deal size averages EUR80mm.

Targets are from a variety of sectors, which reflects the fact that Portuguese PE funds are generalists, targeting companies with stable cash flows and well-known brands irrespective of their sector.

[3] Source: http://213.58.220.193/mei/Document/CapitalRisco_1209.pdf

4.2.4. Buyout Fund Acquires Entrepreneur's Equity

As mentioned, this category represents 6% of transactions in the sample. Buyout funds are present in this category; targets come from a variety of sectors and are typically companies with stable cash flows.

A number of family-owned companies face succession issues and private equity funds represent an exit alternative for retiring entrepreneurs. Given the number of family-owned companies in the country, this could prove to be a growth area.

4.2.5. Secondary Buyouts

The category represents 4% of transactions in the sample and features the largest deal sizes. Notable transactions include the acquisition of Enersis, previously owned by Babcock & Brown.

4.2.6. Distressed, PIPEs and Other

A large number of Portuguese companies are said to be in need of restructuring. Yet few GPs focus on this type of transaction. ECS Capital recently launched a restructuring fund in partnership with a number of Portuguese banks, which may lead to other funds setting up similar structures. Transactions made by this fund were not taken into account in the sample.

PIPEs (Private Investment in Public Equity) are equally rare. An example is the acquisition of a stake in quoted cement producer Cimpor by Caixa Desenvolvimento, in 2009. Elsewhere in Europe, PIPEs are usually the first step towards delisting. Funds acquire a minority interest in a quoted company and after gaining an insight into its activities, decide whether or not to launch a takeover

and acquire 100% of the equity. To our knowledge, there have been no public-to-private transactions in Portugal and as a result, there may be few incentives to use PIPEs as an investment strategy.

"Other" transactions include deals where the seller is not identified or there are insufficient details about the structure to form a view as to the nature of the deal.

Together, Distressed, PIPEs and Other transactions account for 11% of acquisitions.

4.3. Exit Strategies

A total of 23 divestitures were reviewed. The fact that the number of divestitures for which public information is available is lower than the number of acquisitions could be due to a number of factors:

- Market conditions since 2008 have resulted in funds postponing transactions in order to wait for more favourable valuations;
- Government-sponsored funds may find it hard to dispose of minority stakes or their policy is to hold on to those stakes for a long period of time;
- There is limited disclosure on exit conditions, as fund managers try to protect their privacy.

Secondary Sales and Trade Sales are the two largest categories in the sample (each representing 30% of divestitures). In particular, a number of international funds are acquiring companies previously owned by Portuguese PE funds. Equally, a number of international companies, some of them quoted, are acquiring companies from Portuguese sponsors. This may be due to the acquirer's perception that the previous owners have picked up the "low hanging fruit" and improved the companies in the portfolio.

To our knowledge, no PE fund used an equity listing as an exit mechanism, during the period. Euronext Lisbon has increased its liquidity in recent years, which could make it easier for funds to exit via an initial public offering (IPO) but it is still characterised by a high level of insider trading[4] compared with other European exchanges, which could act as a deterrent.

Another possible explanation for the lack of PE-backed IPOs on Euronext Lisbon may be that companies acquired by private equity funds may not be of a sufficient size to qualify for a listing. In fact, this is consistent with private equity's core business: to acquire companies which are not large enough to attract the interest of public equity investors but offer growth and improvement prospects.

5. A Comment on the Economic Effects of Private Equity

The key objective of private equity fund managers is to maximise returns for shareholders. Individual fund managers do not seek to have an effect on the economy. However, private equity investment as a whole does have economic impact, which we will briefly discuss.

- **What is the impact of private equity investment on the overall economy?** To the extent that private equity funds improve the companies acquired, there could be a positive effect of the productivity of the economy. Research evidence shows a positive effect of leveraged buyouts on individual firm performance and the positive effect on the economy appears to hold[5]. The research suggests that leveraged buyouts (and we may add, private equity in general) has a positive effect on the allocation of capital in the economy.

[4] Durev, A. and Nain, A. (2007)
[5] Stroemberg, P. (2009)

- **What value do private equity fund managers actually add to portfolio companies?** Some analysts argue that private equity fund managers bring little value to the companies acquired, relative to other ownership types. In fact, evidence suggests that private equity managers bring much more than equity to the companies in which they invest. They tend to be personally involved in the operations and strategic direction of the companies acquired. Companies owned by private equity funds tend to follow less entrenched business practices than family-owned, privately owned and widely owned public companies, or those owned by governments.

- **Does private equity contribute to improve the operating performance of companies?** The overall result from research is positive – private equity does enhance company performance, and this does not appear to be done at the expense of long-term investment and growth. In order to reach their objectives, private equity fund managers need to improve margins, develop new products and generally increase productivity. There is a limited time frame to improve companies prior to the sale, which may put pressure on managers to reach targets by certain dates.

- **Are private equity funds responsible shareholders?** It has been pointed out that private equity funds are usually the single shareholder and therefore have substantial power over portfolio companies. This power may be used to increase the amount of debt at portfolio company level to unreasonable levels, while bringing limited added value to the firm itself. Cases have emerged, particularly in the US, of companies which are acquired and then sold by private equity funds in a series of secondary buyouts. In some cases, private equity funds increase debt levels at company level and bring little value to the table apart from providing the equity itself. The problem with these isolated examples is that they sometimes fail to capture the real impact of the private equity model. What may have happened in the US does not necessarily hold for European

companies or for most companies held by private equity funds. Private equity is subject to flaws, as is any model. However it may be argued that it brings greater benefits than other types of ownership. Some of these benefits are related to active involvement. Private equity fund managers hold their investments for a longer period of time compared to investors in public equity. Holding periods for institutional investors in public equity have been estimated at 1 year or less, whereas private equity funds tend to keep their investments for 5 to 6 years. As a result, private equity fund managers tend to monitor portfolio companies much more closely and get actively involved in their operations and the definition of their strategy. Their personal success depends on their ability to improve the companies acquired whereas investors in public equity tend to focus more on the short term.

- **Are private equity funds destroying jobs?** There have been numerous debates over this point. The evidence from research is mixed. No study has established a link between private equity investment and job destruction. However, there is no strong evidence that private equity owned firms create more jobs than companies under different ownerships types. It is no secret that private equity firms try to improve the efficiency of the companies acquired and this may lead to redundancies. However, private equity fund managers will also try to develop the company's activities during their tenure. Research results are consistent with this view: private equity owned companies do not destroy more jobs than companies under a different type of ownership, nor do these companies contribute more than others to job creation. Rather, private equity owned companies create economic value by operating more efficiently.

- **Do private equity funds present a systemic risk during downturns?** It has been argued that, since LPs do not have any redemption rights (i.e. the right to withdraw capital invested, during the term of the fund) and

because the funds themselves do not carry any debt, private equity funds do not pose systemic risks during downturns. However, most private equity fund managers will use relatively large amounts of debt to finance their acquisitions. This debt is then “pushed down” to company level. Analysts have pointed out that this can bring instability to the financial system when capital becomes scarce, as portfolio companies may be unable to refinance their debt. So far, no reports have surfaced of a company acquired by a Portuguese private equity fund running into difficulties as a result of excessive debt.

6. Some Myths About Private Equity

Myth 1: Private equity funds acquire companies to break them up and make most of the workforce redundant. Financial sponsors do not acquire companies with the objective of winding them down. This is the job of insolvency administrators. Private equity fund managers have no desire to harm portfolio companies; on the contrary, fund managers are personally exposed to the success or failure of their investments. The financial sponsor will try to cut costs and run a lean operation in order to create shareholder value. This is something that any firm should go through anyway, regardless of ownership.

Myth 2: You must have good connections in the private equity world to get proper introductions and obtain financing. This is not usually the case. Most firms have teams in place whose job is to analyse business plans. Provided that the proposal is attractive and the company itself meets the usual criteria for private equity investment, financial sponsors will talk to anybody irrespective of their background and connections.

Myth 3: Private equity funds are quick to invest. Not really. A private equity manager will review from ten to fifty investment opportunities a month,

depending on the team's size and visibility. Out of say twenty plans, 5 will be of some interest. Out of those 5, the fund manager will analyse 3 in greater detail and enter some sort of negotiation. Out of the 3, maybe 1 will be funded. To get from twenty to 1 involves some time. External consultants will be hired and will need time to draw their own conclusions. Each proposal is weighed against other competing proposals and this can take several months.

Myth 4: There are no opportunities for private equity investment in Portugal. Practitioners seem to think otherwise. In fact, it was reported[6] that the overall level of private equity in Portugal is lower than in other countries and as a result, there is limited competition among funds for existing investment opportunities. Funds on the ground tend to be pro-active in sourcing investment opportunities and tend to avoid so-called auctions i.e. processes organised by banks or consultants for the sale of a company.

Myth 5: Private equity funds finance risky companies that would otherwise not attract investment. This is a common misconception. The fact that in Portugal, private equity is called “risk capital” may contribute to the confusion. PE funds are generally looking for companies with stable cash flows. There may be interest in a distressed company which has some kind of hidden value but in general, funds will prefer companies with solid market shares and established products. In recent years, very few transactions that took place in Portugal involved distressed companies.

Another common view is that financial sponsors acquire companies which are too risky for banks. This is partially true as some private equity funds finance companies at an early stage of development (Venture Capital). Most fund managers however prefer to invest in stable companies and involve banks in financing the acquisition.

[6] Source: Financial Times, FTfm, 14 February 2010

7. Future Development

The private equity industry has considerably evolved in recent years and it would be unwise to try and predict exactly how it will go from here. What can be said is that private equity funds in Portugal and elsewhere face a number of challenges.

While there was a large amount of debt available prior to the credit crunch, access to finance is now greatly reduced. Portuguese banks appear to have escaped relatively unscathed to mortgage-led financial crisis but we still expect that in coming years, private equity funds will find it challenging not only to finance new acquisitions but also to refinance the existing debt at portfolio company level.

Funds are experiencing difficulties as portfolio companies are hit by the global economic crisis. A mitigating factor is that Portuguese companies have gone through a decade of sluggish growth or recession. Those companies that managed to survive and thrive are arguably resilient to prolonged economic downturns.

Funds may also be experiencing difficulties to exit investments. Euronext Lisbon does not appear to constitute an exit route. However, this is an area where private equity funds have some flexibility to wait for a few years and ride out the storm. Following a sharp correction in 2008, equity markets have started to recover and we may witness a number of exits in 2010 as funds take advantage of improved public valuations.

Another challenge comes from regulators, Government and public perception. We have seen that Government is largely responsible for the provision of retirement income and this has translated into limited funding of PE. To our knowledge, there is no policy to invest state-sponsored pension funds into the asset class.

Following a history of direct involvement in the economy, Government has established a number of state-sponsored private equity funds, which act alongside other players in the market. One can question to which extent this is unfair competition, as Government-sponsored funds have access to cheaper financing. Market practitioners do not seem overly concerned and Government-sponsored funds do not seem to play a preeminent role in the market, although the results of the analysis point out that a large number of transactions involve Government-sponsored funds.

The most notorious barrier to the development of private equity may be the slowness of the Portuguese court system. Private equity funds are temporary owners. If litigation arises at company level during the ownership period, it may be critical to deal with the issue before the company is placed on the market. This can be a real difficulty, as the average length of court (1st instance) proceedings in Portugal in 2008 equalled 433 days[7].

Private equity fund managers are increasingly recognising that they cannot keep their activities private – which is one of their most understandable desires. Out of the fifty-one Private Equity funds registered with CMVM, 2 disclosed their 2008 annual report on the regulator's website. The industry is gaining some importance in the economy and will probably need to be more open about what it does and why it does it.

There could be two scenarios for the industry's development in the coming years. The first scenario is one of indecision. The industry will continue to develop as some fund managers reach superior returns. Fundraising conditions will be challenging at least over the short term, as many LPs face a liquidity squeeze.

---

[7] Source: Sousa Santos, B. and Gomes, C. (2009)

Under a second scenario, decision-makers both from the private sector and Government recognise that private equity can have an overall positive effect on the economy by continuously improving the efficiency of portfolio companies, removing some entrenched business practices and improving corporate governance standards (while providing suitable returns for the funds' shareholders).

Under this scenario, Government-run pension schemes would take an active role in the industry's development, by allocating a share of capital under management to private equity investments, while Government itself would manage to increase the efficiency of the country's courts.

Aside from improving productivity in the economy, private equity funds could act as a suitable alternative to Euronext Lisbon, which saw a very limited number of listings in recent years. In fact, evidence shows that private equity funds investing during economic downturns achieve much better performance than private equity funds investing during boom years. This is due to several factors: companies can be acquired at lower multiples during downturns; the target company may improve its results and beat expectations as it benefits from economic growth; companies acquired following a downturn are usually sold when the economy has recovered at an improved valuation. Therefore, private equity funds have strong incentives to invest during downturns and obtain superior returns. By contrast, the market for IPOs is frequently closed following a downturn. Private equity could fill a critical gap in providing equity financing to companies with limited or no access to public markets in Portugal or abroad.

Irrespective of which scenario prevails, there is certain inevitability about the development of private equity in Portugal. The country is heavily indebted at all levels: individuals, Government and companies. It has recently emerged that the net foreign liabilities of Government, banks, companies and individuals taken

together equals 111% of GDP[8]. Perhaps the only way to re-establish equilibrium is to sell assets to international investors. Private equity funds with access to international investors effectively act as a gateway for foreign equity to enter the country.

[8] Sources: Bank of Portugal, INE, March 2010

References

Bygrave, W., Hay and M., Peeters, J. (1999) The Venture Capital Handbook: Strategies for Successful Private Equity Investment, Financial Times/ Prentice Hall, III Edition.

Durnev, A. and Nain, A. (2007) The Effectiveness of Insider Trading Regulation: International Evidence, CESifo DICE Report 1.

Gladstone, D. and Gladstone, L. (2003) Venture Capital Investing: The Complete Handbook for Investing in Private Businesses for Outstanding Profits, Financial Times/ Prentice Hall; Revised and Updated Edition.

Kaplan, S. and Stroemberg, P. (2008), Leveraged Buyouts and Private Equity. Available at SSRN: http://ssrn.com/abstract=1194962

Phalippou, L. and Gottschalg, O. (2007), The Performance of Private Equity Funds, *EFA 2005 Moscow Meetings.*

Richman, L. and Cummings, E. (2010), Bain & Company Global Private Equity Report.

Sousa Santos, B. and Gomes, C. (2009), A Justiça Penal, uma Reforma em Avaliação, Centro de Estudos Sociais, Faculdade de Economia, Universidade de Coimbra.

Stroemberg, P. (2009), The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings. Available at SSRN: http://ssrn.com/abstract=1429322