PRIVATE EQUITY: A LATE ITALIAN GROWTH STORY

Giancarlo Capolino-Perlingieri and Dante Leone of Capolino-Perlingieri & Leone discuss the state of the Italian private equity fund market.

In 2007, Italy continued experiencing exciting growth in the private equity sector and developing the typical characteristics of more mature markets.[1]

With an aim to provide the reader with a general introduction to the main characteristics of private equity fundraising in Italy, we will focus on the coexistence of the local regulations with the (no less strict) non-written conventions distinctive of the international practice. And we will show how, despite a few inherent impediments, Italy is marching on to become a major constituent of the European private equity panorama.

STRUCTURES: TO BE OR NOT TO BE A *FONDO CHIUSO*

In our experience, over the last few years, most Italian sponsors of private equity funds have chosen to adopt the structure of an Italian closed-end fund – called a fondo chiuso – managed by a management company, or società di gestione. Both the fund and the management company are subject to the authorisation, and subsequent supervision, by the Bank of Italy.

This is not to say that there are no alternative structures that are functionally similar to an Italian closed-end fund. These alternatives include Luxembourg or Dutch funds and corporate holding vehicles (generally assisted by an Italian advisor), Italian joint-stock holding companies and ad hoc investment platforms funded by a single investor, such as a global hedge fund.

The choice of Italian closed-end funds is mostly influenced by relatively favorable tax treatment. Italian individual managers are clearly attracted by the low taxation of the carried interest (which is only subject to taxation at the fund level, and currently at a 12.5 percent rate, equal to that applicable on capital gain income). At the same time, investors that are not Italian residents benefit from a gross-up mechanism on distributed fund proceeds that effectively neutralises any taxation at the fund level for those investors, provided they are based in certain white-listed countries with which the Italian tax authorities have concluded information exchange agreements.

Furthermore, reliance on the regulatory framework provided by the Bank of Italy appears to play an important role in the decision by Italian institutional investors to make their private equity investments mostly through Italian closed-end funds.

Flexibility and time saving are the main advantages of organisational structures alternative to the fondo chiuso. The rules for Italian closed-end funds need to comply with certain minimum requirements set by local regulations, and the authorisation process before the Bank of Italy often takes a significant amount of time – all of which requires the devotion of considerable resources on the part of the sponsor.

Unfortunately, each of those alternative organisational structures suffers peculiar disadvantages. In fact, most of the foreign solutions may give rise to thorny fiscal issues (particularly in the case of foreign holding vehicles assisted by an Italian advisor). Italian joint-stock holding companies may not offer adequate corporate governance protection to investors, given that companies' by-laws are not usually versatile enough to provide an effective governance of the terms of the investments, and that the maximum duration of shareholders' agreements is limited by law. Finally, investment platforms often restrict the initiative of the Italian manager, because the principals of the funding entity typically retain the ultimate investment responsibility and, therefore, the Italian local manager may be relegated to acting as an advisor to the funding entity's management company.

In other words, the fondo chiuso is not a perfect structure, but so far its more direct competitors have not shown any clear all-round advantages.

JUGGLING INVESTORS AND THE REGULATOR

Under the Italian closed-end fund structure, sponsors have to coordinate their dealings with prospective investors about the terms of the fund with the timing and pace of the authorisation procedure before the Bank of Italy, which by and large lasts a minimum of three months.

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The Bank of Italy must authorise the establishment of any management company and approve the rules for the management of all funds – the regolamento, which serves the purpose of a limited partnership agreement in a typical UK, Delaware or Cayman structure – as well as any amendments to those rules.

In a typical scenario, Italian sponsors submit to the Bank of Italy a fairly balanced text of rules for a new fund, in order to start the clock for the authorisation procedure.

After that, if negotiations with investors yield a definite set of changes before the authorisation has been granted, there is a chance that those changes may be worked into the text that was submitted to the Bank of Italy, without significant delays to the timing of the authorisation.

More often, however, the sponsor's discussions with investors protract beyond the time of the issuance of the authorisation. With the result that any amendments need to be submitted again for authorisation, and are subject to a further three-month waiting period.

Faced with this possible holdup to the sponsor's ability to begin making investments and drawing down management fees, most investors agree to make an immediate commitment to the fund. In exchange, the sponsor covenants to submit the amendment request to the Bank of Italy and to use its best efforts to obtain the approval of the changes agreed with the investors. But we have also experienced situations in which, because of the extent of the changes negotiated or various other reasons, one or more investors insist on coming into the fund only after Bank of Italy has approved all requested amendments. At which point, the pressure is usually on the sponsor's counsel to lobby and expedite the authorisation process as much as possible.

ITALIAN FUND REGULATIONS: PLENTY OF FLEXIBILITY AND A FEW LIMITATIONS

The Italian regulations applicable to closed-end funds that are reserved for subscription by professional or institutional investors are very accommodating of the typical needs of sponsors.

There are no minimum or maximum size restrictions, no mandatory management fee levels, no limitations on carried interest conditions and no meaningful diversification obligations. There are also no limitations as to the type or nature of the targeted investments. Nor, for offerings that target a limited circle of investors, are there any prospectus or other offering document requirements. For all practical purposes, the terms of an Italian fund, in the hands of expert counsel, may conform very effectively to the international market standard for private equity funds.

In addition to that, as we mentioned above, the fact that Italian funds – and their management companies – are subject to the supervision by the Bank of Italy, makes these funds very attractive to Italian regulated institutional investors, which would instead be more wary of investing in unregulated limited partnership-type vehicles.

Dante Leone

There are, alas, a few drawbacks that arise out of the Italian regulatory framework for private equity funds, which was not drawn up specifically with a view to the international private equity practice.

One of those drawbacks, that we are faced with most frequently, is a general prohibition on warehousing or other similar restructuring operations involving affiliates of the management company.

In fact, Italian regulations prohibit (for all closed-end funds other than real estate funds) all direct or indirect investments by the fund in assets that are owned by a shareholder, director, general manager or statutory auditor of the management company or any of its affiliates, and all sales of any fund assets to those individuals.

Counterintuitive as it may be, this prohibition cannot be overcome through a waiver by the fund's investors – not even if all investors receive proper disclosure and are in agreement – nor by an ad hoc waiver by the Bank of Italy or other competent authority.

As a result, sponsors are effectively barred from structuring any in-house facilities for warehousing investments, even in situations in which the authorisation procedure before the Bank of Italy delays the launching of a new fund. And the same prohibition makes it very difficult for any Italian sponsors to structure secondary or staple funds organised around portfolio companies owned by any of their affiliates, despite having a full consent by prospective investors.

With the overall effect that, in our experience, this rule, originally meant to protect fund investors from potential conflicts of interest with the sponsors, has turned into an important obstacle for sponsors in the fund raising of Italian private equity closed-end funds.

LOOKING FOR CAPITAL: PLACEMENT AGENTS?

Italian sponsors have traditionally raised private equity funds from Italian investors without the help of specialised placement agents. Sources of capital have generally been friends and family, local entrepreneurs, as well as a few local financial institutions (banks, insurances and professional pension plans) with limited specialised knowledge of private equity products. There also exist a very small market of Italian professional fund of funds investors, but most of them do not make commitments to domestic private equity funds.

Nevertheless, by most accounts, investments by foreign investors have come to represent a majority of overall Italian private equity funds raised in the last few years, with a substantial and ever-increasing portion of these investments coming from funds of funds. [2]

These commitments are mostly obtained through placement agents of solid international reputation, to which sponsors have been turning for help on all or part of their fundraising endeavors. The placement agents are ordinarily based outside of Italy, as there are very few Italian-based professionals with a similar expertise and comparable experience, other than a few Italian banks placing captive or self corner-stoned funds.

With the placement agents' help, even Italian sponsors of first-time funds are able to leverage their attractive track record and hold successful foreign marketing efforts, despite their general lack of familiarity with the customs of cross-border fundraising and the standard policies of international institutional investors.

SHORTER INVESTMENT PERIODS + LARGER DEAL SIZE = SHRINKING FUNDRAISING CYCLES

Historically, the investment period of Italian closed-end private equity funds has lasted five years (with an additional five-year period for follow-ons and divestments, possibly extended for two or three one-year periods).

Lately, however, we have noticed a stronger push for shorter investment periods in small and mid-sized funds, mainly from international institutional investors.

This has generally been coupled with a substantial increase in the size of single private equity investments, both in order to acquire progressively bigger targets[3] and, in the current credit conditions, to provide a larger share of the deal's financial needs and retain more flexibility for future financing add-ons at the right time and terms.

More recently, the favorable pricing of public equity has elicited additional interest by private equity fund sponsors, some of which are gearing part of their available funds (or even setting up ad hoc co-investment vehicles) to take advantage of those public equity opportunities, to the extent permitted by their fund rules. This trend is likely to spur a new season of public-to-private transactions in Italy, driven both by interest from private equity concerns and by industrial conglomerates competing with them on the most alluring opportunities.

The reduction of the investment period and the progressive increase in the absolute cost of single investments by private equity funds is increasing the frequency with which Italian sponsors turn to the market in order to raise new capital. Investors are clearly pleased with this development: their committed funds are being deployed more quickly and they can evaluate the performances of sponsors more regularly.

PUBLIC INVESTMENT COMPANIES: IT'S NOT EASY BEING EVERGREEN

Starting in 2006, and continuing in 2007 and in this first part of 2008, a few groups of successful entrepreneurs as well as certain seasoned private equity management teams have raised capital by turning to the Italian stock exchange. This has mainly been accomplished by establishing evergreen investment companies with reasonably wide investment strategies, and by raising upfront capital (with all related cash drag results) from both institutional and retail investors.

Not unlike larger private equity-type investment vehicles launched on other international markets, the terms and conditions for an investment in these Italian evergreen funds are substantially different from the standard terms of traditional closed-end private equity structures.

For instance, with respect to the management of the investment company, these vehicles lack the traditional level of protection that investors enjoy under "key man" and "devotion of time" provisions in mainstream private equity funds. In fact, the listing prospectus would merely warn investors of the risk of investing in a business which is dependent on one or more key persons, and would advise investors that the loss of any such key person might result in a loss of competitive strength, and expose the investment company to the difficulties of replacing any such key persons.

Sponsors' track records are less prominent in the offering materials of Italian evergreen investment companies, partly because of the uncertain scope of potential liability associated with that disclosure: in their stead, the listing prospectus only includes short résumés of the members of the management team.

Additionally, these vehicles seek maximum flexibility as to the sectors in which they may deploy their capital, which often include funds of funds and real estate assets. Obviously, this is in striking contrast with the high degree of precision in the determination of goals and strategies of closed-end funds, which are structured to match the most valuable skills of the managers, and typically include diversification obligations, geographical and industrial limitations and customised prohibitions.

So far, and again consistent with their foreign peers, Italian evergreen investment companies have generally underperformed.

MANY LIKE IT LIQUID

Investments in Italian private equity funds are becoming increasingly liquid. This is partly the result of additional availability of private equity-like opportunities on the Italian stock exchanges. But, mostly, it arises out of an emerging secondary market for investments in Italian private equity funds.

Foreign placement agents and foreign institutional secondary investors are facilitating this development, which has been taking place in spite of certain peculiar regulatory constraints (such as the prohibition on warehousing described above) that often necessitate the use of corporate or non-Italian structures.

IN A NUTSHELL

Interest by foreign institutions, growth of locally-managed commitments and strong deal execution data, all point to an Italian panorama for private equity that is ripe for the picking.

The fact that this is happening notwithstanding unusual regulatory limitations is a testament to the abundance of opportunities, the perseverance of Italian managers and, of course, the foresight of international professional investors.

Not a bad alchemy, we believe. ■

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1. Funds raised by independent Italian managers in the first two quarters of 2007 totaled more than €1.1 billion, a 135 percent increase on funds raised by independent Italian managers in the same period in 2006. An additional €400 million was raised specifically for the Italian market, of which €235 million came from parent corporate entities. Fifteen independent fund managers raised funds on the market, compared to 13 during the same period in 2006. (All data from surveys conducted by AIFI, the Italian Venture Capital and Private Equity Association, in cooperation with PricewaterhouseCoopers - Transaction Services: see www.aifi.it/EN/Statistiche/Statistiche.htm).

2. In the first two quarters of 2007, approximately 32.5 percent of funds were raised from foreign funds of funds (compared to 12.2 percent for the first two quarters of 2006), and a total of 61 percent of funds were raised from foreign investors (compared to 50 percent for the whole year 2006). (Source: see footnote 1.)

3. In the first two quarters of 2007, deals up to €150 million amounted to a total of €1.05 billion, while larger deals amounted to €860 million. In the first two quarters of 2006, deals up to €150 million amounted to a total of €830 million, and no larger deals were reported. (Source: see footnote 1.)

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