

Acquisitions

Supplement 1991

Monthly

Management buyouts
— structures built to last



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ITALY

Strong growth potential

By Anna Sala, Fabio Sattin and Mike Wright

Until 1988, the Italian buyout market was virtually undeveloped. Since then it has shown notable signs of development but still has considerable unrealised potential. This potential is reflected in the large numbers of institutions recently establishing a market presence, although this presence has yet to be converted into a major increase in completions.

As in many other continental European countries, deal identification in Italy is problematical. Comparison with other countries is also made difficult by the frequent inclusion under the general heading of buyouts of acquisitions by financial institutions. According to estimates by the Centre for Management Buyout Research (CMBOR), the Italian buyout market improved its relative position in 1990 to become the fifth equal largest in continental Europe with 27 transactions, a modest increase on the 23 seen in 1989.

In terms of the value of deals, Italy also improved its relative position over 1989 becoming the third largest buyout market in continental Europe in 1990, after France and Sweden at approximately £321 million. This relative improvement was achieved in the context of a decline in deal value in Germany and a small fall in Italy.

Market development in Italy has been particularly associated with both buyouts and buy-ins. The Italian economy contains a relatively high proportion of small and medium-sized privately owned firms facing succession problems, a classic example being the buyout of Nazzareno Gabrielli, a manufacturer of luxury leather goods and number two in the market to Gucci, where succession fell to three daughters. The state-owned sector is important in Italy. Privatisation buyout activity is beginning, with completed deals involving the diesel engine producer VM Motori, the Cedit tile making subsidiary of GEPI, and Italt tractor being recorded.

Divestments have mainly come from foreign-owned groups. Foreign divestments have provided at least three of the largest buyouts in Italy. The Rimoldi Group was divested from the US owned Rockwell Group in July 1988, the Fata buyout in May 1988 involved the Italian factory automation and food processing contracting subsidiary of FKI Babcock, and Grove Italia, a world leader in valves and regulators for pipelines, was bought out from the Canadian Nova group in June 1990. Recent examples of Italian buy-ins include Unimorando, Gruppo Saeco Finanziaria, Conchiglia, SASFI and Pomini-Farel.

Major deals to be completed in late 1990 and the first half of 1991 include the following: Lugli a forklift manufacturer; Mabro a L33.2 billion buyout of a

producer of quality clothing; Cartorama, a L60 billion buyout of a stationery producer; and Synapse Italia, a L0.3 billion buyout of a computer systems firm from Synapse Computer Systems. Lugli, Mabor and Cartorama were all sales by private owners. The Cartorama deal was led by Baring Capital Investors, Mabro was led by Schroders' Italian Venture fund and Lugli by Old Court.

Factors affecting the development of the market

Stock markets are underdeveloped although from December 1990, plans have been put forward for the introduction of a network of local stock markets on a second marché model. The project has been transformed into law, but as yet it has to be established as a real market.

M & A activity, which traditionally has been limited, grew rapidly in the late 1980s and helped the notion of buying and selling companies to become more acceptable. However, indications are that between 1989 and the first half of 1991 the market fell significantly.

Extensive legal and accounting due diligence on Italian targets is a virtual necessity. The tax laws have a crucial impact on the preparation of the financial statements. All tax allowances and deductions must be recorded in the official financial statements in order to obtain the benefit. Items for which there is no tax deduction (eg. inventory allowances for slow-moving and obsolete stock) are very seldom recorded. Fixed assets are valued in the accounts at their historic price, which can be substantially different from their actual value. Apart from listed companies, state-owned firms and insurance companies, company accounts are not audited by independent auditors.

Buyout structures

In Italy there are limitations on the type of shares which can be issued, particularly in respect of redeemable shares. Bridging debt may be necessary because the Italian Civil Code prohibits the target giving any financial assistance for the purchase of its own shares. It is, therefore, common in Italy to put bridging debt in place at the time of completion of the purchase, secured only by share pledges of target and/or NewCo shares, and subsequently to merge the target into NewCo and replace the bridge financing by medium or long-term financing which can be secured on the assets of the merged entity.

A new law passed at the end of 1990 introduced a wide anti-avoidance provision relating to the tax advantages of a merger, bringing Italian rules more into line with those adopted by many other industrialised countries. However, in 1991 further changes to this legislation are being discussed. As a result, there remains much uncertainty about the deductibility of amortised goodwill for tax purposes and more generally the tax advantages relating to buyouts.

Until January 1990, capital gains tax on the transfer of shares by individuals was only payable if the shares had been held for less than five years and were greater than two per cent of a listed company's shares, five per cent of the shares of a company quoted on the secondary market, or 15 per cent of an unlisted company's shares. However, since January 1991, a new decree law means that individuals have to pay a 20 per cent tax on the transfer of shares independently of the number of years for which the shares are owned. However, this change has been the subject of considerable debate.

ESOP schemes have not yet been in- ▶

◀roduced in Italy. Stock options generally are more widespread than previously, but a wide diffusion of shares among employees is still unusual. 17 managers participated in the equity in the Rimoldi buyout and in the Grove Group buyout the intention is to enlarge the number of shareholders, but not below the middle management layer.

Financing and funds

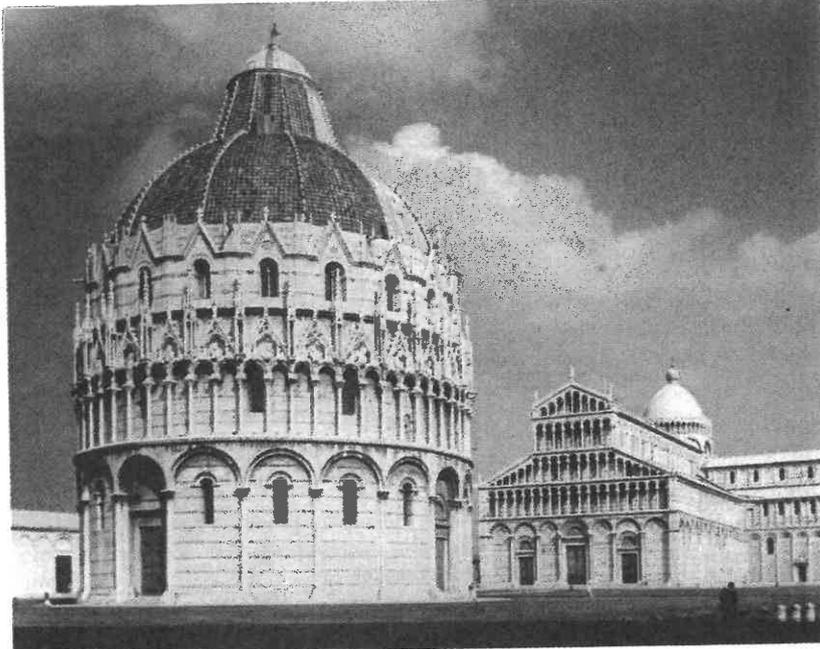
The venture capital industry in Italy began to develop rapidly towards the end of the 1980s, but has been restricted by limitations on the ability to issue instruments such as redeemable shares, the absence of pension funds and by the delay in the introduction of closed-end fund legislation. At present only foreign based closed-end funds are allowed.

As a result, the most active firms are private backed venture capital firms or foreign closed-end funds. Legislation to permit Italian closed-end funds has been under discussion for four years and it is not yet clear when it will be passed. If it is passed, the creation of further funds will, at least in the short-term, add to an already crowded market. However, the presence of new institutional investors may help to promote the recently introduced local unquoted markets. The development of such markets may also help deal with the critical problem of an absence of suitable exit routes for buyout investments.

Attitudes to high leverage among Italian managers appear to be more cautious than is the case in the US or UK, according to research by the Italian venture capital association (AIFI). There is also caution among domestic banks towards lending on the basis that asset sales will be required to pay down debt. As a result, Italian buyout transactions are usually structured with conservative debt/equity ratios. This approach may limit the size of managements' initial equity stakes but it has proved helpful in protecting the transaction from the adverse effects of unexpected market downturns. The vendor may also retain a significant equity stake.

To the early equity players in the market such as Citicorp/Citinvest, San

Paolo Finance, and Invest (a subsidiary of SOPAF, the biggest private merchant bank) has been added a substantial number of offices and funds with an Italian focus by several foreign institutions. The other main active lead founders in the market are Cofilp and B&S Ventures among Italian players and Schroder Associati, Europa Investimenti, Baring Capital Investors, Italy Capital Fund, Equitalia (Pirelli & Co), LBO Italia (a development from LBO France), Advent Group, Andlinger and Chase Gemina Italia. More recently established



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players include Basinvest (part of Charterhouse European Partners), Itavent, Old Court Italian Ventures, and 3i.

The cautious attitude of Italian banks meant that in the initial development of the market, non-Italian banks like Bank of Boston, Bankers Trust, Continental Illinois Finanziaria, Manufacturers Hanover, Crédit Lyonnais, Paribas, Citibank, Chase Manhattan, and Canadian Imperial Bank of Commerce have been major suppliers of senior debt and mezzanine. More recently, several Italian players have also entered the market and some of them, such as San Paolo di Torino are very active.

Exits

Exit strategy is one of the key problems of the buyout market, especially for medium-sized firms. The main market is inappropriate for such firms and the 'mercato ristretto' is still an inefficient and underdeveloped market. Trade sales would appear to offer strong exit possibilities. An alternative possibility, given the importance of majority equity stake

holding by investment firms, is to exit by selling shares to management. When investment firms are in a minority position it is usual to negotiate specific put/call options with other shareholders.

A small number of exits have been recorded. Cantieri Riva, bought out in 1988, was sold to Vickers in January 1990. United Wine Producers, in which Candover was a major investor, was the subject of a trade sale. Investments in Unimorando and Petrini have been realised and the Rimoldi deal incorporated the sale of a 25 per cent stake to the German sewing machine company Durkopp. In early 1991, United Technologies Group acquired a ten per cent stake in Fata, which was bought out from FKI Babcock in 1988.

Although still well down the European buyout league, the Italian market has shown growth over the past two years and displays characteristics for further significant growth. Even though the market is still characterised by an excess of players in relation to the numbers of deals currently being completed, it still represents a market which has sound prospects for increased deal completions in the next few years. There is unlikely to be enough deal flow for all the competitors who have recently entered the market.

The key issue for those who do wish to maintain a strong market presence is to increase their competitive advantage by emphasising a longer-term approach based on industrial logic rather than one related solely to financial engineering and maximising internal rate of return expectations. To achieve this goal, institutions will need to develop strong links with Italian firms and to understand the Italian business environment.

Most importantly, institutions will need to structure themselves to be able to provide support for their client companies to enable them to develop their growth strategies. Buy-ins are particularly likely to have significant prospects for dealing with succession problems in family firms where there is also a need to turn around the business. □

Anna Sala and Fabio Sattin are with AIFI in Milan, Italy, and Mike Wright is with the CMBOR in Nottingham.