MASTER OF SCIENCE IN BUSINESS ADMINISTRATION

THE LISBON MBA INTERNATIONAL 2011 / ESPÍRITO SANTO CAPITAL

WORK PROJECT

“HOW TO INVEST AS A PRIVATE EQUITY”

The new capitalism
How unfettered finance is fast reshaping the global economy

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December 2011
“This (growing inequality) is not the type of thing which a democratic society can really accept without addressing”

-- Former Federal Reserve Chair Alan Greenspan

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1 Source: GRIER, Peter; Congressional Joint Economic Committee hearing, as quoted in the Christian Science Monitor, “Rich-poor gap gaining attention,” June 14, 2005.

ABSTRACT

This work project presents a road map for making deals under the umbrella support of a private equity investor. Fundraising, investment analysis, asset monitoring, and divestment are stages in the process that are covered in-depth and clarified in terms of action plan and procedures. Moreover, private equity brings tangible and intangible efficiency to the economy and companies, not only by providing finance to grow and expand but also by forcing superior organizational organics that foster sustainable business positions. In a world domain, Europe as been a second liner as compared to US in terms of size within the private equity sector, but it is quickly maturing and converging to US numbers. In this sense, Portugal has been improving in both numbers and regulations in order to leverage on its strategic location and position itself as a key player to address future business challenges coming from emerging markets such as Africa and Latin America.
ACKNOWLEDGEMENTS

I sincerely express my gratitude for the help that the Professor Paulo Soares Pinho (NOVA SBE) gave me during the execution of this work project. In addition, I want also to thank the entire Private Equity team in Espirito Santo Capital for the kindness, availability and serviceableness during my MBA summer internship.
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1. INTRODUCTION

“Our desire to anticipate our Clients’ needs, the continuous effort to adapt our business to evolving market conditions and the determination to develop innovative solutions that best fit our Client’s goals is a guiding principle of our corporate culture.”

An investment bank is a financial institution that acts as an intermediary between individuals, corporations and governments in order to create financial value and assist them in reaching successful transactions.

The investment banking world has a wide range of financial services in which private equity is just a small fraction of large spectrum of activities. The following chart summarizes the investment banking departments:

<table>
<thead>
<tr>
<th>Financial Services</th>
<th>Equity and Debt Capital Markets</th>
<th>Research</th>
<th>Private Equity</th>
</tr>
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<td><strong>Corporate Finance</strong></td>
<td>Equity Capital Markets</td>
<td>- Initial Public Offerings (IPOs)</td>
<td>- Equity Capital Markets</td>
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<td>- M&amp;A transactions</td>
<td>- Public/Private capital increases</td>
<td>- Fixed Income</td>
<td>- Growth Capital for Mid Caps</td>
</tr>
<tr>
<td>- Privatizations</td>
<td>- Equity linked instruments</td>
<td>- Bonds</td>
<td>- Equity Buy-outs</td>
</tr>
<tr>
<td>- Setting-up of joint-ventures</td>
<td>- Brokerage</td>
<td>- Infra-structure and Energy</td>
<td></td>
</tr>
<tr>
<td>- Company valuations</td>
<td>- Portfolio/asset management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Corporate financial restructuring</td>
<td></td>
<td></td>
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</tr>
<tr>
<td><strong>Project Finance and Securitization</strong></td>
<td>Debt Capital Markets</td>
<td>- Eurobonds Issues</td>
<td></td>
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<tr>
<td>- Project finance structures and loans</td>
<td>- Domestic Bonds Issues</td>
<td>- Credit Linked Notes</td>
<td></td>
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<tr>
<td>- Private-public partnership</td>
<td>- Credit ratings from international ratings agencies</td>
<td>- Government and corporate bonds</td>
<td></td>
</tr>
<tr>
<td>- Securitization / asset based finance</td>
<td>- Financial instruments for interest rate, exchange rate and commodity price</td>
<td>- Secondary market dealers / market makers (bonds)</td>
<td></td>
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<tr>
<td>- Portfolio management</td>
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<tr>
<td><strong>Leverage Finance</strong></td>
<td>Real Estate/Tourism Investment Banking</td>
<td>- M&amp;A and financial valuations</td>
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<tr>
<td>- Acquisition finance (buy-outs / buy-ins)</td>
<td>- Finding investors/partners</td>
<td>- Equity Capital Markets</td>
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<tr>
<td>- Mezzanine finance</td>
<td>- Leaseback, acquisitions and disposals</td>
<td>- Growth Capital for Mid Caps</td>
<td></td>
</tr>
<tr>
<td>- Structured leasing transactions</td>
<td>- Structuring of financing solutions</td>
<td>- Equity Buy-outs</td>
<td></td>
</tr>
<tr>
<td><strong>Real Estate/Tourism Investment Banking</strong></td>
<td>- REITs and other real estate vehicles</td>
<td>- Infra-structure and Energy</td>
<td></td>
</tr>
</tbody>
</table>

Figure 1: Domain of Private Equity within Investment Banking

*Source: Espírito Santo Capital*

Although the general trend is for private equity to become an independent investment sector, it is still framed within the investment banking sector. The mission is to “assure high returns to its investors by focusing in non-listed companies and putting in place the best management practices”.

This work project is a journey through the private equity market including its inception, deal cycle, current features in Europe (and Portugal), risks and returns for the economy, and fundraising activity.

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2 Source: Espírito Santo Investment Bank, Corporate Presentation, June 2011
3 Source: Espírito Santo Capital
2. HISTORY OF PRIVATE EQUITY

The “venture capital” domain differs by scope in US and Europe. In the former, venture capital includes mature stages whereas in the latter it only designates early stages as start-ups, whereas expansion and buyout operations are called private equity transactions in Europe. The following chart summarizes the courtliness stated differences.

<table>
<thead>
<tr>
<th>The Private Equity industry</th>
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<tbody>
<tr>
<td>Europe</td>
</tr>
<tr>
<td>Venture Capital</td>
</tr>
<tr>
<td>Expansion Capital</td>
</tr>
<tr>
<td>Buy-outs</td>
</tr>
<tr>
<td>United States</td>
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<tr>
<td>Venture Capital</td>
</tr>
<tr>
<td>Private Equity</td>
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Figure 2: Domain of Private Equity within Investment Banking

There is evidence that the very first capital risk operations occurred back in the fifteenth century during the first maritime expeditions. This sort of investments featured a notable amount of risk and usually yielded full-range losses. The next triggering period for capital risk happened two centuries later during the Industrial Revolution. At this time, the investment environment related to emerging manufacturing plants was very profitable and the wealthier individuals supported the industrial entrepreneurs.

Nowadays, the so-called business angels, a modern denomination for the risk capital investors, constitute a fundamental part of the economy and are essential to foster industrial development in several sectors.

Capital risk investing is an alternative form of funding ideas, projects or concepts compared with the traditional form, supported by the banking system. The earliest transactions of capital risk, in the modern format, occurred back in the 1940s. Moreover, Mr. Georges Doriot (Harvard Business School professor), the originator of venture capital, incorporated the first publicly traded capital risk firm in 1946. The American Research & Development (ARD) was created also with the support of the (at the time) Massachusetts Institute of Technology president, Mr. Karl Compton, and the prospective US senator from Vermont, Mr. Ralph Flanders.

ARD’s mission statement was very clear and straightforward: “aid in the development of new or existing businesses into companies of stature and importance”. The most striking case study is the Digital Equipment Corporation that in around 20 years came from USD $70k start up funding to a USD $355mn Initial Public Offer (IPO).

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4 Source: museum.mit.edu
Following ARD’s success, the US congress formed the Small Business Investments Companies program (SBIC) in 1958 which is still in force today. This program was created to pool together the availability of funds from the venture capitalists and the needs of start-up or on-growth companies. The current capital risk figures (2003) soar to US$ 9 billion assigned by the US government (the largest single capital risk investor in US) that along with the private fund sources of US$ 12 billion, make the US entrepreneurs delighted with US$ 21 billion for private equity purposes.

In Europe, the private equity industry has only started in the 1970s in its western part. During the 1980s, European Venture Capital Association was formed (1983). However, the private equity environment endured, back then, fierce struggle due to several withdrawals in early stage investments which were intensified by the 1987 economic crisis. At the time, the bulk of venture capital in Europe was composed by buyouts and expansion transactions.

The major driver that led to the current gap between US and European Private Equity market was the time that each individual economy took to recover from the 1987 crisis. In fact, the US was already on stable grounds in the early 1990s whereas Europe was still struggling to recover.

Another important issue that somehow influenced the development of venture capitalism was the economic environment and conditions to foresee exit strategies after the private equity 10-year cycle. An investor is worried from the beginning of a deal about how long it will take for a company to mature and which process is required to exit an operation. Based on a much more efficient stock exchange, the US evolved better given the favorable perspectives for US investors to exit under IPOs. As opposed to this, the Europeans neither had good perspectives on the companies nor on the stock exchanges, facing a liquidity barrier that harmed the development of the industry.

3. PRIVATE EQUITY: OVERVIEW AND FUNDAMENTALS

“A private equity/venture capital is the corporate entity which advises and/or is responsible for managing the investment capital supplied to it by the funders.” Moreover, a private equity firm promotes an integrated funding alternative to the traditional banking loans, by entering in companies or projects under temporary financial, non-strategic shareholder participation, and fostering business performance improvements to potentiate a posterior alienation with profit gains.

Denominations as seed capital, business angels, venture capital or private equity simply designate the same entrepreneurial finance innovative transaction but in different maturity stages of the project or company. Therefore, in terms of entry timing, the following stages are applicable:

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5 Source: web.sba.gov
6 Source: European Private Equity & Venture Capital Association, Guidelines, May 2003
Early Stage (or Greenfield operations / Venture Capital and Business Angel’s domain):
(i) Seed Capital: financing provided to research, assess and develop an original concept or technology not yet tested and still right after the incubation stage.
(ii) Start Up: financing provided for product development, initial marketing and other forehand operations right before the process of starting commercialization. Companies or projects must be in the process of being set up or even be in the business without commercial activity for very little time.
(iii) Other early stages: financing provided to start ups which already started the commercialization but have not yet reached any profits. The investment is directed to improve the existing procedures (production, marketing and commercialization).

Later Stage (or Brownfield operations / Private Equity domain):
(i) Buyout: financing provided to enable management changes or other shareholders’ shift before the company is listed in stock exchange. This type of operation receives the following distinctive designations regarding its main triggers and goals:
a. Management buy-out (MBO): internal management acquires a stake in a company from existing shareholders with the support of a private equity entity.
b. Management buy-in (MBI): external investor acquires a stake in a company with the support of private equity entity.
c. Buy-in management buy-out (BIMBO): transaction that incorporates both the internal managers (MBO) and the external investors (MBI) in a partnership to acquire a stake in a company.
d. Institutional buy-out (IBO): a MBO transaction where the buyer is an institutional investor as a private equity and may take partial control over the management.
e. Owners buy-out (OBO): when an existing shareholder enlarge its position with the support of a private equity entity.
f. Public to private (PtoP): acquisition of outstanding shares in order to de-list the company.

The previous operations are usually done in a leveraged basis which introduces an extra letter in the designation (eg. MBO goes to LMBO). Notice that the leveraged means that it includes debt capital which will be part of the post-transaction financial structure.
(ii) Expansion or development capital: financing provided to a company in a mature phase. The purpose ranges from internal reasons (increase production capacity, market development or portfolio enlargement) to international gearing (evolve geographically).
(iii) Bridge capital: financing provided to a company within the small transition period (typically up to 2 years) from being privately held to being publicly quoted.
(iv) Replacement capital/secondary purchase: direct purchase to a certain interest in a company to another private equity or investor typically within its divestment phase.

Turnaround: financing provided to ongoing businesses which are experiencing trading difficulties in a form of rescue plan to reestablish welfare.
Addressing the project’s lifespan, particularly within the infrastructures’ domain (e.g. wind farms or solar power plants), the transaction can be classified as primary or secondary. The former is related to an entry before or along the construction phase and the latter applies when the private equity steps in during the operational phase of the infrastructure itself. In terms of risk, the secondary market has much less uncertainty than the primary market due to the construction variability effect that imposes vulnerability to non-financial issues, such as raw materials price fluctuations, bidding costs, environmental or construction disasters, licensing blocking, low-cost driven construction that potentiate expensive maintenance scheme, etc.

Given that the secondary stage projects present less risk (and though lower perspectives on profits), the demand for them is quite significant. However, to enter in a completion phase, the private equity firm must be an established investor with strong partnerships with the project sponsors (development / construction companies). From the point of view of the private equity, the project becomes compelling if it has already reached the budget close (to avoid over-aggressive bidding tactics) and quite near the financial close (to reduce exposure to financial crises collateral damages).

A typical scenario of risk exposure, investment requirements and remuneration acquired during the transaction in the infrastructure domain could be the following:

As can be interpreted in the previous chart, the operation is riskier in the beginning than in the end. Notice that the risk decreases along the evolution of the construction phase due to several non-controlled variables that might delay the process.

Notice that participation can be a “build-up” transaction when the targeted company is already inside the portfolio and a position enlargement is under perspective.

The following chart summarizes the presented information about capital risk maturity stages:
4. PRIVATE EQUITY: TRANSACTION LIFECYCLE

The private equity process includes several stages and decision making milestones that go from raising funds, identifying and choosing opportunities (deal flow) to closing deals, tracking performance, and lately exiting the company or project. The following chart presents the entire process and the above mentioned stages:

**Figure 5: Private Equity Milestones**

4.1 Fundraising

Before raising any funds, the private equity must clearly define the rules of the fund: governing principles (bylaws and committees), scope (industry and region to invest in) and Private Placement Memorandum (CV of management team, market overview, etc). Moreover, the initial capital commitments are asked along with the schedule of further subscriptions, classes of participation, investors profile and targeted profitability (carried interest) over the 10 years lifetime (5 years for investment and 5 subsequent years for divestment).

In terms of investment policy, the fund bylaws translate objectives, conditions, type of transactions (infrastructures or buyouts), targeted market maturity and any type of constraints (range of investments, minority/majority stakes, and committee procedures for large investment, exit strategies, etc). In addition, on the risk management side, it is also defined the maximum size of each investment, diversification guidelines both by geography and industry, forbidden investments (industries, indebtedness limits, etc).

The management of the fund is composed by the private equity team, which is remunerated with a fee and further compensations indexed to the business performance. A “key-person” event is when the management team is subjected to a change that is considered harmful and then the activities are suspended until a substitution is approved by the investors.
Addressing the remuneration of investors, deadlines for distributable amounts are defined along with allocation priority and procedures if outstanding results occur. It is also important to frame the most efficient tax treatment regarding the countries involved.

In Portugal, fundraising is mostly driven by the public sector and banking system rather than by insurance and institutional investors as in Europe. This trend has been changing because national institutional investors have started to appear in Portugal along with an attraction for foreign direct investment.

Notice that the type of investors committed to raise a fund is very important for a private equity coming out of a large banking group (e.g. Espírito Santo Capital). Herein, the diversity by geography and type of shareholders is imperative to create a sense of independency from the large parent bank. In addition, to be entitled to invest in a private equity fund, an individual or entity must be classified as a “qualified investor” (state, public institutions, foundations and associations, societies or funds of capital risk - “funds of funds” - credit institutions, investment and financial societies, insurers and pension funds).

Among the shareholders, it is possible to be a general partner (GP) or limited partner (LP). The former individually holds 20% of the entire fund whereas the latter includes a group of investors together holding the remaining 80%. The GP also accumulates management functions.

Regarding the marketing image of the fund, it is relevant to place a significant focus on mature markets in order to gain reliability and credibility. Moreover, the general partner must have previous experience and recognized know-how in the prospective investment’s areas.

The fundraising process road map includes (i) definition of the fund’s documents (business plan and commercial agreements) and preliminary marketing activities, (ii) settlement of the management team, (iii) road show and negotiations with investors.

4.2 Investment

The investment analysis process is structured in the following steps:

 Origination and Dealflow → Investment Analysis → Negotiation and Due Diligence → Closing

Figure 6: Investment Analysis Road Map

4.2.1 Origination and Deal flow

The origination stage is when market opportunities are identified, based on external sources (independent consultants or direct approach by the company/project leaders) or by going directly through the market on its own, especially if the private equity belongs to a banking holding where the retail bank’s database provides important information on potential private equity opportunities.
The most important triggers to qualify a company to be eligible for a private equity transaction are the EBITDA margin (above 20% for industrial companies and 8-10% for service companies\(^7\)), EBITDA value itself (larger than 1M€) and the firm’s dimension regarding the funds’ constraints.

Notice that the deal flow turnover is a relevant indicator of how a private equity is committed with the market and actively looking to pursue the best businesses available. However, given the large “mortality” rate of deals, those efforts must be balanced with the market demand for capital risk transactions, in order to place the right amount of time assigned to chasing deals.

### 4.2.2 Investment Analysis

While the originator is pursuing his job, an analysis team starts to assess the deal propensity to be part of a private equity operation. The investment’s breakdown has two distinct stages: preliminary and in-depth analysis. The former is the very first review, not only of the company or project, but also of the related market. The latter stage corresponds to developing a study as deep as possible that will evolve from the preliminary document.

The main reason for the existence of the two stages is the time and effort optimization that the preliminary analysis represents. Actually, once a deal is originated, the first milestone is a “go-no-go” decision over the in-depth analysis. The decision is to evaluate whether the deal falls into the private equity’s fund investment philosophy and its most significant business indicators. Notice that a deal can be out of scope from a certain fund regarding investment dimension, sector of activity, maturity stage of the company or even the market (geographies of operation, etc.).

Therefore, in order to perform a thorough first round, the preliminary internal report (PIR) must focus on financial statements of previous 3 years plus the ongoing year up-to-date (evolution of sales, gross margin, EBITDA, CAPEX, working capital, etc.), business plan for the upcoming 5 years, strategy and long run perspectives (marketing, sales and industrial), competitive advantage vis-à-vis competitors, market and industry environment (including complementary markets), and, last but not the least, management team curricula (experience and credibility). In the case of infrastructures, a project finance framework analysis is performed.

In addition to the previous workload, it is imperative to start sharing with the company how a private equity deal is structured and the main contractual clauses. Given that this is a very sensible topic and not usually familiar to managers, to prevent further discussions about the private equity main drivers and protections, the firm must get acquainted with the fundamentals and mechanics of the prospective transaction.

The PIR is submitted to the private equity’s investment committee and, in the case of positive endorsement, the in-depth analysis takes place then on.

\(^7\) Source: Espírito Santo Capital
The detailed examination of the company includes a much broader and deeper introspection than the preliminary approach. Herein, the domain of analysis goes also through an on-field job over the company’s clients, suppliers, banks and other significant entities that can yield important information about how the company behaves in the market. In addition, if available, a database of the company’s historical performance is also consulted.

For a complete and deep report about a company or project, it is necessary to prepare a document for the board of investment, incrementally integrating the PIR with broader analysis of the business plan (sales per sector, evolution of prices, headcount, outsourced services, growth potential, product mix, market trends, etc), due diligence over key clients and suppliers, corporate governance and structure, preparing the changes that will take place with the private equity entry.

Regarding the previous analysis, it is very important to define the strategy to implement once the private equity funding comes in, aligning all the interests across the shareholders.

The company’s financial valuation is performed by the discounted cash flow method (DCF) or by comparison with multiples. The former method presents high subjectivity and relies on several assumptions (e.g. growth rates, market share, equity and debt risks) that must be determined as precisely as possible as they affect the final accuracy of the results. The latter is more straightforward but can only be applied to companies with stable cash flows which allow to perform comparisons to other similar in-sector companies, based on indicators such as price-earnings ratio, enterprise value to EBIT or EBITDA, price-to-cash flow ratio, among others.

<table>
<thead>
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<th>Deal size range</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009**</th>
</tr>
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<td>€10m-€25m</td>
<td>9.2</td>
<td>10.5</td>
<td>9.5</td>
<td>9.8</td>
<td>9.8</td>
<td>7.0</td>
</tr>
<tr>
<td>€25m-€50m</td>
<td>11.4</td>
<td>10.3</td>
<td>11.2</td>
<td>11.8</td>
<td>12.4</td>
<td>10.0</td>
</tr>
<tr>
<td>€50m-€100m</td>
<td>12.8</td>
<td>15.0</td>
<td>9.7</td>
<td>11.9</td>
<td>14.2</td>
<td>14.8</td>
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<td>€100m-€250m</td>
<td>14.0</td>
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<td>16.6</td>
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</tr>
<tr>
<td>Over €250m</td>
<td>13.6</td>
<td>18.2</td>
<td>18.6</td>
<td>18.5</td>
<td>16.9</td>
<td>10.7</td>
</tr>
</tbody>
</table>

**Figure 7: Private Equity Multiples (Price/EBIT) – Buyouts in Europe**

*Source: EVCA/CMBOR/Barclays Private Equity, EVCA Buyout Review 2009.*

Notice that the multiples method is as reliable as the sector or the comparable companies are correctly evaluated, requiring also an alignment in corporate strategies and growth perspectives. It is recurrent to introduce adjustments by the end of the evaluation in order to reflect any uniqueness of the company (for instance, if a firm is market leader).
The main goal of the valuation diligence is to determine the implicit profitability of the company considering both the investment and divestment plans. In addition, for certain industries where non-current assets are crucial, the value of the company integrates the value of these assets. Notice that the transaction’s value is defined over the equity value and not the enterprise value (equity plus non-current debt) and sensibility analyses should be performed over the time to exit, on a timeline of 3 to 5 years.

The previously described road map is defined based on several meetings between the private equity team and the company’s management, where there is an intense, cordial exchange of information, protected by non-disclosure agreements.

By the end of the analysis, in the case of a positive judgment about the transaction, the in-depth report is presented again to the investment committee after which, under an approval basis, a non-binding offer is developed for the firm. The company must transmit its positive opinion about the proposal in order to set the foundations for the next stage.

4.2.3 Negotiation and Due Diligence

This is the last phase prior to the deal, where the business fundamentals are confirmed under an extended due diligence process that leads to the structure of the transaction.

The external due diligence is an outsourced, independent consulting process where the private equity wants to get a confirmation that the data provided by the company is legally valid, aiming also to acquire additional information relevant for the transaction. It is crucial to understand both the reliability of the company data and the quality of its earnings. Typically, a consortium of consultants is hired to go through fiscal, financial accounting, commercial, legal, industrial, information technologies and environmental documents. The due diligence costs are supported by the company and not by the private equity. In case of a no-go decision, the upside for the company is that it will keep a complete process about its own operations and structure, yielding relevant information for further improvements that may be put in place even without a private equity partner.

In parallel with the external due diligence, the private equity management team starts the negotiation process of the shareholders’ governance and subscription or buyout contracts. In addition, the transaction is structured regarding the private equity’s positioning as follows:
(i) Buyouts: the acquisition is made using a special purpose vehicle (SPV) which holds the debt and the participation on the entity targeted by the private equity transaction. Other relevant points to be defined are the amount of debt within the transaction (remainder goes on equity), the shareholders’ capital repartition between the existing ones and the private equity entity, the “envy” which is the ratio on price paid per shares by the private equity and by existing management, and the “ratchet” which is an adjustment method to share profits regarding the attained levels.

(ii) Expansion: In addition, for this sort of transaction, it is absolutely required an alignment of interests between shareholders regarding equity value to add and shareholder subordinated debt to release.

Addressing the contracts that support the transaction, it is required to celebrate a legal framework to manage the sale itself (subscription or sale contract) and another document to establish the governance rules to be followed. The main features to be included in these contracts are:

(i) Subscription / Sale Contract: In addition to the regular issues to be tackled in this type of contract, the private equity entity imposes several protecting measures to prevent any non-desired “surprise” (not detected in the due diligence process) during the transaction lifetime. Therefore, the existing management is liable for the events prior to private equity entry on fiscal, social security, environmental, industrial, legal, labor, accounting and financial domains. The existing management (or vendor) is entitled to indemnify the private equity entity for any loss or damages with prior origin to its entry in the company’s capital.

(ii) Corporate Governance Agreement: This document regulates the private equity’s representation in the governing bodies, veto rights in strategic issues, periodic disclosure of information, non-competing honor of the management team and lock-up period (typically 24 months), when the management team cannot leave the company neither during the private equity presence nor on a certain extend after divestment process.

In addition, the most common tools for a private equity entity to block any opportunistic behavior are the following:

- Tag-Along: in the case that any current shareholder intends to sell its shares, the private equity has the right to also sell its shares under the same terms and conditions of price and payment.

---

8 The Envy Ratio (ER) expresses the relation of how committed is the private equity (PE) on the investment. As a typical example, if the PE paid 1.000M€ for 60% and the existing shareholders retain 40% by 250M€, ER = (1000/60) / (250/40) = 2.7x. Therefore, the PE paid 2.7 times what existing shareholders did.

9 E.g.: for IRR > 8%, 20% of shares goes to private equity and 80% for the management team instead of following the regular slices of each party. Usually it rewards the management team if the firm is performing well, being a form of incentive to promote good management practices and in an additional basis to year bonus.

10 “Acordo Parassocial” in Portuguese
Drag-Along: at any time, the private equity can sell all the shares (100%) of the company, even if it has a minority position in the company’s capital. For this purpose, an “Escrow Account” is created in a bank institution designated by the private equity, in which the shareholders’ shares are deposited, becoming available at any time to activate the drag along right.

Dead-lock: to solve an impasse, the private equity entity can buy the shares of the other shareholders by a determined price indexed to the entry amount (or multiple) and to the Euribor rate.

By the end of process described above, and with the full range of conditions assured, the investment committee is warned that the transaction is prepared to go on and may countersign it. A binding proposal is now delivered to the targeted company.

4.2.4 Closing

The final closing stage is just the formalization of the transaction where the contract of sale or subscription and the corporate governance are signed with the company. In addition, given that the private equity issued debt for the faith of the transaction, the financing contract with a bank institution must be signed a-priori in order to have the funds available to immediately proceed to the transaction’s financial liquidation.

Across the process, the private equity manager must present several skills, from industry knowledge to a proactive mindset, in order to overcome these demanding steps, as shown in the next diagram.

![Figure 8: Key Skills of a Private Equity Financial Manager](source: EVCA, Why & How to Invest in European Private Equity and Venture Capital, 2009)
4.3 Monitoring and Asset Management

Once the transaction is closed, the private equity starts the engagement in the company’s affairs, actively participating in operating and financing strategy in order to create value to the shareholders by combining risk-bearing and governance functions. Generally, the private equity only participates in shareholders meetings where the most important matters are discussed. However, if the risk of the operation is high, some non-executive position can be occupied in the management team of the company. In addition, it is common practice to place a chief financial officer (CFO) in companies that do not have pre-organized financial accounting procedures, being reliable to have a longtime seasoned professional to foster the right faith within the bridge between the company and the private equity.

There are several topics to be discussed and approved with the private equity as annual budget, property acquisition or alienation, financial operations, changes in product mix, expansions to new geographies, remuneration policies for employees (wages) and shareholders (dividends) and annual financial reports.

To create conditions for the private equity to participate, especially regarding the financial health of the company, the accounting information must be released monthly (financial statements, budget deviations and working capital analysis), quarterly (prospects of annual budget compliance) and annually (forecasts for next year: annual budget and investment plan).

During the investment lifecycle, the participation is continuously subjected to a valuation process from its book value to the ongoing fair value. In fact, the participation remains one year with the acquisition’s book value and then depreciates/inflates regarding the company’s performance and market trends. The valuation process is established by EVCA and CMVM, but in Portugal CMVM guidelines must be complied. The methodologies to be followed are based on the latest transactions (benchmark on comparable deals concluded recently), multiples (earnings, EBITDA or net assets) or DCF update. There are also some industry specificities to be considered as “price per subscriber”, for instance.

The most common process is to determine all the stated ratios and then proceed with an average in order to perform a smoothed value based on the entire effects of each ratio.

The outstanding aspects of having a private equity on board in a company are management, negotiation, operational and financial experience and systematizations to be used to step up the firm’s procedures and results in the market. Moreover, a private equity entity is typically seasoned in expansion projects, mergers and acquisitions transactions and, as expected, has a strong networking, which, among other advantages, can lead to successful recruitment of top managers.
4.4 Divestment

The divestment phase closes the private equity life cycle and is where the major slice of transaction’s profitability comes from. It is both important to understand when to leave an operation and to plan the method to structure the exit.

The drivers to divest can be either internal or external. The former are linked with the company’s outstanding performance and stable cash flows. The latter comes from a market momentum, the allocation of an operation to another investor with greater propensity to strategically create value or, on the downside, as a measure to stop losses.

Along with the decision to divest, it is necessary to establish the format to exit and to find the required institution that is interested in the deal. The range of opportunities available in the market is the following:

(i) Sale to a strategic investor: Most common solution but quite limited in the case of minority stakes. It features a large flexibility given that the current business figures go to a second layer of importance, overlooking marginal losses and small capitalization size and considering operations in strong competitive markets.

(ii) Initial public offer (IPO): the requirements must be robust given that the capital markets are selfish by definition and only absorb advantageous operations. Firstly it is necessary a favorable capital bull market condition, otherwise the in-place volatility will block any admission to the stock exchange. Moreover, it is mandatory for the company to have significant profitability and sizeable dimension. A remark to the Portuguese context, in which the stock exchange is not prepared to lead IPOs over SMEs (small and medium enterprises). In general, the IPO is always the most desired alternative for the shareholders, given that it will guarantee access to further sources of financing and greater liquidity. However, it is costly and time consuming, in terms of regulations to comply with.

(iii) Secondary buyout: this transaction can occur to any financial investor or even to the management team currently in the company (which could be the previous owner before the private equity cycle). The latter option is very straightforward given that no due diligence schemes or guarantees are necessary, which simplifies the process. However, the transaction usually occurs at discount vis-à-vis a normal buyout. On a regular basis, a secondary buyout closes a cycle of capital risk, setting the foundations for another private equity operation to proceed with a new investment plan. Notice that the secondary buyout approach is a direct answer to the nowadays lethargy of capital markets.

Once the sale process is defined, the implementation is done by hiring a specialized entity or investment bank to perform a competitive auction. As an alternative, it is possible to promote a direct approach to a restricted number of entities. As part of the process, recalling the very early stage of investment preparation, the due diligence process, the execution and the negotiation of contracts to the sale, followed by an announcement to the market are imperative.
5. **WORLDWIDE PRIVATE EQUITY MARKET**

The current business environment is now under the influence of an economic crisis, from the sub-prime effects to the bulk of sovereign debt within each country. As a result, easy funding to a project no longer exists and entrepreneurs need to place mind-blowing efforts and creativity to get the money to develop their ideas.

Hence, transferability of projects’ ownership got really active where the sponsors (e.g. the construction companies in the case of infrastructures) were able to sell their positions and no longer stay to run the operational phase. Actually, they start to face problems in getting the required amount of equity to undertake a project, due to the tightening of the debt market and to credit restrictions, along with a trend of costs enlargement. In addition, within the companies’ scope, liquidity problems are spread all over, forcing them to sell equity interests and/or to alienate non-core activities in order to refocus and go back the initial roots.

Besides the troubles in the entrepreneurial side, the market still has entities willing to invest and others as pension funds that are now starting to become active.

As consequence, both the demand and supply side are likely to remain vigorous or even to grow, and a world of investment opportunities exists to the ones with liquidity and willing to bear some risk. From primary and secondary opportunities to public-private partnerships, a private equity investment fund has a whole range of profitable deals available in the market.

Addressing the competing forces between the U.S. and Europe, private equity will be a fundamental element in corporate restructuring, to foster competitiveness in order to dilute the current gap. In addition, globalization asks for a favorable business environment in Europe to permit attraction of foreign domestic investment and thus allow local players to compete in a diversified and internationalized industry.

Looking in perspective, a scale up of transactions is expected and further exploitation will occur in new geographies, especially in emerging markets (Africa and Latin America). Moreover, as long as the private equity grows world wide, the main trends will become specialization and segmentation.

The following chart presents the market share of each world region (data from 2006) regarding investment turnover, clearly showing that emerging markets are still in the incubator stage in the private equity domain.
The European Venture Capital Association (EVCA) outlooks fundraising and investment to remain calm as compared to previous years, where UK, France and Germany will continue to dominate (60% of investments market share in 2009), and almost 1.700 European players are managing more than €530 billion and private equity transactions are directed to capital growth and turnarounds.

The previous chart gives an accurate sense of the private equity market significance in each European country. Considering the individual GDP figures, it is possible to reach the following comparisons:
Figure 11: Private Equity Investments per inhabitant in each country (2009)

Source: Eurostat, 2009

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP per inhabitant</th>
<th>PE % GDP</th>
<th>PE Investment per inhabitant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>76.600 €</td>
<td>1,020</td>
<td>781 €</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>13.100 €</td>
<td>1,017</td>
<td>133 €</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>25.300 €</td>
<td>0,300</td>
<td>76 €</td>
</tr>
<tr>
<td>France</td>
<td>29.300 €</td>
<td>0,163</td>
<td>48 €</td>
</tr>
<tr>
<td>Germany</td>
<td>29.300 €</td>
<td>0,114</td>
<td>33 €</td>
</tr>
<tr>
<td>Italy</td>
<td>25.200 €</td>
<td>0,103</td>
<td>26 €</td>
</tr>
<tr>
<td>Finland</td>
<td>32.500 €</td>
<td>0,398</td>
<td>129 €</td>
</tr>
<tr>
<td>Sweden</td>
<td>31.300 €</td>
<td>0,370</td>
<td>116 €</td>
</tr>
<tr>
<td>Denmark</td>
<td>40.300 €</td>
<td>0,216</td>
<td>87 €</td>
</tr>
<tr>
<td>Spain</td>
<td>22.900 €</td>
<td>0,101</td>
<td>23 €</td>
</tr>
<tr>
<td>Portugal</td>
<td>15.900 €</td>
<td>0,185</td>
<td>29 €</td>
</tr>
<tr>
<td>Europe</td>
<td>23.500 €</td>
<td>0,181</td>
<td>43 €</td>
</tr>
</tbody>
</table>

Luxembourg, with the larger GDP in Europe, has a private equity investment per inhabitant of €781 whereas the Czech Republic, with a similar percentage PE investment over GDP, only reaches €133 per inhabitant. For the rest of Europe, the Scandinavian countries lead the way with €129 per inhabitant (Finland) followed by the United Kingdom with €76 per inhabitant.

Portugal has an investment in private equity quite similar to the European average in terms of GDP percentage, yielding €29 per inhabitant, which is larger than the Iberian peer (Spain - €23 per inhabitant) but still below the European average (€43 per inhabitant).

Figure 12: Private Equity investments and number of financed companies (2000-2009)

Source: EVCA/PEREP Analytics, Yearbook 2010.

Addressing the evolution of investment levels and financed companies, it is possible to see that the golden years were 2006 and 2007, topping €73 billion of amount invested in 2007. Driven by uncertainties and cautiousness, the private equity investment decreased to €23 billion in 2009, representing a drop of 57% in 2008 and 68% in 2007.
However, the number of financed companies has had a smaller downturn, reflecting a shift in focus from the high end market in 2006-2008 to a concentration in low end deals, as in the beginning of the decade (2000). This finding is obtained by comparing the investment amounts with the total number of financed companies.

The previous charts on investment by private equity stage focus show that buyouts are definitely the sort of transaction most done in Europe. Only after the crisis, some other opportunities arose, such as growth capital deals and turnaround operations, which doubled from 2008 to 2009.

The replacement capital transactions have been significantly low but increased 17% from 2008 to 2009. In terms of early stage, the overall quota on the market increased from 2007 onwards showing, not only resilience to turbulent effects, but also propensity to support business innovation and R&D, mostly placed in France and Germany. Moreover, Italy has the larger percentage of replacement capital operations and France the lower percentage of buyouts, due a higher focus on growth capital transactions.

According to EVCA, in 2009, Europe had 9 large buyouts (two in Germany and the others spread across Europe) and 3 mega buyouts, figures that are strongly lower than those of 2008 (45 large plus mega buyouts) and 2007 (84 large plus mega buyouts).

This decreasing trend is generally due to the lack of leverage in the financial markets. By the end of 2009, the debt markets showed some relief setting the foundations for 7 large and 1 mega buyout occurrences during the last quarter, which saved the year from more drastic closing figures.
Addressing the sectors of the private equity market, life sciences (15% of total amount invested) is the leading sector, followed by consumer goods and retail (13% of total amount), communications (12% of total amount), and business and industrial products (11% of total amount).

Management teams in private equity are mostly based in the UK given that London is the financial capital of Europe. However, when it comes to place investments, the UK retreats in relevance and the rest of Europe increases in importance. Currently, countries as Poland, Romania, Croatia and Czech Republic are under great attention of the so-called “westerns”, which explains the 23% of investment placement in the “rest of Europe”.
A final remark concerns the credit crunch undergoing in Europe that has been leading to a steady decrease in the level of debt raised in private equity deals.

![Figure 16: Average Deal Structures for European Private Equity (Buyouts, Deals>€100mn)](source)

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity</th>
<th>Mezzanine</th>
<th>Debt</th>
<th>Loan note</th>
<th>Other finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
<td>34%</td>
<td>43%</td>
</tr>
<tr>
<td>2005</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
<td>34%</td>
<td>43%</td>
</tr>
<tr>
<td>2006</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
<td>34%</td>
<td>43%</td>
</tr>
<tr>
<td>2007</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
<td>34%</td>
<td>43%</td>
</tr>
<tr>
<td>2008</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
<td>34%</td>
<td>43%</td>
</tr>
<tr>
<td>2009*</td>
<td>30%</td>
<td>31%</td>
<td>32%</td>
<td>34%</td>
<td>43%</td>
</tr>
</tbody>
</table>

6. **ECONOMIC EFFICIENCY OF PRIVATE EQUITY**

The private equity market is generally directed by institutional investors with conservative views over the investments, which require long-term high returns with an appropriate risk associated regarding their own portfolio risk. Many of these investors, such as pension funds, have a mandate to provide future income and so the private equity class is the tailored type of investment for their profile given the long-term stable life cycle.

The private equity enables entities to enter in the equity market, in which they cannot enter by themselves. The inverse transition is also doable when a company is experiencing an outstanding performance under public ownership but requires to be privatized in order to make possible some mandatory transformations to step up the business level.

The uniqueness of private equity comes from its property to mobilize and gather capital from investors, to diversify the risk among each individual portfolio and capital risk institution, and to identify and foster rewarding usages of the capital. From the point of view of the investor, the top advantage comes from having reliable entities developing the field work and offering the opportunities. Moreover, the private equity firms have an important role to fulfill the overall capital markets and so the overall economic success, making it also possible to profit in counter-cyclical opportunities when liquidity in the market does not exist but there are private equity funds already raised which are not only available to invest but also looking for those benefitting occasions.
From an innovation point of view, traditionally, investors have been willing to assess only quoted companies (and fall upon capital markets) careless with governance principles or market corporate control. Private equity brings the beauty of unlisted companies to be addressed and wants to have a say on governance procedures in order to foster better positions in the market.

In addition, during the process of structuring a deal, by taking the due diligence procedures, a private equity obliges the companies to have a thorough in-depth strategic reflection over the entire business chain alerting to good practices, compliance and transparent management methods.

In terms of seizing opportunities, the private equity comes as white knight to solve the paradox of public capital, meaning that public financing is “readily available when a company may not need it and least available when it does”\(^{11}\). Moreover, public capital is provided when returns are in-force whereas private equity has a strategic mindset. Therefore, it firstly looks to step up business performance in order to later receive the bounty.

In case of the deal’s concretization, the targeted company becomes fortified in terms of equity funds and financial structure. However, given that most of the transactions do not occur, the most common solely outcome for the economy, in particular for the company, is the dynamic cycle of contacts exchange among institutions (financial, legal, etc) which ease and promote future business opportunities (and the results of the due diligence that are very helpful).

The principal benefits for the economy resulting from the private equity activity are:

(i) Competitiveness increase: Driven by funding and management expertise, a private equity approach to a given company offers extra skills to help in developing strategic options to increase profitability and growth. Moreover, the new bulk of equity will support product and processes development or international expansion. In the latter case, a seasoned private equity will also aid by providing access to the international networks and market analysis. As a result, the company takes advantage, when compared to its competitors, and suffers a boost in its own business and bargaining power in the market. Notice that micromanagement by a private equity investor is rigorously defined given that managing the company is not the core business purpose and regularly active board participation is strictly appropriate.

(ii) Development of governance policies: The most important base for a private equity to operate in a company is the flow of information that must run continuously out from the company itself. Private equity management, in monitoring the participation, will oblige the investee company to implement corporate governance policies in a professional way, setting a certain level of discipline and standards. Moreover, to assure the accomplishment of the proposed goals, internal business and managerial procedures are reorganized, promoting the dilution of information's asymmetry within the company. Some specific examples can be identified as the reduction of agency costs (related with divergences between management and shareholders and with information asymmetry) by realigning interests towards value maximization, mitigation of free cash flow distress or nourishment on peripheral non-core (but value added) activities which require an entrepreneurial boost\(^\text{12}\). Furthermore, in case of ownership dispersion, a private equity can buyout those individual positions, restoring better levels of active voice with a board committee or shareholders meeting.

(iii) Prepare for public markets: To list a company in stock exchange, following the previous point, a company must be well prepared to restrict management processes and risk control procedures in order to be admitted to be publicly traded on regulated markets. The fact is that IPOs backed in private equity operations tend to outperform other IPOs.

(iv) Financial structure: Once a deal is closed, the targeted company becomes fortified in its shareholders capital, funds availability and diversification of risk by enlarging the sources of equity. In addition, the private equity operator assimilates part of the company’s risk.

In each stage of private equity, the positive contribution is different. In the early stage, the private equity accelerates business concepts, fosters innovation and entrepreneurship, and promotes alternatives to the traditional job market. Furthermore, in the later stage, the private equity helps in solving succession problems in family owned companies, disposing non-core assets and streamline operations and promoting business expansions. Finally, at the turnaround stage, the private equity allows to restore business plans and correct poor management procedures, making it possible to keep valid business models running.

From a profitability point of view, the economic efficiency can be related with dividends (ongoing remuneration) or gains at the exit (outcome of the restructuring process). Moreover, the private equity investors are usually seemed as looking to outgoing profits from other shareholders. However, the fact is that in the short run this might be probable but in the long run the investee company remains much more structured and prepared to step up wealth maximization.

In contrast to the upside points already presented, some discussions have been taken around the harmful effects that private equity has in the market. Some opportunistic concerns raised about private equity transactions are\textsuperscript{13} the asset stripping and flipping (buy a company with poor management but valuable assets and just to sell to make quick profits without value creation for the company itself), drawbacks in employee remunerations and HR policies (restructuration for-profit measures with negative impact in employment and/or respective remunerations but employees are supposedly moved to other activities in the market that are more profitable to the economy, adding more value to it), ease tax programs (SPVs off company’s balance sheet reduces tax payments) and deep strategic interventions\textsuperscript{14} (by taking seats on boards and promoting contractual restrictions, the private equities can at some point harm certain business lines).

In addition, private equity investors differentiate from standard investors\textsuperscript{15} by having short term investment perspective, lower risk aversion and more ability to improve production efficiency, higher targeted return. However, the most striking differences are the leveraging up and the potential asymmetries in information (private equity better informed) both together justifying the low-investment profile of a private equity investor vis-à-vis standard investor.

On a long term basis, there is evidence\textsuperscript{16} that an investee company that goes public tends to perform poorly. In fact, an aggressive management during the private equity cycle fosters underperformance of the post-issue stock as compared with a conservative management. It is claimed that overpriced equity issuing and failure of market participants to incorporate information tend to occur. Moreover, an aggressive private equity management will address the accruals accounting in a way to boost overpricing, forbidding even sophisticated investors to uncover the true value of the company where current earnings are not good predictors of future cash flows. Other effects as agency problems or overoptimism can also harm the stock performance in the mid run. The final outcome is that companies can go into default, be delisted again or even pursue accounting manipulation grounds which are not sustainable in the long run.

To avoid these and other pernicious effects to the economy, regulation is required in order to foster the upside (e.g. incentives for more production on the fiscal bill) and limit as much as possible economic the downside (e.g. ceiling in added leverage) but without making transactions impossible.

\textsuperscript{13} Source: WRIGHT, Mike et al; Private Equity and Corporate Governance: Retrospect and Prospect, Corporate Governance: An International Review, 2009, 17(3), pp.353–375
\textsuperscript{14} Source: Mike Wright et al, Private Equity: A review and synthesis, International Journal of Management Reviews, 2009
\textsuperscript{15} Source: Sebastian Ernst et al, Are Private Equity Investors Boon or Bane for an Economy? – A Theoretical Analysis, European Financial Management, 2011
The following points summarize the intangible benefits of private equity to the economy:\(^{17}\):

1. Governance by a small board of directors with significant equity ownership;
2. Decentralization of decision-making;
3. Adoption of new performance measures that emphasize cash flow, growth and long-run value; and
4. Adoption of a new management compensation system that includes higher levels of compensation, with more pay at risk; bonuses based on cash flow and/or value metrics, and; significant percentage management equity ownership.

7. **PRIVATE EQUITY: RISK AND RETURNS**

Measuring private equity returns is not an easy task, mostly due to some entry position uncertainty, non-disclosure of information and other market issues as \(^{18}\) time taken in disclosing information, illiquid assets that turn comparisons difficult, general partners and limited partners’ relationships in fostering business performance, and limited track record as compared to regular capital markets (bonds and securities).

The best way to generally show how a private equity transaction evolves is by the so-called “J-Curve” which represents the compound return overtime of a private equity fund.

![Figure 17: J-Curve - Compound Return (left) and Cash Flow Drawdowns/Distributions (right)](image)


Source (right): EVCA, Why&How to Invest in European Private Equity and Venture Capital, 2009

The internal rate of returns (IRR) are typically negative until fourth year (can extend to fifth year) due to cash outflows of either management fees or capital calls. Afterwards, when investments start to mature, cash inflows arise, producing the desired results. Remark the break-even attainment in the fifth year which is aligned with the beginning of the predicted divestment phase.


In the previous chart, the stated ceiling for returns is 10% as an example but the IRR varies across the investment stage, having different tier performances.

<table>
<thead>
<tr>
<th>Stage</th>
<th>Sample size</th>
<th>Top-quarter pooled IRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early-stage</td>
<td>104</td>
<td>12.0</td>
</tr>
<tr>
<td>Development</td>
<td>49</td>
<td>18.0</td>
</tr>
<tr>
<td>Balanced</td>
<td>41</td>
<td>13.5</td>
</tr>
<tr>
<td>All venture</td>
<td>196</td>
<td>13.6</td>
</tr>
<tr>
<td>Buyout</td>
<td>116</td>
<td>30.2</td>
</tr>
<tr>
<td>Generalist</td>
<td>35</td>
<td>22.9</td>
</tr>
<tr>
<td><strong>All private equity</strong></td>
<td><strong>345</strong></td>
<td><strong>21.8</strong></td>
</tr>
</tbody>
</table>

**Figure 18:** Return per stage of investment/top tier (left) and overall performance\(^{19}\) (right)

*Source: EVCA/Thomson Reuters, 2009 European Performance Figures (based on 1980-2009 data)*

Regard that the performance information available in the market is quite diffuse and companies tend to assume a protectionism basis in their disclosure behaviors. However, buyouts tend to be the most performer segment by far whereas early stage private equity is still not getting major results. Notice that the low-end private equity performers have poor results that reach almost 20% negative IRR (confronting with 20% positive IRR of the high-end segment).

Relying on US data, private equity tends to outperform the capital markets or bonds, implying acceptable risk levels vis-à-vis index volatilities. The following charts show exactly that private equity has a mean return of 16% which is above 12-14% in S&P500 or NASDAQ and 8% in Bonds. Moreover, the volatility of private equity is around 13% being lower than 15% plus in capital markets but higher than 7% in bonds. A private equity asset class has an improved behavior of return-volatility combination.

**Figure 19:** Private Equity – Risks and Returns


\(^{19}\) Net Pooled IRR is based on pooling cash flows before computing IRR and net of management fees and carried interest.
Notice that, as already pointed out in the reflection about the efficiency effects to the economy by the private equity, the benefits to a company go far beyond the finance figures and returns.

In terms of risks, private equity tends to create a basis of “risk-sharing” by aggregating several investors in a pool (syndication of risks) and thus dispersing ownership of risks. This method yields low probability but intensive systematic crises if any economic shock occurs. Remark also that if any of the investors resell the debt, in case of restructuring or default, extra risks exist due to the requirement of debtholders to have a say in the process.

In a global perspective, it is a fact that the private equity funds typically perform better (or at least more consistently around 12% IRR) than public markets which are much more volatile as shown in the following chart of the profitability of private equity as compared with public markets indexes.

![Figure 20: IRR Comparison Private Equity versus Public Markets](image)

*Source: EVCA/Thomson Reuters, Why&How to Invest in European Private Equity and Venture Capital, 2009*

In order to understand the market perception of the private equity operation, it is presented next the evolution of Blackstone and Blackrock stocks as compared with the market (S&P500) from 2007 to 2011. Notice that both the enterprise groups have wide range of operations within the asset management domain, where private equity is also included along with Real Estate Investment Trusts (REITs), Hedge Funds, among others.

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20 Source: ACHARVA, Viral V. et al; *Private Equity: Boom and Bust?*, Journal of Applied Corporate Finance, volume 19, No. 4, 2007, pp.44-53
21 For public markets index, the IRR is calculated by investing equivalent cash flows of private equity into the public market index.
In terms of future perspectives, a private equity that goes public is simply selling future perspectives of management fees and carried interest. As shown above, both Blackstone and Blackrock have a trend similar to the market with more volatile, especially Blackstone that strongly devalued during the 2009 crash. Moreover, there is evidence that private equity funds tend to perform 3% below S&P500 if net-of-fees but 3% above S&P500 if gross of fees, being lowered by another 3% if risk adjusted (overall 6% less than S&P500, net-of-fees).

8. FUND-RAISING: PROCEDURES and ACTIVITY ANALYSIS

The fundraising (or marketing) stage must be directed by principles of “integrity, transparency and skill, care and diligence”. The initiators (who run the fundraising process) are legally liable to follow market laws, provide reliable information to investors, and verify the origin of the funds. Regarding the attention to jurisdictions’ restrictions within geographies, the initiators must work with experienced investors and foster awareness of the risks. In the case of acceptance of less seasoned investors, additional warnings and protections may be necessary.

The “money laundering” is a serious problem that the initiators face. Therefore, a confidential record of individuals targeted by the initiative must be kept along with direct and cross checking over companies about the origin of the funds.

The practitioners of fundraising must comply with the code of conduct of each country and still adhere to the European and even worldwide standards. A globalized activity demands a united universal community in accountability, transparency and effectiveness. In addition, each fund will go across several jurisdictions, being entitled to endorse each one of them.

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23 Source: European and Venture Capital Association guidelines, May 2003
Once an investor intends to enter the fund, procedures must be taken to avoid withdrawal. Moreover, any investor must receive equal treatment from the initiators. The exemption to the rule is only when an investor is grounded in large amounts of funds as compared to the others, but the investment’s peers must clearly know that this situation is undergoing. Other important issue to be assured since the very beginning is how to treat processes of investor’s default.

The fund documentation already described must be available before the first closing with an investor and any amendment must be delivered in equal conditions along the entire stream of participants. Recall that some changes can make an investor no longer eligible to participate in the fund due to legal constraints.

In order to have clear goals since the early stages, initiators of fundraising must establish a period to close the fund which is indexed to a reasonable time after the first closing date.

From the investors’ side, usually intermediates (or gatekeepers) are hired, who are the front face, allow the investors to remain in a private domain, place a consultant role and recommend compelling investment funds. Each intermediate is normally specialized by industry, geography or sort of transaction.

The fundraising activity analysis depends on several forces, not only related to the private equity market itself, but also to the business environment, in terms of entrepreneurship administrative barriers, cultural and sociological factors. Remark that some factors are not easy to measure due to confidential domains and different patterns followed.

Among others, the most relevant issues to address in order to perform a complete analysis are the investment’s flow, the sources of funds, portfolio management team, sizes and stages of corporate investing tissue, the dynamism of stock market (IPOs, growth of capitalization), returns to investors, capital gains taxation, regulation of pension funds, rigidity of labor market, reliability of accounting procedures, macroeconomic situation and perspectives, financing environment and interest rates and bankruptcy procedures.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Effect Description</th>
<th>Fundraising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment flow</td>
<td>Limited flow of capital into the industry limits new concepts development. However, an excess of funds will impose larger prices in the transactions.</td>
<td>Harm-to-Ease</td>
</tr>
<tr>
<td>Sources of funds</td>
<td>Funds are a scarce resource which tends to run out in very little time as long as it is being allocated to the prospective investments. The location, type of entities and their policies are issues to consider when outlining the activity in fundraising. Liquidity constraints will make fresh capital hardly to rise.</td>
<td>Harm-to-Ease</td>
</tr>
<tr>
<td>Portfolio management</td>
<td>The fund management team is a key aspect for the private equity transaction’s success. Therefore, a team must have a good reputation fostered by a good track record of operations, field experience, size of on-going</td>
<td>Ease</td>
</tr>
<tr>
<td>Portfolio, etc.</td>
<td>Each stage of investment has a specific level of risk and investors will allocate their funds regarding the intensity of dealflow and their own profile.</td>
<td>Neutral</td>
</tr>
<tr>
<td>----------------</td>
<td>--------------------------------------------------------------------------------</td>
<td>---------</td>
</tr>
<tr>
<td>Investing stages</td>
<td>A dynamic stock market is a guarantee of easy exit for a private equity operation. In addition, the hotter the stock market, the greater the returns. Recall that the entrepreneurs will also be exposed to effortless extra financing or be able to bring back the company’s control. In case of turbulent times in stock market, the solely exit strategy is the trade sales.</td>
<td>Strongly Ease</td>
</tr>
<tr>
<td>Stock market</td>
<td>The returns solely are a good indicator but they get full empowerment when compared to the other options in the market. Therefore, fundraising will be boosted if the other available investment options are not performing that well or at least in a lower level.</td>
<td>Strongly Ease</td>
</tr>
<tr>
<td>Returns</td>
<td>Government’s policy over taxation on capital gains has deeps effects on the fundraising new commitments. For the investors, it is important to be on the most favorable field in terms of taxes and so any incentives to the private equity market are welcomed.</td>
<td>Strongly Ease</td>
</tr>
<tr>
<td>Capital gains taxes</td>
<td>Pension funds constitute a great vehicle to raise funds given that they usually manage large sums of money. If the regulation allows investing in unquoted companies, the liquidity in the market grows a lot.</td>
<td>Ease</td>
</tr>
<tr>
<td>Pension funds</td>
<td>The rigidity of labor market has effects on the risk of an operation. If an investor will face restrictions to lay-off in case of company’s failure, the exit uncertainties will grow exponentially. Moreover, the birth of new concepts to invest is also negatively affected.</td>
<td>Harm</td>
</tr>
<tr>
<td>Labor market</td>
<td>The market relies on information which is the base of any operation. Good accounting habits and regulations ease the identification of possible deals and imply less time in the respective analysis. Moreover, it will foster an environment of strongly grounded confidence.</td>
<td>Ease</td>
</tr>
<tr>
<td>Accounting procedures</td>
<td>The current situation of a country or region determines the propensity for investors to start new funds. Moreover, the nearby future perspectives can trigger new ventures both in the fundraising side and in the creation of new business concepts/start-ups. However, in a globalized world, this aspect tends to be overcome and retain weak effect because investor can pursue high quality targets and earnings visibilities in other geographies.</td>
<td>Neutral to Ease</td>
</tr>
</tbody>
</table>
Interest rates

Considering asset’s investment and loans as alternatives, the increase of interest rates will lead to the decrease in fundraising due to fierce (and maybe better) funds competition.

Bankruptcy

A private equity investor requires that, in case of the transaction’s failure, it is easy to take the money out and proceed to a new venture. In addition, if any of fund’s peers faces financial troubles, the management team must have simple measures to write that entity off without harming others/fund. This protection can come also from the funds regulation.

Figure 22: Fundraising – Most Relevant Issues

Source: Espírito Santo Capital

The previous stated points are fundamental to define the fundraising environment and can promote or not grounds for more or less activity in the sector of private equity. The following charts summarize the information and current fundraising market situation in Europe, in the last decade.

Figure 23: Fundraising and Private Equity Investments (2000-2001)

Source: EVCA/PEREP Analytics, Yearbook 2010.
As expected, the fundraising activity intensified during the beginning of the decade at times of stable macroeconomic environment. It is notable the sharp increase from €48 million in 2000 to €112 million in 2006, right before the sub-prime crisis took off. The €83 million in 2007 is a prompt answer for the foreseen unstable times (sub-prime crisis started in August 2007) but even with those troubled times, the fundraising activity remained steady throughout 2008 at around €80 million. In 2009, liquidity issues flooded the market and the fundraising activity dropped to €16 million, reaching values as low as in 1997. In terms of investments, they follow the trend of fundraising. Furthermore, it is not normal to completely invest the fund right after the raising process, leaving room to proceed with transactions even if funds are not being lift. That is why in 2003, 2004 and 2009 the investments were superior to funds raised, which is reliable strong sign of turbulence in the financial markets (2003/2004 are recovering times from the dot.com bubble).

More precisely, it is important to note that the fund’s size (at financial close) narrowed down in 2009, with only 2 funds reaching marks above €1 billion, instead of 15 in 2008 or 12 in 2007. Notice that the total values from the two previous charts are different because the last one only includes funds with financial close in each year. Therefore, the number of closes is also a compelling benchmark to highlight the effects of the crisis, given that those 68 funds in 2009 compare to 141 in 2008 and 169 in 2007.

To wrap up, the effects of liquidity and leverage constraints, lower distributions in existing private equity transactions, uncertainty for the future along with a philosophy of “wait and see”, and non-convergence of buyers and sellers’ expectations resulted in a deep decrease in fundraising activity.

Point out also the activity freeze in the entire ranges of fundraising activity. Moreover, buyouts focused funds suffered a huge drop of almost 90% which completely justifies the halted activity.

24 According to the EVCA’s Yearbook of 2002, the funds raised in 1997 were €20mn.
Addressing the activity by type of investor in Europe and individually in each country, it is possible to see that the mechanics change over time and geography.

The main takeaway of the previous chart is that banks, pension funds and government agencies are the most active investors in the market. Remark that almost 10% are still unknown sources of funds which indicate the confidential basis that are still in force when the initiators have to report their sources of money resources.
In perspective, the main type of investors remains the same with the unknown slice still being significant. However, there has been a trade-off between banks and pension funds where the latter led the fundraising force in the recent past with remarkable slices of around 25% in 2005, 2006 and 2008. In 2009 banks assumed the leader position due to an overall volume decrease mostly triggered by a 90% retreat by pension funds whereas banks retain the same level of funds.

In terms of geographies, pension funds led the way in the UK and Italy (here along with funds of funds) while banks support the market in Portugal and Germany. It is worth to observe that in Portugal the banking system has an overwhelming position of 80% of the fundraising market.
Still related to geographies, in terms of European funds input, the most active country is the UK by far with almost €6.5 billion, as compared to other relevant investment peers, such as France, Switzerland and Germany which lie around €1-2billion. In addition, UK and Italy raise funds focused on the top end market (average fund size of circa €450 million) whereas France, Switzerland and Germany are still struggling in the lower-to-mid levels (average fund size of circa €100 million).

![Figure 29: Fundraising – sources and management teams location (2009)](source: EVCA/PEREP Analytics, Yearbook 2010)

Addressing the relation between the sources of funds and the location of the management private equity firms, it is relevant to observe that the US contributes €2billion of foreign domestic investment in Europe. However, in 2009, there were €5.4 billion raised in UK with only 50% of domestic input while the remainder was due to other geographies (European or not). Remark also that both in France and Italy significant amounts were raised (around €2 billion) followed by Portugal, Germany and Switzerland (around €1 billion). In an overall basis, the European companies introduced €4 billion in the market.

9. **PRIVATE EQUITY and FUNDRAISING IN PORTUGAL**

The private equity activity in Portugal is regulated by the Decree-Law 375/2007 from November 8th. This document recognizes capital risk as “term acquisitions of share capital and other equity instruments in companies with high development potential aiming to benefit from the respective valorization.”The supervision and regulation of the private equity actions in Portugal is committed to the Portuguese Securities Market Commission, “CMVM” (“Comissão do Mercado de Valores Mobiliários”).

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25 Source: Decree-Law 375/2007 November 8th, article 2;
To invest under a private equity structure, investors must follow on a capital risk society (SCR), fund (FCR) or investor (ICR), in which FCRs are managed by SCRs and ICRs only have a sole shareholder. In case of large investments, it is normal to create syndicates for the operations, aggregating the capital amounts to use and sharing the risk among the participants.

To provide a historical overview, private equity arose in Portugal back in 1986, experiencing rapid growth in the very first years, to become a mature market in the top 4 of 2009’s fundraisers in Europe. The government has been developing several improvements to foster investment by private equity, evolving the existing decree-laws which stabilized in the one currently in force. Some measures taken are the extension to 10 years of the period to invest, easing the bureaucracy of funds’ registration and tax exemptions for capital income or investments with a life older than one year (excluding non-resident entities). Notice that over the last years, some of these fiscal incentives have been written off to respond to public financial difficulties. Generally, from a macroeconomic perspective, Portugal is seen as a country with a favorable fiscal and legal environment for private equity, where both government and private operators are willing to invest.

The following chart summarizes the figures of fundraising, investments, divestments and portfolios under management in Portugal since 2000.

![Figure 30: Private Equity in Portugal (2000 – 2010)](image.png)

*Source: EVCA/PEREP Analytics, Yearbook 2002-2010.*

The general trend is an enlargement in terms of capital involved in private equity in Portugal. In addition, in terms of GDP, the private equity industry has been gaining share, from 0.10% in early decade to almost 0.20% in 2009, revealing a high propensity for this type of investments within Portugal.

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26 Figures of “Portfolio at cost” not disclosed in 2008 and 2009.
In 2007, there were €767 million under portfolio management in Portugal. Moreover, the funds raised had a peak also in 2007 with almost € 300 million resulting in maximum investments in 2008 with the same value. The divestments have a stable behavior by following the same trend of the investment, where the highest values were in 2005 and 2008 with € 177 million and € 136 million, respectively.

The sharp increase of funds for private equity in 2009 is due to the governmental program COMPETE which released a credit line to foster innovation, growth and internationalization of the small to mid cap companies (SMEs)\textsuperscript{27}. Capital is available under FCR, which will manage investments according COMPETE’s directives.

Other sources of capital in Portugal are mainly banks, with overwhelming slices of the total funds raised. However, along with government agencies, corporate investors and family offices are growing in terms of relevance in the fundraising process.

Regarding the segments, funds are typically raised for later stage deals, mostly buyouts but a large percentage as generalists. The early stage still remains quite weak, especially due to the fact that COMPETE does not cover this segment. Furthermore, traditionally the early stage focused on innovation and high technologies, which are only evolving now and starting to be spotted by private equities along with sectors as energy and industrial services.

To wrap-up, the fundraising activity stabilized in Portugal during the period from 2007 to 2009, meaning that funds under portfolio management increased, giving scale relevance to the private equity industry.

10. CASE STUDY: WINDWAY SGPS, S.A.– START UP COMPANY FOR WIND FARMS

The Espírito Santo Infrastructures Fund I (ESIF) led the process of creating Windway SGPS S.A., in a joint venture with the Meneses Group (MG), an industrial partner expert in managing energy projects, among other areas. Being the financial arm within the project sponsors, ESIF is a €96 million private equity fund managed by Espírito Santo Capital (ESK) and dedicated to investments in infrastructures of transport, energy or social/government institutions across Europe (EU and non-EU countries).

\textsuperscript{27} Source: www.pofc.qren.pt
Windway was incepted in January 2009 to invest in wind power generation on geographies as Iberia and East Europe, having a shareholder structure of 60% held by ESIF/Espírito Santo Capital and 40% by the Meneses Group. In addition, an agreement was established to regulate the governance model, functions of each side, targeted returns and other type of interest safeguards. There is an important driver of the venture which was the land rights that MG acquired and its expertise in managing the wind farm’s licensing process. However, ESK brought the financial framework know-how (including mandatory project finance skills of concession models) with vast track record in this field, risk assessment and management, and negotiation experience with banks, insurance companies and EPC vehicles (engineering, processes and components). Last but not the least, it is very important to define efficient corporate governance rules that foster healthy business environment, and in which the private equity partner assume a relevant role based on other long term relationships still existing in the market.

The current portfolio of Windway includes 4 wind farms with a total capacity of 107 MW divided into 23MW on operation in Portugal and 84MW under licensing in Poland. Moreover, the company expects to invest €160 millions until the end of 2012.

Addressing the wind farms market, the entry process can be through a public bidding over licenses or by buying it in the secondary market. Afterwards, the most important milestones are the rights in the field (reached in partnership with landlords either in rent or profit sharing basis) and the operation licensing of the wind farm.

The so-called São Macário II wind farm is the very first project materialized by Windway, having the following features:

<table>
<thead>
<tr>
<th>SÃO MACÁRIO WIND FARM - OVERVIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Location</strong></td>
</tr>
<tr>
<td><strong>Capacity</strong></td>
</tr>
<tr>
<td><strong>Forecasted Annual Production</strong></td>
</tr>
<tr>
<td><strong>Investment</strong></td>
</tr>
<tr>
<td><strong>Technology</strong></td>
</tr>
<tr>
<td><strong>Sustainability</strong></td>
</tr>
</tbody>
</table>

**Figure 31: São Macário II Windfarm (North of Portugal)**

As already stated, the private equity mission in these projects is to define a financial framework under a set of assumptions, working to identify the risks and mitigating them as much as possible. Therefore, aside from the technical inputs, there are a lot of scenarios to work on and create turnkey future procedures to avoid vagueness. The fundamental assumption is the number of wind hours and probability of their occurrence. For instance, a scenario called P90 has 90% odds of reaching annual forecasted production (or 10% odds of not reaching annual forecasted production). The other cases commonly used are the P50 and P75.
The following chart presents the key business plan drivers for São Macário II:

<table>
<thead>
<tr>
<th>Driver</th>
<th>Assumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wind Hours</td>
<td>P50 average hours of 2,500</td>
</tr>
<tr>
<td>Equipment availability</td>
<td>95.90%</td>
</tr>
<tr>
<td>O&amp;M costs</td>
<td>5% of revenues</td>
</tr>
<tr>
<td>Tariff</td>
<td>€70/MWh (15 years), pool price afterwards</td>
</tr>
<tr>
<td>Project life</td>
<td>25 years</td>
</tr>
</tbody>
</table>

**Figure 32: São Macário II Windfarm – Business Drivers**

The next financial step is listing the risks and submit them for a due diligence process. Herein, the private equity assumes a very important role given that it is fundamental to have a team of experts for each area with proven capabilities to identify the major issues. Therefore, the private equity introduces its own experience in the process to choose the right team in the market for the job purpose. For São Macário II, the due diligence team was as follows:

- Financial and Tax: PwC – Price Waterhouse Coopers;
- Insurance and Risk Management: Willis;
- Technical (wind): INEGI – Institute of Mechanical Engineering and Industrial Management;
- Technical (equipment): Multipower;
- Project Finance: ES Investment Banking.

Among the previous entities, the most important is INEGI which brought the technical expertise to study the bulk of wind hours, investment schedule and operational procedures. The remainder entities are crucial to identify the investment risks (and benefits), which are presented next:

- Market Risk: sector completely isolated from the current economic turmoil, without demand uncertainties, because injected electricity in the grid is legally entitled to be purchased.
- Management Team: consortium includes members with high influence and knowledge of the renewables market.
- Operating Performance: strong equipment availability (almost 96%) and fair amount of wind hours (P50 net wind 2.500 hours).
- Operational Risk: the project relies on the performance of windmills from NORDEX N90, which are high-efficiency and proper for onshore use. A mitigant is necessary in order to prevent future unexpected costs. Therefore, a conservative estimate of O&M costs was done.
- Financing Risk: the comfort letters from banks are given upfront with the valuation model approved. Further renegotiations are not expected to occur given the tight credit markets.
- Tariff Risk: legally guaranteed for the first 15 years for the predicted level of production (70€/MWh). If this level is surpassed, the pool tariff subjected to market
demand/supply rules will be applied earlier on. It is normal to enter the pool phase by the 12-13th year (60-65€/MWh).

- **Construction Risks:** EPC companies will provide turnkey services with fixed prices, assuming entirely the risks. This contract structure imposes a premium over a base case where risks shall be shared by service renderers and projects owners.
- **Force of Majeure Risks:** covered by insurance.

From a perspective of value creation, it only occurs in the very beginning during the process of structuring the deal because all the variables are locked under agreements (with tools as cash and time measures) yielding a stable scenario for the project owner. The only non-controllable issue, which will impact on revenue stream, is whether the wind will blow.

Along with the process of analyzing the entry in an infrastructures project, the private equity starts readily to define the exit procedures and target returns. In fact, for São Macário II, an IRR of 13% within 25 years lifetime is targeted. However, given the capital risk funds legal context, which limits their life time to 10 years, it is completely impossible to remain in the project for its entire life span. In São Macário, Windway expected to exit around year 5 or 6, depending on both the renewables and financial markets. The main driver will be to find the right conditions in the market, without surpassing the forecasted years to exit. If any problem happens, the fund can ask for up to a 2-year prorogation with a proper justification.

The most important benefit introduced by the private equity is to make it possible for the renewables market to evolve in hard times of market liquidity. Moreover, as compared to a typical project finance framework, private equity is the solution for the lack of availability of bank sourced debt, making it possible for these projects to go on without directly depending on the banking system.

Moreover, the private equity can be seen as a partner, not only of the industrial company (MG), but also of the Portuguese Government because it enables the diversification of energy sources, establishing the steps to reduce dependence on foreign energy supplies. Portugal is not self-sufficient in the energy domain (really far from it), but at least this sort of venture is triggering the process of creating national energy sources. Besides, notice that a 3-year start up has created jobs, tax revenues and is already prepared for internationalization.

To conclude, it is important to observe that the infrastructures’ deals are project finance models but, in the case of São Macário, instead of having regular sponsors, the private equity fund takes part of the process as investor and formulates the financial framework to move the business forward, making it possible to have a turnkey solution (investor plus project finance studies) for any industrial sponsor (as MG). Notice that with a private equity committed, the remainder sponsors are backed by high-end financial skills within the investors’ team.
11. CONCLUSION

Private equity is a truly compelling area because it links the finance domain with entrepreneurial mindsets, yielding a dynamic multi-task working bundle. Moreover, given the current debt crisis times and banking system weaknesses, private equity should be assumed as a solid alternative investment vehicle for those who still have capital available and are willing to engage in equity deals.

Considering the road map outlined in this work project and the summer internship experience in Espírito Santo Capital, the best opportunities available in the market are later stage deals by expansion (organic or internationalization) or by buyouts (including family owned companies’ succession), along with infrastructures/energy deals in the primary market under consortiums or on the secondary market by acquiring existing positions;

In a long run view, the most prospective challenges to reach value added transactions are:

(i) Incrementally intensify a “hands-on” participation in the companies;
(ii) Abolish cultural and organizational barriers to private equity entry in the companies, promoting ongoing improvements of existing and upcoming corporate relationships, especially in mutual interests’ alignment and ease of divestment processes;
(iii) Promote better transparency of the sector (legal pressure, tax implications, accounting regulatory);
(iv) Foster innovation, internationalization and globalization of Portugal-based private equities;
(v) Understand the importance and challenges in emerging markets, and, for Portugal, leverage the prime position for markets as Angola, Mozambique and Brazil (see following figure).

Figure 33: Private Equity – Future Markets
Source: Espírito Santo Bank.

For further research, it would be important to outline an in-depth comparison of early/later stage transactions, study the consequences and opportunities led by first waves of private equity over the second ones, the impact of the current credit risk crisis and further cautions, and finally, the limits and activeness of the private equity sector.
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