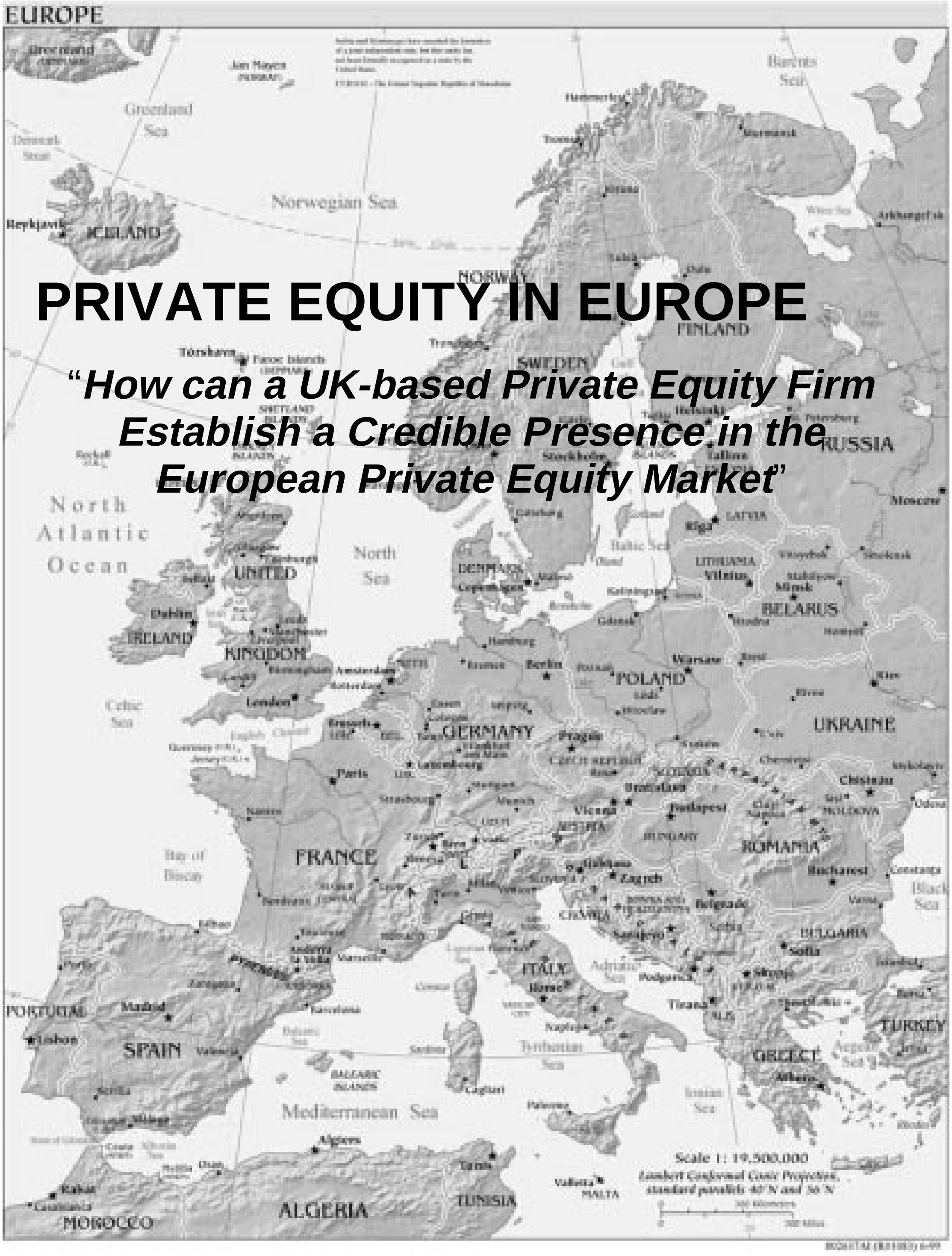
PRIVATE EQUITY IN EUROPE

"How can a UK-based Private Equity Firm Establish a Credible Presence in the European Private Equity Market"



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1. SYNOPSIS

The objective of this thesis is to evaluate the opportunities available to a UK-based Private Equity firm to enter the European Private Equity market.

The firm in question is a wholly-owned subsidiary of a major UK banking group which has itself recently acquired a larger UK-based rival bank and is consequently going through a major review of its own UK and European strategies. The firm was established in 1993 as a development capital startup and quickly established a leading position in its own home market (the Scottish central belt based around Glasgow and Edinburgh). By 1999, the firm had invested nearly £500m and had built an investment portfolio which was valued at some £750m. Along the way, it had made successful exits from certain of its earlier investments and had generated capital gains of nearly £100m, representing a realised Internal Rate of Return of circa 25%. Having started from a base in Edinburgh with six staff, by 1999 the firm had established offices in Glasgow (1994), London (1994) and Birmingham (1996) and had a total staffing complement of some 25 executives.

Having successfully launched itself in the UK, the firm used its parent company's contacts with a major Spanish banking group to establish a relationship with that group's development capital subsidiary in Madrid. This relationship allowed the UK firm to participate in transactions sourced by its Spanish associate and vice versa, giving both firms exposure to each others' markets without the threat of direct competition. Additionally, the firm established a relationship with a major French venture capital group based in Lyons. The nature of this relationship allowed the UK firm to participate in transactions sourced by the French associate, without reciprocal rights being granted to the French.

Initially the firm operated as a captive fund manager, in that all of its investments were financed from funds contributed by its parent. However, during 1998 it negotiated a 3rd-party fund management agreement with a London based "gatekeeper" firm which gave exposure to 3rd-party fund management for the first time. From January 1999 to July 2000 some £85m of 3rd-party funds had been invested alongside the parent bank's own cash.

At the dawn of a new millenium, with a period of success in its domestic market behind it, the firm is now looking to develop its activities in two critical areas:

- Firstly, by leveraging maximum advantage from its successes in managing its parent's money, it is now looking to secure further funds from external sources. The firm is seeking to change its "captive" status towards being "semi-captive" with the ultimate aim of becoming a largely "independent" fund management operation.

- Second, and the focus of this thesis, the firm wishes to expand its operations directly into European markets, where it can build on the valuable experience it has gained over the past five years from its dealings with its European associates in France and Spain.

Consequently, the main focus of this thesis will be to investigate the opportunities that exist for establishing a presence in Europe by trying to identify:

- European countries/regions where the conditions for entry and the competitive environment are favourable

- Appropriate modes of market entry in the region

Accordingly, the thesis will draw on significant elements of the course material covered throughout the MBA programme, including:

- Strategic Management

- International Business Strategy

- Management and Organisational Behaviour

- Marketing Strategy

2. EXECUTIVE SUMMARY

This thesis focuses on the entry strategies available to UK-based Private Equity firms seeking to enter the European market. In order to identify the strategies available, it was necessary to:

- Identify the nature and scale of the Private Equity sector in Europe, including the types of firms that operate in the market and the particular market segments that they target

- Understand the dynamics of the Private Equity sector, in terms of the flow of funds into the industry, the sources from which those funds originate and the key factors that underline successful fund raising

- Understand the relationship between the scale of funds available to individual Private Equity firms, the determinants of fund size, and the impact this has on the market sectors that firms can target

- Understand what factors make individual countries attractive to Private Equity firms, including economic conditions, the existence of suitable legal and fiscal arrangements and the existence of a strong, dynamic entrepreneurial culture

- Evaluate the entry strategies adopted by existing players in the European market, and understand why those strategies were adopted and the reasons for their success or failure.

As a result of the research work carried out, including analysis of statistical data, reading various literature sources and interviewing key executives of Private Equity firms that have already established a presence in Europe, we were able to conclude that:

- The size of investment funds available to a firm has a direct impact on the scale of transactions it can undertake. Firms that have access to large amounts of investment funds can target significantly larger deal sizes where a detailed understanding of the underlying dynamics and management issues facing investee companies is less important than financial engineering skills. On the other hand, firms with smaller funds need to target smaller transactions, where success is based on understanding local market conditions and a willingness to maintain a close involvement with the managers of the companies in which they invest.

- This in turn impacts the entry strategies and organisational structures that firms can adopt. Firms targeting large transactions can maintain small, highly concentrated teams based out of a single office. Firms at the lower end of the deal range need to maintain more complex management and control structures over potentially larger numbers of people located in geographically diverse offices.

- We were also able to establish which countries appeared to offer the most attractive conditions for entry for Private Equity firms. These were countries that had a developed infrastructure, with a core population of strong, owner-managed businesses combined with appropriate legal and fiscal policies encouraging entrepreneurship.

3. INTRODUCTION

Thesis overview

This thesis seeks to answer the question "*How would a UK-based Private Equity firm establish a presence in the European private equity market*?". On the face of it, a simple enough query, but hiding a plethora of challenges and pitfalls that must be negotiated carefully in order to achieve success and avoid failure. The riches that will come with success are potentially great; the price of failure unimaginable.

The various questions that must be asked along the way are several, however out of necessity we shall restrict ourselves to considering certain basic themes, as follows:

- *What countries should we be in?*
- *What sectors in those countries should we target?*
- *What transaction sizes should we look at?*
- *How can we secure investment funds for us to invest in those countries?*
- *How can we beat our competitors in the markets we choose to enter?*
- *What modes of entry are available for new geographic markets, and which should we adopt?*

In considering the answers to these core questions we shall cover many fundamental themes that have been the core of the MBA programme. Subject matter and theories from the following MBA modules will be applied:

- Strategic Management
- International Business Strategy
- Management and Organisational Behaviour
- Marketing Strategy

The thesis will systematically apply various tried and tested analysis tools to enable specific issues to be studied in depth so that sound and reasoned conclusions can be drawn, as follows:

- The Boston Consulting Group Grow/Share matrix
- Ansoff's Product/Market matrix
- The "7 S's" framework

Literature Review and Methodology

The Private Equity sector has been the subject of innumerable books, articles and other publications over the years, most of which focus on a basic statistical analysis of the number and sizes of transactions, sectors, sources of funding and growth potential of private sector companies. Similarly, there are many publications that discuss the pro's and con's of doing business in various countries around the world, as well as text books and publications covering how firms can develop and then manage themselves on an international and ultimately global basis. However, despite the fact that an increasing number of UK, US and European private equity firms are expanding their operations across the European continent, there is little evidence of formal review of their rationale for doing so or of their strategies for entry and the likelihood of success or failure.

Nevertheless, many private equity firms do appear to have established a firm foothold outwith their own domestic markets in Europe. Consequently, a significant element of the review work that has gone into this thesis is based on face to face interviews with a small number of key executives from private equity firms that have established themselves as European players.

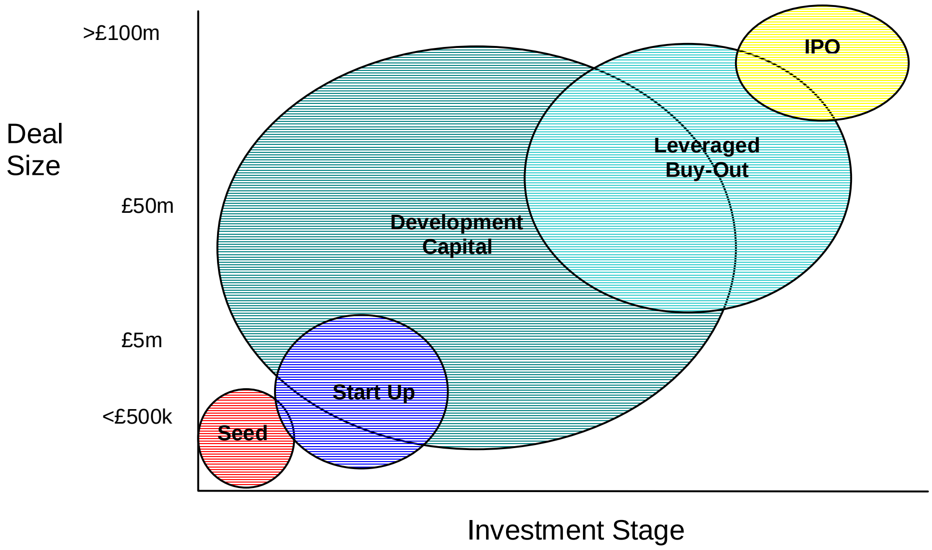
There exist various sources of information specific to the Private Equity industry. The specific sources that have been used in the preparation of this thesis have been:

- The British Venture Capital Association (BVCA) website (www.bvca.co.uk)
- The European Venture Capital Association (EVCA) website (www.evca.com)
- The International Private Equity Network (IPEN) website (www.ipen.com)
- The European Venture Capital Journal, published by the EVCA
- Initiative Europe – Focus Report 2000 – Data Analysis on trends in the European Private Equity
- The Management Buy-out Manual – Ashurst Morris Crisp, edited by Garry Sharp

These sources gave valuable information on trends and attitudes across the Private Equity industry, as well as providing useful and enlightening statistical analysis of various regional and European markets. By interpreting the analyses and comment presented by these publications, we are able to build a picture of the various stages in the Private Equity sector, ranging from small, seed capital and start-up transactions, through to larger-scale development capital, buy-outs and IPO finance[1]. The various deal-size sectors can thus be illustrated as follows:

[1] See index of terms in Appendix A

Diagram 1
Private Equity sectors and typical deal sizes

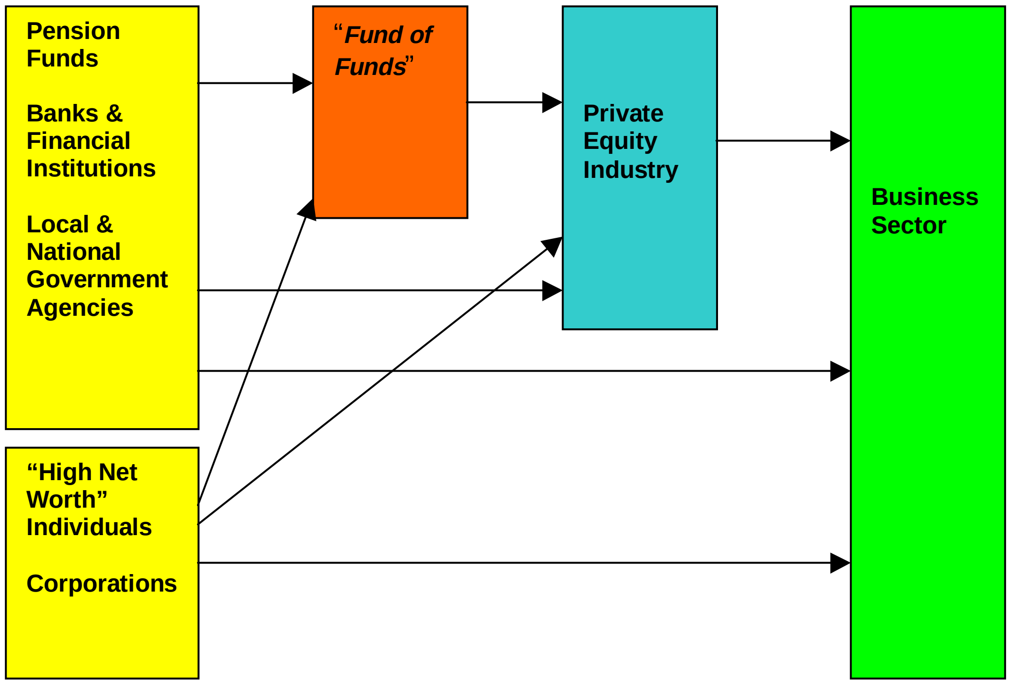


This helps in appreciating how firms tend to specialise at a particular stage of the deal-size spectrum. For example, it is rare for a firm specialising in seed capital and start-up finance to be active in the higher-value development capital and leveraged buy-out markets. This is because the skills required at the seed and start-up phases are significantly different to those required in large buy-outs and IPO's. At the same time, the amount of funds required to be able to do transactions at either end of the spectrum is also very different, with the result that firms are potentially constrained by the amount of funds they are able to raise.

Equally important to an understanding of the Private Equity industry is an appreciation of the flow of funds into the industry from the various sources that exist, ranging from Pension Funds and Financial Institutions, Government and Local Authority industrial development budgets

The following diagram illustrates the various participants in the Private Equity industry, and the part they play in channelling investment funds into the business sector:

Diagram 2
Flow of Funds via the Private Equity Sector



Additionally, various government, general business press and academic publications proved to be invaluable sources of information on issues specifically connected with the European Private Equity industry or generally with the economies and structures of various European countries:

- The Financial Times
- Harvard Business School Review
- Price Waterhouse and KPMG guides "*How to do business in*….."
- The CIA World Factbook (www.odci.gov/cia/publications/factbook)
- The Translink Deal Review 1999

These publications gave detailed analysis of the various European economies, including levels of transactions in the Private Equity market, growth levels and other macroeconomic information, together with details of legal and fiscal structures. All of this helped to put together a detailed understanding of how well-adapted the economies were to the needs and expectations of the Private Equity industry, and allowed us to assess whether Private Equity firms would find attractive opportunities in each of the countries which were analysed.

Various textbooks and publications on general business subject matter as published by business schools and universities made a key contribution to the construction of the argument in this thesis:

- The various topic workbooks published by the University of Wales/Manchester Business School Institute for Financial Management
- Charles W Hill's "International Business"
- Robert M Grant's "Contemporary Strategy Analysis"

These publications enabled us to adopt proven and documented techniques in order to give substance and weight to the arguments and conclusions drawn by our analysis.

Various specific academic publications also provided valuable reading material giving background information on the workings of the Private Equity industry, both in Europe and by comparison with the more well-developed US model:

- Paul A Gompers, "*Contracting and Control in Venture Capital*", Harvard Business Review 9-298-067, February 1998
- Reyner Indahl & Eric Zinterhofer, "*A Note on European Private Equity*", Harvard Business Review 9-299-017, October 1998
- Paul A Gompers & Josh Lerner, "*What Drives Venture Capital Fundraising*", Harvard Business Review, August 1998
- Paul A Gompers & Josh Lerner, "*A Note on the Venture Capital Industry*", Harvard Business Review 9-295-065, November 1994
- Mike Wright & Andrew Burrows, "*Management Buy-outs Quarterly Review – Spring 2000*", The Centre for Management Buy-out Research, University of Nottingham Business School

Finally, this thesis has relied heavily on the individual contributions, in various publications, of Michael E Porter.

Countries

Europe is a vast region, with a turbulent past and including a variety of nations, cultures, languages, currencies, religions and political ideologies. As such, it presents an ever-shifting sand upon which companies will undoubtedly find it hard to lay solid foundations for future success. Consequently great care is required in choosing which European markets to enter.

For the purposes of this thesis, we have chosen to focus on the countries in Europe where the underlying business culture and political and economic systems most closely match those of the UK. The most obvious region is the European Union, where there have been strident efforts made over the past few decades to harmonise the economies of the member states. We have further narrowed down our focus to those countries that entered the Single European Currency on 1 January 1999, as follows:

- Austria
- Benelux Countries (Belgium, The Netherlands and Luxembourg)
- Finland
- France
- Germany
- Ireland
- Itally
- Portugal
- Spain

The limitations of restricting the analysis to these countries is fully recognised; there is strong evidence of opportunities for Private Equity firms in other Western European nations, such as Sweden, Denmark, Switzerland and Norway. Similarly, there are opportunities further afield in other European nations such as Greece and Turkey as well as in the developing independent nations of the former Soviet Union and the Eastern Bloc countries.

However, to have analysed all of these regions in full would have been a major task beyond the time constraints of this thesis. Therefore the region chosen for review presents a sensible and sufficiently challenging framework for our purposes.

Competitors

In any situation, a business needs to be aware of the activities of its competitors, both current and potential and in both its existing markets and those markets into which it seeks to enter.

This thesis assumes that the organisation in question has a good understanding of its existing competitors in its home market and therefore concentrates at looking at the activities of potential competitors in the markets it seeks to enter.

The sources of information on competitors is extensive, including a variety of business publications and the trade associations to which the large majority of Private Equity firms belong, these being the British and European Venture Capital Associations (BVCA and EVCA). These sources have been extensively investigated in the preparation of this thesis, but have been backed up by face-to-face interviews with key executives of certain organisations.

The research carried out has been intended to identify:

- *Which Private Equity firms have successfully made inroads to the European market?*
- *In which countries have they established themselves*
- *What types of businesses and size of transaction are they targeting?*
- *What entry modes have they chosen to adopt, and why?*

The Challenge

The challenge to any commercial organisation seeking to grow its business is manifold, involving the successful recognition, analysis and resolution of a broad spectrum of issues including:

- its current position within its industry
- the options for growth that present themselves and an understanding of the risks and implications involved in each
- the activities, successes and failures of its existing and potential competitors and the lessons that can be learned from their experiences
- the key factors affecting its current market, and the factors that may come to bear on its intended markets

Key to successfully tackling such issues is to recognise the existence of tried and tested tools and techniques that can be applied. The development of the academic analysis of various business environments is such that there are many techniques that could be so applied. Given the necessarily restricted scope of this thesis, only a few of the multitude of techniques has been applied here, and these are as follows:

- The Boston Consulting Group Grow/Share Matrix is useful in giving an understanding of the current position by analysing the growth rate of the market and the competitive position of the firm. This helps in determining initially what options are available to the firm to grow.

- The Ansoff Product/Market Matrix is useful in allowing us to examine various growth opportunities for the firm and giving guidance as to how these might best be tackled.

- Finally, having analysed current position, opportunities for growth and their implications, the “7 S’s” framework allows us to examine in specific terms how the firm might put into effect the options for growth and development that it has chosen.

4. CONCLUSIONS

Entry Modes

The conclusions reached by this thesis are that there are essentially two generic market entry modes that can be adopted by a UK Private Equity team entering the European market, which are as follows:

- The "parachute" approach — The parachute approach is where a firm does not have a direct presence in a European country, but instead chooses to cultivate contacts that will introduce it to deals and then execute those transactions utilising resources from a single office, the location of which is not seen to be important to its ability to penetrate the market.

- Direct entry modes — Direct entry involves two further options, either:
  (a) placing teams on the ground in specific geographic centres tasked with researching the local market and transacting deals as they are unsurfaced; or
  (b) joint-venturing with local partners in order to gain access to deals that they uncover

These generic entry strategies can be also be described in terms of multi-domestic, inernational or global strategies as follows:

- The "parachute" approach represents a strategy that is international in nature in that it implies that demand for large scale equity finance is homogenous across countries and that the same basic approaches to market, style and delivery can be applied across geographic boundaries and national and regional cultures. If the strategy were to be applied across an even wider geographical area, covering regions outwith the European continent then it could be more accurately described as a global strategy. However, the extent to which this can be explained falls outwith the scope of this thesis.

- On the other hand, the direct entry modes involving the employment of local teams and joint venturing imply a multi-domestic strategy that recognises that different regions demand an approach, style and delivery that is sympathetic to local norms.

The choice of entry strategy is determined by several factors that are themselves interlinked:

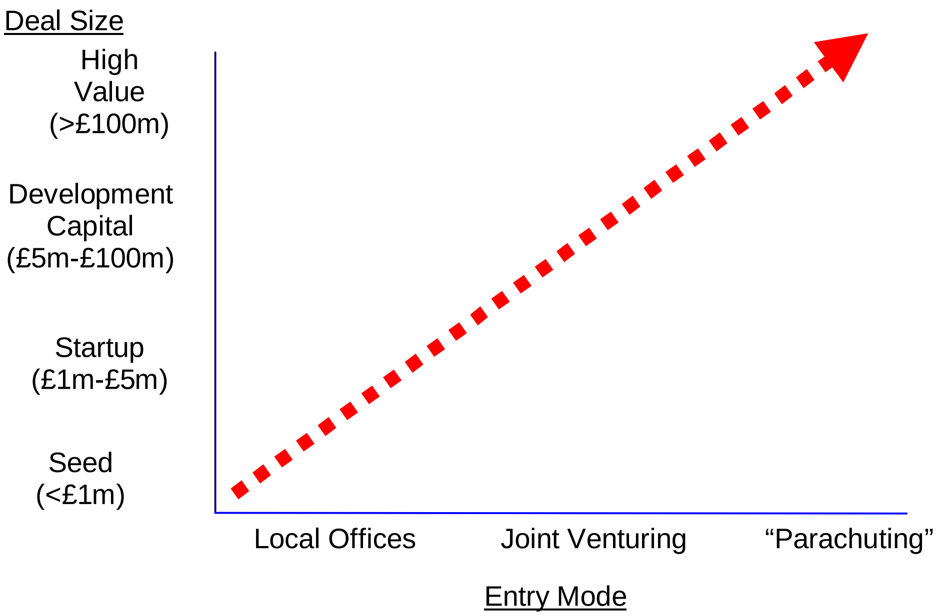
- Target deal size — There is a parallel between the sizes of deals targeted by specific firms and the entry strategies they choose to adopt, as follows:

  (a) in the high-value end of the market (£100m plus deal size), which typically involves large leveraged buy-outs, public-to-private and Buy & Build transactions, there is a perception that the key factor in being able to win transactions is the ability to do the deal. That is, the Private Equity firm must have sufficiently large funds available combined with a demonstrable track record in doing such deals. In this sector of the market, the geographic location of the firm is seen to be irrelevant, both the seller of the business(es) and the management teams involved in the transaction are solely concerned with the firm's ability to do the deal.

  (b) At the smaller end of the market, particularly at the seed capital and startup phases, a local presence is seen to be a crucial factor in winning transactions. At this end of the market, local management teams and business introducers are potentially more parochial in their approach and prefer to deal with an equity investor that is close to the ground, has an understanding of the local market and can play a key role in the development of the business.

  Consequently, the generic strategies can be illustrated as follows:

Diagram 3
Generic Entry Modes Determined By Target Deal Size



At the higher range of the market, from the mid-market development capital sector (deal sizes from £20m to £100m) and into the high-value end of the market, there may be a mix of strategies depending on the history of the particular firm. However, broadly speaking the above illustration sums up the generic strategies succinctly.

- Amount of funds available

Inextricably linked to the sizes of deals that a firm can effectively target is the amount of funds it has available for investment. Clearly, it is not practical for a Private Equity firm with a £150m fund to invest in a single transaction, since a critical element of any fund management remit is to spread a portfolio over a number of investments. Typically, firms that have raised funds of such a size would seek to invest in blocks of £2m to £5m, such that its portfolio would be spread across some 20 to 30 transactions involving deal sizes in the lower mid-market range. On the other hand, firms with larger funds would seek to target the same number of deals, but each of a higher value.

- Track Record

A critical factor behind the amount of funds that a firm can raise is its track record. It is not unusual to see Private Equity firms that initially raise small funds to invest in small transactions begin to move up the deal size range once they have established a track record and begin to raise larger amounts of funds from satisfied previous investors and more cautious new ones.

Target Countries

The research carried out in Section 5 leads us to conclude that the European countries we have analysed can be broadly split ot two categories:

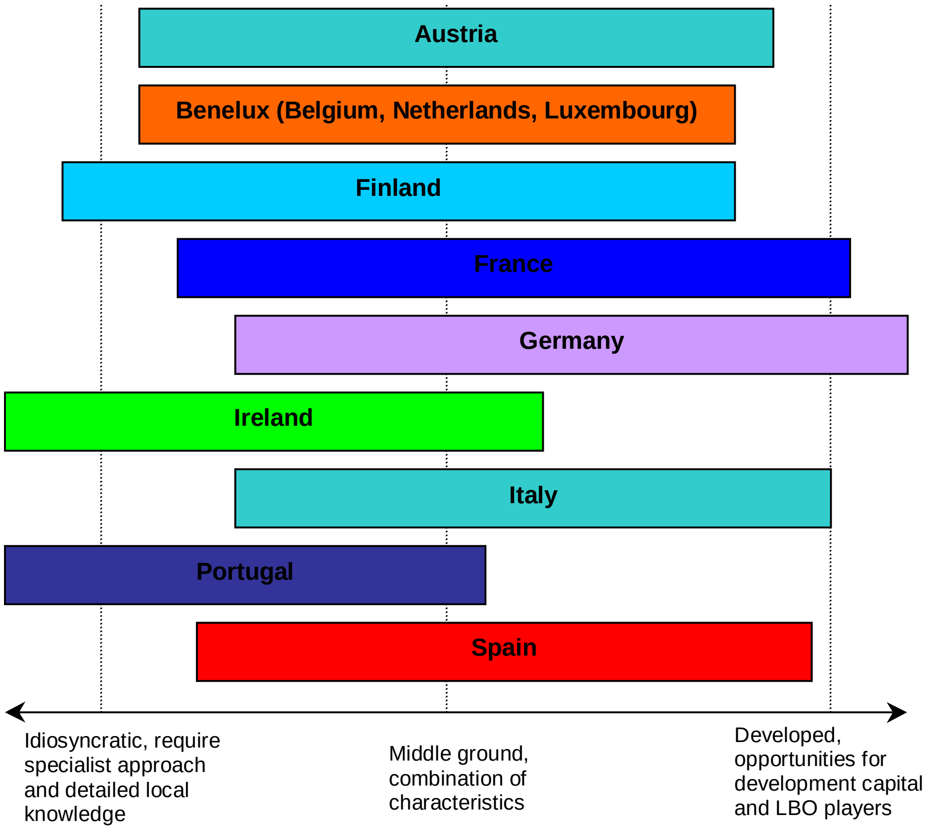
- Those where the economy is well developed, offering opportunities for larger transactions in the development capital and large buy-out segments of the Private Equity industry;

- Those where the economy lags some way behind the rest of Europe and where there are some idiosyncrasies that require a specialist approach combined with detailed local knowledge.

Of course, there are circumstances in which a country displays a combination of characteristics, depending on the particular industrial and commercial sectors targeted. For example, although Germany can be seen as a developed industrial nation where there are opportunities in the middle market, there is also the existence of a promising high-tech industry, where a more focused approach is appropriate.

The extent to which individual countries fall within the spectrum can be illustrated by the following diagram which is based on the findings presented in Section 5:

Diagram 4
Country Characteristics



This suggests that France, Germany, Italy and Spain present the most favourable markets for entry, given that they exhibit a broad range of characteristics and therefore opportunities for Private Equity players at all points in the industry spectrum. Ireland and Portugal, given their small size, present limited opportunities for all but the most specialised of operators, while the other countries (Finland, Benelux and Austria) remain somewhere in between. This would appear to reflect the evidence available; that most Private Equity firms appear to be concentrating their efforts in France, Germany, Italy and Spain where there are seen to be the most significant opportunities for the sector.

Implementation Framework

The choice of entry mode and the target countries selected will have direct consequences for how the firm should structure itself to ensure a successful outcome. This will be explained in detail in Chapter 7, in terms of the “7 S’s” framework, but can be summarised as follows:

The "7 S's"

- Strategy
- Structure
- Style
- Shared Vision
- Skill
- Systems
- Staff

Clearly, the choice of entry mode has important implications for all of these key factors of delivery. For example, the key skills required to be in evidence in the people employed by a player in the high-value end of the market will be significantly different to those required in teams focusing on small, local deals. Similarly, the management structure required for a dispersed team of individuals of different nationalities will be very different to that required for a single team based in the same office.

5. EUROPEAN COUNTRIES

Introduction

Indahl & Zinterhofer[2] conclude that the two most pressing concerns facing the European Private Equity industry are as follows:

- The market is becoming more competitive, especially in the UK. This means that Private Equity firms need to develop their skills beyond financial engineering so that they can add value to their portfolios by helping their investee companies with their operations. This requires a detailed understanding of industrial sectors and geographic markets as well as financial expertise.

- The levels of competition now being seen in the UK market will force Private Equity firms to look to other markets to sustain their growth. *Indahl & Zinterhofer* suggest that many firms are increasingly turning towards the European market, which appears to offer attractive opportunities similar to the conditions that existed in the UK during the heyday of the UK Private Equity sector of the mid to late 1980's.

The key issue then is to identify which European markets exhibit the more favourable conditions for entry. Companies looking expand into foreign markets face a variety of risks, as follows:

- Political Risk — The politics of a particular nation can present challenging scenarios such as the unexpected nationalisation of industries and changes to corporate and fiscal regulations and policy which can adversely affect the value of investments. Private Equity firms, as with all other profit-seeking entities, need to be aware of and evaluate these risks before parting with their cash.

- Economic Risk — As the world economy becomes ever more interlinked, it is important to be aware of the state of a particular economy in relation to others and its potential for growth (or collapse).

- Financial Risk — Financial risk relates to the individual circumstances of each individual transaction that a Private Equity firm undertakes, and involves ensuring that the acquired business is capable of

[2] Reyner Indahl & Eric Zinterhofer, "*A Note on European Private Equity*", Harvard Business School 1998

meeting its financial targets in the long run. Such risks are commonly fully addressed as part of the "due diligence" process.

- Culture Risk — It is important to be aware of differing cultural norms when investing outside one's domestic market. This can have an impact of negotiating styles, attitudes, management styles and a range of other factors.

- Currency Risk — Finally, regardless of whether a particular investment is performing well in its home market, its value can be dramatically affected by fluctations of the region's currency compared with the investor's domestic currency.

In deciding which European countries to evaluate, it therefore seems sensible to restrict the evaluation to include countries where these risks appear to be less threatening. Accordingly, this thesis includes those countries that are part of the European Union and have participated in the launch of the Euro currency, on the basis that::

- Political risk is mitigated by the fact that each country has signed up to the various European trade and legal harmonisation agreements.

- Economic risk is mitigated to some extent by the fiscal and economic structures that European Union nations have had to put in place in order to qualify for participation in the Euro.

- Cultural risk is becoming less of an issue, to some extent driven by legal harmonisation, although there remains a need to be wary of potential problems. As Dr Paul Whitney, chairman of Parallel Ventures Managers[3] says "*all the Europeans generally live up to their stereotypes and it's useful to be aware of that*".

- Finally, currency risk is mitigated to the extent that the currencies of all the Euro-participating nations are now pegged at predetermined levels. There remains the risk of fluctuation in the Sterling value of investments denominated in Euros for UK firms, but this will be addressed should the UK eventually join the other Euro countries in the single-currency market (although this must remain in some doubt now that Denmark has rejected the adoption of the Euro).

[3] See Section 6 – Private Equity Players (Parallel Ventures Managers)

Europe Overview

Before going on to look at each of the European countries included in our analysis, it is useful to have some background information on the levels of transactions taking place across the region. Table A in Appendix B shows information extracted from *The Translink Deal Review 1999*[4]. This publication focuses on cross-border Mergers and Acquisitions, including transactions undertaken by Venture Capital funds, Investment companies and other financial buyers. The data provided is useful for analysing the number of transactions that could be of interest to financial buyers (such as private Equity firms), thereby giving some indication of the potential size of the market that such firms could target.

From this, we can highlight certain interesting facts:

- The most acquisitive countries were Germany, Holland and France, which together accounted for some 71% of the activity, suggesting that firms in these countries are most active and a potential source of exit opportunities for Private Equity firms looking to realise their investments.

- On the other hand, firms in these countries are also a potentially significant competitive threat to Private Equity firms seeking to buy businesses.

- France is by far the most targeted country, with Germany, Spain and Italy following some way behind. This suggests a potentially rich source of acquisition targets in France.

- Across Europe, the number of transactions undertaken by Private Equity/Investment companies represents just 9% of the total. This could be interpreted to mean either that Private Equity firms are failing to penetrate the market, or that industrial buyers are willing to pay more for companies than financial buyers. The latter could be important for Private Equity firms when seeking potential exit opportunities.

- Of the transactions undertaken by Private Equity/Investment companies, the most targeted countries were France, Germany, Spain and Italy, suggesting that these are the regions in which such firms are concentrating their efforts.

[4] Translink is an independent partnership specialising in Mergers & Acquisitions (M&A), based in Switzerland. Its publication analyses cross-border M&A activity, including transactions by financial buyers.

As far as the overall Private Equity market in Europe is concerned, Initiative Europe[5] has produced interesting statistics highlighting trends in Private Equity market segments, which can be summarised as follows:

- The relative significance of the buyout market is declining (from 42% by volume in the first half of 1999 to 25% in the first half of 2000)

- Conversely, the relative significance of the early stage market is increasing (34% of all Private Equity transactions in the first half of 2000, up 14% from the equivalent period in 1999). This is probably due to the increased popularity of technology startups, which have been the subject of significant interest over the past 12 months.

Table B in Appendix B summarises key economic and social information for each of the European countries considered in this thesis, while each country is considered individually in the sections that follow.

Austria

Background: Once the center of power for the large Austro-Hungarian Empire, Austria was reduced to a small republic after its defeat in World War I. Following annexation by Nazi Germany in 1938 and subsequent occupation by the victorious Allies, Austria's 1955 State Treaty declared the country "permanently neutral" as a condition of Soviet military withdrawal. Neutrality, once ingrained as part of the Austrian cultural identity, has been called into question since the Soviet collapse and Austria's increasingly prominent role in European affairs. A prosperous country, Austria joined the European Union in 1995 and the euro monetary system in 1999.

Economy - overview: Austria with its well-developed market economy and high standard of living is closely tied to other EU economies, especially Germany's. Membership in the EU has drawn an influx of foreign investors attracted by Austria's access to the single European market. Through privatization efforts, the 1996-98 budget consolidation programs, and austerity measures, Austria has brought its total public sector deficit down to 2.1% of GDP in 1999 and public debt - at 63.1% of GDP in 1998 - more or less in line with the 60% of GDP required by the EMU's Maastricht criteria. Cuts mainly have affected the civil service and Austria's generous social benefit system, the two major causes of the government's deficit. To meet increased competition from both EU and Central European countries, Austria will need to emphasize knowledge-based sectors of the economy and deregulate the service sector. Growth, which slowed to 2.0% in 1999, probably will rebound to 2.8% in both 2000 and 2001.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

Austria has recently hit the headlines over the increasing power of its extreme-right-wing Freedom Party (FPO) headed by Jörg Heider and has been threatened with isolation from the European Union over some of its right-wing policies.

Despite its credible economic performance and evident potential, Austria has not attracted much direct interest from Private Equity firms. This could be either because of concerns over the political direction of the country or, more likely, the fact that the

[5] Initiative Europe – *Focus Report, July 2000* – Data Analysis of Trends in European Private Equity

nation's economy is so closely linked to that of Germany. Given the cultural and economic ties between the two nations, it is likely that a Private Equity firm could satisfactorily exploit potential opportunities in Austria via a vase in its bigger and more economically attractive neighbour.

Benelux Countries

Background: Belgium became independent from the Netherlands in 1830 and was occupied by Germany during World Wars I and II. It has prospered in the past half century as a modern, technologically advanced European state and member of NATO and the EU. The Netherlands remained neutral in World War I but suffered a brutal invasion and occupation by Germany in World War II. A modern, industrialized nation, the Netherlands is also a large exporter of agricultural products. Founded in 963, Luxembourg became a grand duchy in 1815 and an independent state under the Netherlands. It lost more than half of its territory to Belgium in 1839, but gained a larger measure of autonomy. Full independence was attained in 1867. Overrun by Germany in both World Wars, it ended its neutrality in 1948 when it entered into the Benelux Customs Union

Economy - overview: Belgium has a modern private enterprise economy which capitalises on its central geographic location, highly developed transport network, and diversified industrial and commercial base. Industry is concentrated mainly in the populous Flemish area in the north, although the government is encouraging investment in the southern region of Wallonia. The Netherlands successfully addressed the issue of public finances and stagnating job growth long before its European partners. This has helped cushion the economy from a slowdown in the euro area. Strong 3.8% GDP growth in 1998 was followed by an only slightly lower 3.4% expansion in 1999. The outlook remains favorable, with real GDP growth in 2000 projected at 3.25%, along with a small budget surplus. Luxembourg is a stable, high-income economy that features moderate growth, low inflation, and low unemployment. The industrial sector, until recently dominated by steel, has become increasingly more diversified to include chemicals, rubber, and other products. During the past decades, growth in the financial sector has more than compensated for the decline in steel. Services, especially banking, account for a growing proportion of the economy.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

The Benelux triumverate forms an important gateway into Europe, physically and financially, occupying as it does the pivotal point between the key economies of the UK, France and Germany. Brussels is the headquarters of the European Union agencies and of the European Parliament and as such is an important powerhouse in all things European. Holland is the most significant financial centre of the three countries, reflecting its international trading history as an imperial power that rivalled that of England at its height. Perhaps for this reason Holland has developed a very strong local Private Equity industry and financial services sector, which controls much of the financial activity in the region and beyond which makes it a very difficult market to enter.

One of the interviewees in section 6 reports that he has "*never seen so many crooks as in Belgium*", adding some fuel to rumours of financial and political irregularities in the region that the European Union is particularly keen to address.

Finland

Background: Ruled by Sweden from the 12th to the 19th centuries and by Russia from 1809, Finland finally won its independence in 1917. During World War II, it was able to successfully defend its freedom and fend off invasions by the Soviet Union and Germany. In the subsequent half century, the Finns have made a remarkable transformation from a farm/forest economy to a diversified modern industrial economy; per capita income is now on par with Western Europe. As a member of the European Union, Finland was the only Nordic state to join the euro system at its initiation in January 1999.

Economy - overview: Finland has a highly industrialized, largely free-market economy, with per capita output roughly that of the UK, France, Germany, and Italy. Its key economic sector is manufacturing - principally the wood, metals, engineering, telecommunications, and electronics industries. Trade is important, with exports equaling more than one-third of GDP. Except for timber and several minerals, Finland depends on imports of raw materials, energy, and some components for manufactured goods. Because of the climate, agricultural development is limited to maintaining self-sufficiency in basic products. Forestry, an important export earner, provides a secondary occupation for the rural population. The economy has come back from the recession of 1990-92, which had been caused by economic overheating, depressed foreign markets, and the dismantling of the barter system between Finland and the former Soviet Union. Rapidly increasing integration with Western Europe - Finland was one of the 11 countries joining the euro monetary system (EMU) on 1 January 1999 - will dominate the economic picture over the next several years. Growth in 2000 will probably be at the same level as in 1999, enough to continue the decline in unemployment from its current high level.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

Finland's is a very small economy with a population of a mere 5m which perhaps explains why it has attracted little interest from the Private Equity industry to date, although it has a satisfactory GDP growth rate of 3.5% (against 1.9% in the UK) and a healthy per capita GDP figure. Its geographic location, occupying a peninsular to the North-West of Russia also makes it a seemingly remote and obscure location for UK investors.

France

Background: Although ultimately a victor in World Wars I and II, France suffered extensive losses in its empire, wealth, manpower, and rank as a dominant nation-state. Since 1958, it has constructed a presidential democracy resistant to the instabilities experienced in earlier parliamentary democracies. In recent years, its reconciliation and cooperation with Germany have proved central to the economic integration of Europe, including the advent of the euro in January 1999. Today, France is at the forefront of European states seeking to exploit the momentum of monetary union to advance the creation of a more unified and capable European defense and security apparatus.

Economy - overview: France's economy combines modern capitalistic methods with extensive, but declining, government intervention. The government retains considerable influence over key segments of each sector, with majority ownership of railway, electricity, aircraft, and telecommunication firms. It has been gradually relaxing its control over these sectors since the early 1990s. The government is slowly selling off holdings in France Telecom, in Air France, and in the insurance, banking, and defense industries. Meanwhile, large tracts of fertile land, the application of modern technology, and subsidies have combined to make France the leading agricultural producer in Western Europe. Persistently high unemployment will continue to pose a major problem for the government; a 35-hour work week is being introduced. France has shied away from cutting exceptionally generous social welfare benefits or the enormous state bureaucracy, preferring to pare defense spending and raise taxes to keep the deficit down. France joined 10 other EU members to launch the euro on 1 January 1999.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

France's economy is dominated by a relatively small number of large MNC's, complemented by a raft of fragmented smaller companies in a variety of sectors. The country has a strong financial centre in Paris and is seen as one of the premier investment routes into Europe. Many Private Equity firms have already established offices in the country, or are serious about doing so in the near future. France shares many of the characteristics of the German and Italian economies, with industries ripe for consolidation; a prime hunting ground for the Private Equity executive.

A key attraction of France is that it is seen as an ideal entry point from which to target other European opportunities.

Germany

Background: As Western Europe's richest and most populous nation, Germany remains a key member of the continent's economic, political, and defense organizations. European power struggles immersed the country in two devastating World Wars in the first half of the 20th century and left the country occupied by the victorious Allied powers of the US, UK, France, and the Soviet Union in 1945. With the advent of the Cold War, two German states were formed in 1949: the western Federal Republic of Germany (FRG) and the eastern German Democratic Republic (GDR). The democratic FRG embedded itself in key Western economic and security organizations, the EC and NATO, while the communist GDR was on the front line of the Soviet-led Warsaw Pact. The decline of the USSR and the end of the Cold War allowed for German unification in 1990. Since then Germany has expended considerable funds to bring eastern productivity and wages up to western standards. In January 1999, Germany and 10 other EU countries formed a common European currency, the euro.

Economy - overview: Germany possesses the world's third most technologically powerful economy after the US and Japan, but its basic capitalistic economy has started to struggle under the burden of generous social benefits. Structural rigidities - like a high rate of social contributions on wages - have made unemployment a long-term, not just cyclical, problem, while Germany's aging population has pushed social security outlays to exceed contributions from workers. The integration and upgrading of the eastern German economy remains a costly long-term problem, with annual transfers from the west amounting to roughly $100 billion. Growth slowed to 1.5% in 1999, largely due to lower export demand and still-low business confidence. Recovering Asian demand, a push for fiscal consolidation, and newly proposed business and income tax cuts - if passed - are expected to boost growth back to trend rates around 2.5% in 2000 and beyond. The adoption of a common European currency and the general political and economic integration of Europe will bring major changes to the German economy in the early 21st century.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

Germany is characterised as a high-quality industrial and service economy, where many of its largest corporate entities are classified as world leaders in their chosen field. This is complemented by a large and diverse range of smaller companies (The Mittelstand), family-owned enterprises that are also, in many cases, world leaders in their chosen sectors. Many of these businesses were started in the immediate aftermath of the Second World War and are now facing generation hand-over issues, a situation that is ripe for exploitation by the Private Equity industry.

However, "*the joke in Frankfurt is that there are more private equity firms touting for business than there are buy-outs completed in the entire German market*" according to the *Financial Times*[6]. The potential is definitely there and the Private Equity teams are

[6] Financial Times, 2 December 1999

moving in to exploit them, but the deals have not happened yet. As Nigel Hamway, director of Charterhouse Development Capital's European operation says "*everyone is talking about the Mittelstand, but we are still seeing only large buy-outs from industrial conglomerates*"[7].

The understanding of the Private Equity industry in Germany seems to be a problem, as are the country's restrictive tax and company laws, although the latter are being addressed by an imminent shake up of the nation's fiscal policies. The former is being addressed over time, and there is now some evidence that the new generations of German business managers are aware of, and keen to embrace, the concept of Private Equity.

However, with many firms having been in Germany for a number of years, competition in the Private Equity arena is likely to be fierce once the promised rationalisation of the Mittelstand begins.

Ireland

Background: A failed 1916 Easter Monday Rebellion touched off several years of guerrilla warfare that in 1921 resulted in independence from the UK for the 26 southern counties; the six northern counties (Ulster) remained part of Great Britain. In 1948 Ireland withdrew from the British Commonwealth; it joined the European Community in 1973. Irish governments have sought the peaceful unification of Ireland and have cooperated with Britain against terrorist groups. A peace settlement for Northern Ireland, approved in 1998, has not yet been implemented.

Economy - overview: Ireland is a small, modern, trade-dependent economy with growth averaging a robust 9% in 1995-99. Agriculture, once the most important sector, is now dwarfed by industry, which accounts for 39% of GDP and about 80% of exports and employs 28% of the labor force. Although exports remain the primary engine for Ireland's robust growth, the economy is also benefiting from a rise in consumer spending and recovery in both construction and business investment. Over the past decade, the Irish government has implemented a series of national economic programs designed to curb inflation, reduce government spending, and promote foreign investment. The unemployment rate has been halved; job creation remains a primary concern of government policy. Recent efforts have concentrated on improving workers' qualifications and the education system. Ireland joined in launching the euro currency system in January 1999 along with 10 other EU nations. The construction and other sectors are beginning to press against capacity, and growth is expected to drop in 2000, perhaps by 1 percentage point.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

Ireland has enjoyed a renaissance in its economic fortunes over recent years, with economic growth outstripping the other European nations by a considerable margin.

Much of its growth is down to the aggressive targeting of the high-technology sector by the Irish government, with Ireland now seen as one of the leading technology centres of Europe.

[7] See Section 6 – Private Equity Players, Charterhouse Development Capital

Despite its much improved economic performance, the country has not been subject to a great deal of interest from the European private Equity sector, possibly because it remains a very small economy, with a population of just 4m. Nevertheless, an appropriate focus could bring significant opportunities to Private Equity firms choosing to target the region.

Italy

Background: Italy became a nation-state belatedly - in 1861 when the city-states of the peninsula and Sicily were united under King Victor EMMANUEL. The Fascist dictatorship of Benito MUSSOLINI that took over after World War I led to a disastrous alliance with Nazi Germany and Italian defeat in World War II. Revival followed. Italy was a charter member of NATO and the European Economic Community (EEC) and joined the growing political and economic unification of Western Europe, including the introduction of the euro in 1999. Persistent problems include illegal immigration, the ravages of organized crime, corruption, high unemployment, and the low incomes and technical standards of southern Italy compared with the more prosperous north.

Economy - overview: Italy has a diversified industrial economy with approximately the same total and per capita output as France and the UK. This capitalistic economy remains divided into a developed industrial north, dominated by private companies, and a less developed agricultural south, with more than 20% unemployment. Most raw materials needed by industry and more than 75% of energy requirements are imported. For several years Italy has adopted budgets compliant with the requirements of the European Monetary Union (EMU); representatives of government, labor, and employers also agreed to an update of the 1993 "social pact," which has been widely credited with having brought Italy's inflation into conformity with EMU requirements. Italy must work to stimulate employment, promote wage flexibility, hold down the growth in pensions, and tackle the informal economy. Growth was 1.3% in 1999 and should edge up to 2.6% in 2000, led by investment and exports.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

On the surface, Italy shares many of the characteristics that make Germany seem on the one hand a potentially rich source of transactions for the Private Equity sector with, on the other hand the same frustrations in terms of a lack of understanding of the industry among the nation’s entrepreneurs.

Italian companies are typically financed through retained profits and bank debts, particularly short-term debt. As a consequence, the Italian financial system is dominated by the banks which enjoy a strong relationship with the country’s small and medium-sized business sector and Italian companies average debt to equity ratio three times that of UK companies and double that of those in France and Germany. This is now seen as one of the weak links in the Italian financial system, as the undercapitalisation and consequent low debt capacity of Italian companies has become one of the main impediments to growth, and this is now increasingly recognised in the traditionally “closed” culture of Italian entrepreneurs.

According to IPEN[8], Italy's stock market has shown increased signs of strength and development in recent years, indicating a viable potential exit route for Private Equity investors. Combined with legislative developments and the perception of Italy's entrepreneurs that they need to grow their businesses to continue to compete effectively on the international arena, this points to healthy opportunities for Private Equity investors.

Italy is one of the world's major industrialised countries with a strong core of small businesses, many of which are family-owned and face the same generation hand-over issues as the equivalent sector (The Mittelstand) in Germany. As such, the country has seen an influx of Private Equity firms. As in Germany, this is a double-edged sword in that, while the number of firms selling the message of Private Equity has helped increase the sector's profile and acceptance among its target audience, so too has it raised levels of competition and thus entry prices.

Those Private Equity firms that have penetrated the market have, however, reported excellent returns on the investments they have exited. For example, UBS Capital has claimed an average 65% IRR on its exits, with Schroder Associati claiming similar returns and 3i claiming returns in excess of 50%[9]. These are good IRR's, far outstripping average returns achieved in recent years in the UK.

However, with the increased competition for deals and the inflationary effect this undoubtedly has on entry prices, the days of such high returns may be numbered. It is likely that those firms that have already successfully entered the Italian market have enjoyed the benefits of "first mover" advantage, and remain ahead of the following pack.

Nevertheless, the prospects in Italy continue to look attractive, and appropriately focused and determined Private Equity firms should still be able to make good money in the region.

Portugal

Background: Following its heyday as a world power during the 15th and 16th centuries, Portugal lost much of its wealth and status with the destruction of Lisbon in a 1755 earthquake, occupation during the Napoleonic Wars, and the loss of its Brazilian colony in 1822. A 1910 revolution deposed the monarchy; for most of the next six decades repressive governments ran the country. In 1974, a left-wing military coup installed broad democratic reforms. The following year Portugal granted independence to all of its African colonies. Portugal entered the EC in 1985.

Economy - overview: Portugal is an upcoming capitalist economy with a per capita GDP two-thirds that of the four big West European economies. In 1999, it continued to enjoy sturdy economic growth, falling interest rates, and low unemployment. The country qualified for the European Monetary Union (EMU) in

[8] IPEN – *The International Private Equity* Network (www.ipen.com)
[9] Source: *Financial Times, 2 December 1999*

1998 and joined with 10 other European countries in launching the euro on 1 January 1999. Portugal's inflation rate for 1999, 2.4%, was comfortably low. The country continues to run a trade deficit and a balance of payments deficit. The government is working to modernize capital plant and increase the country's competitiveness in the increasingly integrated world markets. Growth is expected to remain stable in 2000 as the economic integration of Europe proceeds. Improvement in the education sector is critical to the catch-up process.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

Portugal remains the poorest of the economies under review, with GDP per capita the lowest at $15,300. However, the country has a respectable GDP growth rate of 3.2%, pointing to more promising future.

Nevertheless, Portugal remains seen as less attractive to Private Equity firms than other countries, largely due to the control exercised over opportunities in the region by two or three of its major investment banks. This makes it a difficult market to enter, even if there were seen to be attractive transactions available. Nevertheless, according to *The Translink Deal Review* analysis in Table A, Portugal reported higher levels of deal activity than Ireland and Luxembourg, therefore it could yet prove to be an attractive market in future years. As with other European nations, Portugal requires development of its corporate and fiscal policies, as well as heightened awareness of Private Equity, to bring it in line.

Spain

Background: Spain's powerful world empire of the 16th and 17th centuries ultimately yielded command of the seas to England. Subsequent failure to embrace the mercantile and industrial revolutions caused the country to fall behind Britain, France, and Germany in economic and political power. Spain remained neutral in World Wars I and II, but suffered through a devastating Civil War (1936-39). In the second half of the 20th century, it has played a catch-up role in the western international community. Continuing concerns are large-scale unemployment and the Basque separatist movement.

Economy - overview: Spain's mixed capitalist economy supports a GDP that on a per capita basis is three-fourths that of the four leading West European economies. Its center-right government successfully worked to gain admission to the first group of countries launching the European single currency on 1 January 1999. The AZNAR administration has continued to advocate liberalization, privatization, and deregulation of the economy and has introduced some tax reforms to that end. Unemployment, nonetheless, remains the highest in the EU at 16%. The government, for political reasons, has made only limited progress in changing labor laws or reforming pension schemes, which are key to the sustainability of both Spain's internal economic advances and its competitiveness in a single currency area. Adjustment to the monetary and other economic policies of an integrated Europe - and reducing the unacceptably high level of unemployment - will pose difficult challenges to Spain in the next few years.

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

The Spanish *Bolsa* is now the fourth largest stock exchange in Europe, although it is characterised by a relatively small number of companies that account for a significant share of the total market capitalisation. For example, *Telefónica*, the internet subsidiary of the major Spanish telephone operator has recently been weighted at nearly 20% of total market, suppressing liquidity in other stocks and making new flotations difficult.

Nevertheless, activity levels in Spain are comparatively high, as indicated by Table A in Appendix B with total acquisitions in the region ranking third behind France and Germany. In terms of Private Equity transactions the analysis indicates that Spain is pushed into fourth place by Italy. This indicates a bouyant market for the Private Equity sector and this is evidenced by the fact that a number of firms are active in the region, among them Charterhouse, Electra, Granville Baird 3i and Excel Partners. These foreign imports rub shoulders with strong local competitors, among them Mercapital and 21 Invest.

A major attraction of Spain is its commercial links with a large part of the South American sub-continent, which is mostly Spanish-speaking (apart from Brazil where the official language is Portuguese). As the South American economies modernise and develop, this affords Spanish companies the opportunity to take advantage of its historic links and common culture with the area. There is evidence that the inroads made by the larger Spanish banking, telecommunications, leisure and utility firms are being followed by ranks of medium-sized companies seeking to expand internationally (*source IPEN*).

Spain shares many of the characteristics of other European markets:

- It has a strong small/medium sized business sector that is seeking to improve its ability to compete internationally, and needs external funds to finance expansion.
- Many of its core industrial, commercial and service sectors are fragmented, offering good opportunities for consolidation.
- Attitudes to, and awareness of, Private Equity are improving with the combination of increased market entry by Private Equity firms and the needs of its economy.
- There remains a need for further improvement in the legal and fiscal infrastructure, although Private Equity transactions are certainly possible.

According to IPEN, Spain is "*an attractive market for investors who understand the eccentricities*". Consequently, Spain is a market where good local contacts are probably more important than elsewhere. Those firms that have cracked Spain have carefully cultivated their contacts there for a number of years, and are now reaping the benefits of their patient approach.

6. PRIVATE EQUITY PLAYERS

Introduction

A key component of the research work for this thesis was face-to-face interviews with selected Private Equity industry executives and professionals who had a track record of successful entry into the European market and could therefore give direct advice and guidance on the key issues they faced in establishing themselves in Europe.

Given the large number of Private Equity houses that have now made inroads into the European market it was impossible to interview everyone. Nevertheless, the small sample of individuals who kindly agreed to be interviewed represent a reasonable cross-section of the industry.

The interviews were conducted informally but based around a set of broad questions that can be summarised as follows:

- *What was the spur behind the decision to expand into Europe?*
- *On what basis did you decide which countries to go into and exactly where in those countries to base yourself?*
- *How would you describe the three or four key characteristics of each country that directly affect the way you operate there?*
- *What are the main legal and tax differences that you encounter in specific European countries, to what extent do these differ to the situation in the UK and how do you manage to get around any difficulties?*
- *How would you sub-divide the Private Equity market in each of the countries you are in?*
- *What entry mode did you choose to adopt in each country, and why?*
- *What do you see as the key economic sectors in each country, and which ones have you opted to focus on?*

- *What do you see as they key determinants of a successful private equity sector in an economy?*

- *How important is it that you understand the language and culture of the country?*

- *What do you see as the main threats to your European business, and how to you envisage protecting yourself?*

The choice of questions was deliberately broad and unstructured in order to give the interviewees the opportunity to expand on connected issues and talk freely about their experiences in expanding their businesses into Europe. Without exception, of all of the interviewees responded candidly and expansively, giving a range of useful insights into the issues they faced at the start, the issues they continue to face and the individual successes and failures that occurred along the way.

Set out below are summaries of the comments made by each of the individuals interviewed.

Granville Baird Capital Partners

Granville Baird is a London-based independent private equity house that was established in the mid-1980's to focus on mid-market development capital deals between £5m and £60m. It now has some 40 staff spread across its offices in London, Leeds, Barcelona and Hamburg and specialises in the development of technology-based businesses across the board.

The firm recently merged with Robert W Baird & Co, a US stockbroking firm, but manages itself independently from the stockbroking and market-making arms of the combined business.

The firm currently has some £400m under management, secured primarily from some 32 UK and European financial institutions (largely banks, insurance funds and pension funds) although there is growing evidence that the Middle East is a potentially lucrative source of institutional and corporate investment funds. The US financial institutions market has proved difficult to crack because of their desire to place blocks of funds in minimum slices of £50m while at the same time seeking to avoid taking more than a 10% share in any single fund. Granville Baird's individual funds have historically been smaller than £500m, so this has been a problem in terms of securing funds from the US, although they are currently raising a new fund which it is hoped will reach some £750m.

The firm is optimistic that the size of the new fund will encourage more active participation from US investors.

Granville Baird's entry into the European market dates back to the mid-1980's, when there was a view that the UK market, while bouyant at the time, would inevitably experience a dip in fortunes. Granville Baird decided that the time was right to start establishing contacts in Europe in the expectation that those contacts would eventually give rise to the required quality of deal flow after suitable cultivation. The firm never expected to be able to suddenly ramp up its exposure to Europe. Rather, it anticipated the need to carefully cultivate a network of trusted, reliable and educated local contacts over a period of several years.

"*In our target market the key is a local understanding and close, personal relationships with advisers and management teams in the area you're working in*", says Mike Fell, Granville Baird's managing director. Fell says that Granville Baird recognised the need to have local people on the ground, with good knowledge of their market places and excellent contacts among the community of advisers and business managers.

"*Of course that brings with it certain problems if its own*", acknowledges Fell, accepting that Granville Baird's chosen route to entry gives rise to various issues, including:

- Firstly, it is difficult to control a dissipated and diverse team of people. Fell is of the opinion that strong systems and procedures are required to underpin the relationship between offices of different nationalities. "We haven't got it totally right yet, but we are definitely getting there", he insists adding that a key role is to integrate the offices and instil a shared sense of purpose and vision.

- Second, he acknowledges that the availability of high-quality people with the appropriate background and understanding of the Private Equity sector is low in Europe. "We started by dropping in our own people to recruit and then train up our local teams in our way of doing things", he says. "*Once they are up to speed, we can leave them to run their own ship, although we still need to control the overall strategy and quality of work from the centre, as would any firm in our business*".

- This in itself gives rise the next major issue, which is staff retention. "*We don't want to train people up and then see them leave to join the next new UK house that enters the market behind us*", he says, "*we need to reward people on a common basis, which means that we all share the same pot*", alluding to Granville Baird's policy of operating with a single bonus structure where individuals are remunerated on a basis that reflects the success, or otherwise, of the entire organisation regardless of geography.

The company is taking a cautious approach to its European expansion, although this does not dim their ambition in the region. Fell believes that a suitably focused team which is properly trained, skilled and incentivised can reap major rewards. "*There are a lot of firms trying to establish in markets they don't understand and expecting results too quickly*", he offers. "*At our end of the market it takes time to develop contacts and establish relationships with the right people. Only then will the right deals come your way*".

He clearly believes that he has got it right in terms of choosing where to be, citing Hamburg as "*where much of the new developments in the German technology arena are being started up*". He believes that the new generation of German business managers are well-educated; many of them have MBA's and find the traditional structure of the large German corporates as too suffocating and restricting. "*These people are the new entrepreneurs who want a slice of their own pie. These are the people with ideas and energy who we want to back*", he says.

As for Spain, Fell says that it was a simple choice: "*50% of the Spanish economy is in Madrid, with the other half in Barcelona*", he says. "*We found the people we wanted to come aboard with us in Barcelona first, so that was where we opened our office*", although he adds that the opening of a Madrid office is in the pipeline.

Granville Baird's next likely office will be Paris, Fell believes, because of its central location and the dynamics of the business sector which make it a more favourable target for a small operation looking for small deals than a team looking to do "mega buy-outs".

Further afield, Fell thinks that there are few other opportunities in the traditional European markets:

- He doesn't believe there is much in the way of economic structure in Portugal to attract Private Equity investors, because the economy is so small and dominated to a large extent by local merchant banks

- Further, he feels that the Nordic countries, while having several attractive features in terms of infrastructure, legal structure and awareness of Private Equity, are too well tied up by a small but aggressive group of local investors.

- As for Italy, "*it is not on our radar map at the moment*", he concedes, but only because they have enough to do for the moment in integrating their existing offices, opening up Madrid and planning for Paris. Fell does not want to stretch the management of the business to such an extent that it cripples the organisation.

Fell's view is that success in Private Equity is based on a few simple principals:

- Access to funds is vitally important; "*if you can't pay then you can't play*".

- Second, a detailed knowledge of the local market is, Fell believes, a prerequisite "*certainly at our end of the range*".

- Third, an awareness of, and an ability to focus on and exploit, exit opportunities. "*It is the exit that gives the investors their return, and consequently the confidence to allocate further cash the next time you raise a fund*"

- Finally, to underpin everything is strong management and controls to ensure the cohesion of the team and, in the end, satisfied investors.

Notwithstanding the above, Fell's parting shot is that none of it is that important once you get into the very large transaction sizes. "*There*", he says, "*the most important thing is that you have access to sufficiently large amounts of cash to do the deal, the rest is simply not that important*".

Candover Investment

Candover is involved at the high end of the deal size range, specialising in transactions between £50m to £1bn; typically large, leveraged buy-outs from major industrial companies and public-to-private transactions. The firm was established in 1980 and now has 20 years' experience in its sector, and enjoys a high reputation in the industry as one of the most powerful and innovative players in the Private Equity market.

According to Hamish Mackenzie, a director of Candover since 1997, "*we have a reputation for delivering larger deals and we aggressively target that market throughout Europe*". However, this means that the number of transactions completed by the firm is necessarily quite small by comparison with firms at the lower end of the market. As the firm's brochure points out, since 1980 Candover has completed "*some 75 deals with a total value of £3.5 billion*", which represents some 3 deals a year, far short of the average number of transactions a year completed by smaller firms.

This implies that Candover has to research each transaction thoroughly, not surprising given the magnitude of the sums involved and is able to bring to bear a wide range of financial engineering experience and expertise to each one.

"*This is the key to our success*", says Mackenzie. "*We have a reputation for having the resources, both cash and expertise, to enable us to complete large transactions. That is the key factor*".

Mackenzie believes that the European markets that hold the greatest opportunities for Candover are Germany, "*where there is raft of mid-sized companies that will need our financial backing to support their plans for growth*", France, Italy and Spain. However, Mackenzie and his colleagues are open to opportunities wherever they might arise. "*Sure, we travel around Europe a lot*", he says. "*But I don't think that in our market a direct European presence is necessary to throw up the kind of deals we're looking for*". Rather, he insists, it is important that their name is on the lips of the major European financial institutions and international business leaders, and this something they can achieve without directly opening offices. Candover has no offices outside London, relying instead on its reputation as a firm that can deliver large deals in order to win business on the continent.

The logic for moving into Europe is clear, according to Mackenzie. Candover's early days coincided with the mid-1980's era when the UK government was conducting an aggressive de-nationalisation policy while at the same time the industrial conglomerates that had arisen during the 1960's and 1970's were divesting themselves of non-core subsidiaries in order to focus more narrowly on core activities. This was accompanied by fundamental changes in company law and fiscal policy that favoured the fledging Private Equity industry. As a result, the UK Private Equity industry flourished, but has now begun to stagnate as competition has increased. "*The same conditions that existed in the UK in the mid-1980's are now present in Europe*", he says, "*and this gives us the opportunities to apply the experience we've gained over here to develop the market on the continent*".

Mackenzie doesn't experience the same problems with lack of understanding of Private Equity and parochial attitudes that the smaller investment firms come across. He says: "*the vendor firm (often a large MNC) just wants to know that somebody will buy the business from them, they don't care whether they're British, French, German or whatever. Similarly, the management teams we deal with are international people with international experience and expectations; they're not constrained by local market views*".

As for exit opportunities, Mackenzie believes there is a range of options available to Private Equity investors nowadays. "If you look at the deals we've exited over the years, they've been split 50:50 between flotation and trade sale, although nowadays trade sale looks the more likely route. You need to buy into a regional business that looks like it will attract the attention of a multinational that wants to expand its geographic and market coverage".

Charterhouse Development Capital

CCF Charterhouse Development Capital is based in London, and has been a well-known and respected member of the Private Equity industry for a number of years. I spoke to Nigel Hamway who is one of the senior directors responsible for Charterhouse's European operations.

Charterhouse's policy during the 1980's was to have regional offices throughout the UK and the intention at that time was to replicate this set up in Europe. However, the advent of the 1990's and the dip in the industry's fortunes in the UK during 1992/93 lead to a rethink of the strategy for the way forward. This was based, says Hamway, on the belief that larger sized deals, which was the market that Charterhouse was most interested in, could be sourced from a single office in London with no need for regional offices and the additional expense and administration that they require. Consequently, Charterhouse closed all its UK regional offices and concentrated its efforts on building a credible team with big deal experience in London.

Charterhouse has had a French business since 1972. Hamway was at pains to stress that this is a completely independent (although majority-owned) team that raises its own funds and therefore has no conflict with Charterhouse in the UK or elsewhere in Europe. "*The big market in France is for smaller deals*", says Hamway. "*However, where the French team is useful is that they occasionally uncover a larger deal which they bring to us in London. They don't have the expertise or the appetite for such transactions. We're both happy with the set up – we stay out of their target market and they stay out of ours*".

Charterhouse's policy is to incentivise well-connected local industrialists and advisers to introduce them to potential deals. "*We adopt the parachute approach*", says Hamway. "*It avoids the costs of setting up and staffing a local office that might take years to do a deal, or that might get pinched by another team just as they're starting to get some momentum. Believe me, there is going to be a lot of movement of people in the industry over the next few years. You've got the Americans and the Brits moving in offering big money to people to move jobs, and then you've also got teams who've established themselves at other people's expense who are deciding they can do it better on their own. There are a lot of houses just now who are worried about how to retain their people*".

In particular markets Charterhouse has adopted a strategy of wrapping up good local sources of transactions, for example:

- In the mid to late 1980's they established a relationship with a Swedish industrialist who gives them introductions into the Swedish market and also on the international stage. "*The relationship suits us both well*", says Hamway. "*We get the introductions we want into the types of transactions we're looking to do. He gets the kudos of being seen to be a big player in the Swedish corporate scene and he also gets well rewarded for the successful deals he brings us*".

- In Spain Charterhouse originally got involved with Vista Capital de Expansión in the late 1980's "*almost by accident*", says Hamway. "*We had our bags packed and were heading to the airport the next day to speak to Mercapital about doing a jv when suddenly George* (George Mathewson, chief executive of The Royal Bank of Scotland which at that time owned Charthouse) *phoned up and told us to deal with Vista. We phoned Mercapital and cancelled our meeting and flew out to meet Vista instead. We dropped in a couple of Brits to train the locals up for a couple of years and then pulled out and pretty much left them to it*", he adds. Following the sale of Charterhouse by The Royal Bank in 1993, the bank kept the relationship with Vista and Charterhouse, which by then had reviewed its approach to Europe went out and recruited the former head of the Spanish Federation of Industry on a similar arrangement to that with their contact in Sweden. "*We also have a semi-formal arrangement with 21 Invest*", adds Hamway. "*Basically we help to fund their local office while they focus on smaller deals and bring us any big ones they come across. It's a good relationship, similar to that in France and both parties get something out of it for minimum outlay*".

- Similarly, in Holland Charterhouse have access to the market through a locally well-known and connected "High Net Worth" individual. "*We set up a jv with him, called Indofin Charterhouse*", says Hamway. "*Again it's good. He can do small deals in the knowledge that if he comes across a large transaction he has access to our investors to get the money in. He gets the plaudits in the local market which does his reputation no harm at all, while we get to invest our money in good quality transactions at the right end of the market*".

Hamway is sanguine on the situation in many European markets where he has direct experience of running down and doing deals. "*Germany is where they all say the money will be made next*", he says. "*There is a lot of talk about Mittelstand companies* (Germany's large family-owned business sector) *being ripe for a massive influx of development capital as family businesses seek to hand over the next-generation managers*. *If it's happening we haven't seen it*", he says. "*We're still doing traditional buy-outs from larger corporates. The Neuer Markt* (set up in 1997 to enable smaller companies to achieve listed status) *has certainly helped raise the profile of development capital and external investors, but it's been a painful learning curve for the Germans – they're just not used to the notion.* Hamway has some amusing anecdotes about dealing with German business managers. "*One German management team we were talking to reported us to the holding company board*", he says, smiling. "*They thought we were bribing them when we offered them an equity stake in the business. It just shows you how far we still have to go to educate people*". However, Hamway is optimistic for the German market, saying that he believes that change in the ownership structure of the Mittelstand has got to happen sooner or later.

He is less enthusiastic about prospects in the Nordic countries. "*There you have an extremely well developed local venture capital community that has wrapped up the sector pretty firmly under their control. Also, there are very few larger deals and you only get to see them if you're on the ground digging out the smaller ones as well. It's a really tough market to break into*".

He sees Portugal as a fairly insignificant market, which is tied up by a couple of the country's merchant banks which keep whatever deal flow there is to themselves. "*The only good thing about going in to Portugal as a Brit is that you're seen not to be Spanish*", he says. "*There's very little deal flow and what there is is very small – not really a market that interests us*".

Italy is seen as a market that could be developed if the country's corporate laws were tightened. He speaks openly of a transaction that Charterhouse did in Italy where the company's principal assets were moved elsewhere in the group immediately post-deal. "*As the law stood, there was nothing we could do about it*", he says, clearly irritated by the experience. However, he does see parallels with the German market in that there is a significant core of very well-run family companies that will experience generation hand-over problems in the near future. Once again, the key is to educate the Italian business mentality in favour of Private Equity investors.

On the structure of the industry across Europe, again Hamway has some useful insights. He says that the key to the Private Equity business involves sorting out certain basics, which are:

- Funding — You need access to funds to invest. He says that there are clear signs that the investors, US Pension Funds, Middle East money, the Japanese and the British see Europe as where they want to put their cash. Therefore, getting money to put into Europe is getting much easier, but you still need a track record to get the funds in the first place.

  "*Nowadays*", says Hamway "*the vogue is for European funds rather than specific country funds. The Americans in particular want to see Europe as a single market – the existence of the Euro helps that*".

- Finding the deals and doing them — "*It's pretty straightforward*", he says pointedly. "*If you want to play at the smaller end of the market you need local people on the ground who have the pulse of the region. Whether you employ them or tie them up with arms-length incentives is your choice. Either way it takes time and patience*". However Hamway clearly believes that employing people is the most expensive and problematic option.

  As for larger deals, Hamway sees the key issue being whether you have the funds available to that size of transaction. "*Big deals are basically a blinking contest*", he says. "*You don't need to know the local market, because it's just not important. The big companies will be international anyway. All you have to do to stay in is to keep* *up with the bidding – you're never going to pay more than 5% more than the guy who comes second*".

- Making the exit — The existence of a developed local stock market doesn't really matter, Hamway believes, other than in helping to educate local management about Private Equity. He sees secondary buy-outs or trade sales as the most important exit mechanism. "*We've done 35 deals in France and Germany and exited 17 of them so far – only two of those were floated*", he says.

In summary, Hamway believes that the European market will continue to develop as the Private Equity message gets stronger. However, it is a double-edged sword in that while the flood of US and British entrants to the market helps get the message across it also increases competition. As entry prices get higher, so the ultimate exit returns will fall so that the market ends up like the UK market at present. However, he believes there is still time to make money out of Europe. "*There are some good deals around and, once Germany and Italy in particular sort themselves out there will be more to come*", he says.

Parallel Ventures Managers

Parallel Ventures Managers (PVM) is a "fund of funds" firm based in London that takes blocks of funds allocated by major pension funds and places these with selected investment managers, including 3i, Barclays, Bridgepoint Capital (formerly NatWest Development Capital) and Royal Bank Development Capital. I spoke to Dr Paul Whitney, chairman and founder of the firm and Grant Haggith, PVM's senior investment director.

PVM itself has limited direct contacts in Europe, preferring instead to place funds with Private Equity firms that can give them exposure to the European market. Until fairly recently, this involved PVM seeking out UK-based firms who had a credible European track record. PVM have avoided opening up direct in Europe, preferring instead to base themselves in London, which they see remaining a key gateway for channelling money into Europe. Their target market is the traditional mid-market MBO or development capital transaction, with deal sizes ranging from £20m to £100m. "*We don't have the fund availability to chase very large buy-outs although that is not to say it is not a market that would interest us in the future*", says Whitney.

The logic for moving into Europe seems pretty clear according to Whitney. "*Europe now is in the same stage of development that the UK was in the early 1980's*", he says. "*Then, a company couldn't use its own assets to fund an MBO and generally corporate law was very restrictive as it still is pretty much across Europe, although this is slowly* *changing*". Haggith points to imminent changes in German corporate tax laws which will reduce the tax burden on German corporations selling subsidiaries as a sign of some progress in creating a fiscal environment in which Private Equity can flourish.

The biggest issue facing the European market in general, they both agree, is a lack of understanding among the leading corporate managers and entrepreneurs about what Private Equity is. Whitney points out that, despite the rash of Private Equity firms that have sprung up in Europe over the years the European market still has little experience of the industry. "*In terms of numbers of deals done and total funds invested, the UK still by far outstrips the rest of Europe in terms of size*", he says.

Both Haggith and Whitney suggest that European ways remain slightly different to those of the UK and US. "*In Europe the history of financial transactions has been that they are relationship-driven, rather than transaction-driven as here or in the US*", says Whitney. "*That means that unless you are on the ground a great deal of the time and have spent a lot of time and effort cultivating your contacts, you aren't going to get a look-in*". He sees this as especially true in the smaller to mid-market deal range, but acknowledges that it is less important in the larger transactions.

Haggith notes specific issues with various European markets, as follows:

- There can be problems in France where it is difficult to establish control mechanisms for the equity investor where he only has a minority stake. "*You can get around it with some clever legal work on the shareholder agreement*", he says. "*But then again you often come up against the problem of the locals' lack of understanding. Legal structures in France don't help either*", he says, pointing out that in French corporate law limited liability can be transparent leaving shareholders directly exposed. "*You can always get around these things, but it's not for a naïve investor to dive in expecting things to be as straightforward as in the UK. It's always good to have good legal advice and local knowledge on board*".

  Haggith also points out that the concept of a Limited Partnership is not recognised in France which can cause some issues, although there are suitable alternatives (such as the FCPR) which can be useful to know about.

- Italy can also hold hidden pitfalls for unwary UK equity investors, where again there is no suitable legal structure in place for an investment vehicle. "*You either have to go* *into each deal on an individual basis, or set up a Luxembourg or Belgian holding company to get around it*", says Haggith.

Whitney is similarly cautious about adopting a UK approach in Europe. He says that in Germany there is a well-recognised generation hand-over problem among the Mittelstand companies and an obvious and well-documented need for rationalisation of many of the industrial sectors in the country. "*It just hasn't happened yet because the natives don't really understand the concept of external equity investors yet*".

France is a difficult market because many of their companies are very small and therefore the opportunities to do reasonable sized deals is limited. "*3i have been in France since 1984*", says Whitney. "*But they didn't do their first MBO until the 90's – they're still doing mainly small development capital deals and their added problem is that clear exit opportunities don't really exist*".

As for the Scandinavian sector, Whitney believes that it is more or less "sewn up" by local firms who control it very well. "*It's a very hard market to enter, therefore almost not worth expending the effort on*", he says.

Whitney and Haggith are clear on the key elements of a successful Private Equity sector. "*First you need the availability of cash to do the deals, which means having Pension Funds and other financial institutions with an appetite for the European market*", says Haggith. Next is an appropriate legal system with the right protections in place for equity investors, and a fiscal system that encourages entrepreneurship. "*These things are falling into place gradually*", says Whitney, "*as is the understanding of the local management teams and larger corporates*", which is the next most important element. Finally, a clear opportunity for exit so that the investors can get their return.

"*There is a SmallCap* (smaller capitalised companies) *problem across the UK and Europe*", says Haggith. "*It is very difficult to float because liquidity in SmallCap listed stocks is low*". He believes that the most obvious route for exit remains trade sale; "*You buy a small business, develop it and then flog it to an MNC*", he says.

Given their unique position as a "fund of funds", PVM are well-placed to evaluate the extent to which certain managers have succeeded on the European stage. Haggith likes the approach taken by Citicorp for example, where he sees the key components of their successful strategy being:

- London remains the core location for the business, with very strong “Anglo Saxon” quality control over every transaction
- Training local team leaders in the “Anglo Saxon” way, which involves:
  - Ensuring institutional control
  - Making sure there is a business plan and the management stick to it
  - Corporate governance
  - Focus on exit

However, Haggith and Whitney agree that this is really only applicable to their own market, which is mid-market transactions, and the smaller seed capital and startup transactions. “*In our market the personal touch is what is expected and you can only provide that with people on the ground, and mainly local people at that because they understand the market and the attitudes”,* says Whitney*. “You need to be aware that the Europeans all live up to their stereotypes in one way or another; the Italians are emotional, the Spanish are very laid back, the French are supercilious and the Germans can be incredibly pedantic. You can only cope with that if you understand them well*”.

On the larger transactions, however, both are adamant that “cash is king”.

Others

As well as interviewing individuals from specific firms, an attempt was made to analyse the major firms listed in the BVCA's list of member firms. The table below summarises a sample of the major firms extracted from the BVCA's database, illustrating the number of executives in the UK and Europe, the size of each firm's Funds Under Management (FUM) and their Average Investment Size. Note that the Average Investment Size will indicate a total deal value of up to five times the value of the individual investment.

Firm	UK Execs	Europe Execs	FUM £m	Avge Inv Size £m	European Offices *
Advent International	25	15	1,500	20	G, I, F
Advent Venture Partners	10	-	220	3.5	-
Alchemy Partners	13	-	525	15	G (consultant)
Apax Partners	43	37	1,500	7	Ir, S, I, G, F, Sw
Bridgepoint Capital	65		1,700	15	G, F, Sw, I
Candover	13	-	1,800	50	-
Charterhouse	16	-	2,000	100	Fr (independent)
Cinven	23	-	3,000	85	G, F
CVC	16	-	1,400	50	H, B, Sw, G, S, F
DLJ Europe	11	-	135	6.9	F, G
Electra Partners Europe	20		1,100	50	S, I, F (associates)
Friends Ivory & Sime	13	-	310	5	-
Granville Baird	14	8	478	7	S, G
HSBC Private Equity	23		1,100	20	F, G, Sw
Legal & General	13		700	40	G, F
Mercury Private Equity	16		650	20	G
PPM Ventures	20		950	18	F
Schroder Ventures	26	22	1,340	N/D	G, I, F

* Country abbreviations:	G=Germany, F=France, I=Italy, Ir=Ireland, S=Spain, Sw=Switzerland, H=Holland

Source: The British Venture Capital Association (www.bvca.co.uk)

The table shows that there is a range of entry modes taken by firms targeting the various deal size ranges. However, there is some evidence to bear out what the various interviewees said about the difference between targeting smaller deal and larger deals, in that:

- To target larger deals (in the £100m range), physical location is less important than the availability of funds. Those firms with the higher average investment values may list European offices, but interestingly do not generally list numbers of executives based in Europe. This suggests that their European offices are either associates or simply unstaffed bases for the use of visiting executives.

- To target smaller deals requires a direct local presence or good independent local representation. The firms with the lower Average Investment Sizes (Granville Baird, Apax, DLJ) do tend to list European executives and European offices. Those that do not (Friends Ivory, Advent) would seem to be sourcing their deals through networks of independent contacts.

7. THE CHALLENGE

Introduction

In the thesis overview in section 3 it was stated that a firm seeking to grow by expansion or diversification first must understand the situation and the specific issues and choices that it faces, as follows:

- its current position within its industry
- the options for growth that present themselves and an understanding of the risks and implications involved in each
- the activities, successes and failures of its existing and potential competitors and the lessons that can be learned from their experiences
- the key factors affecting its current market, and the factors that may come to bear on its intended markets

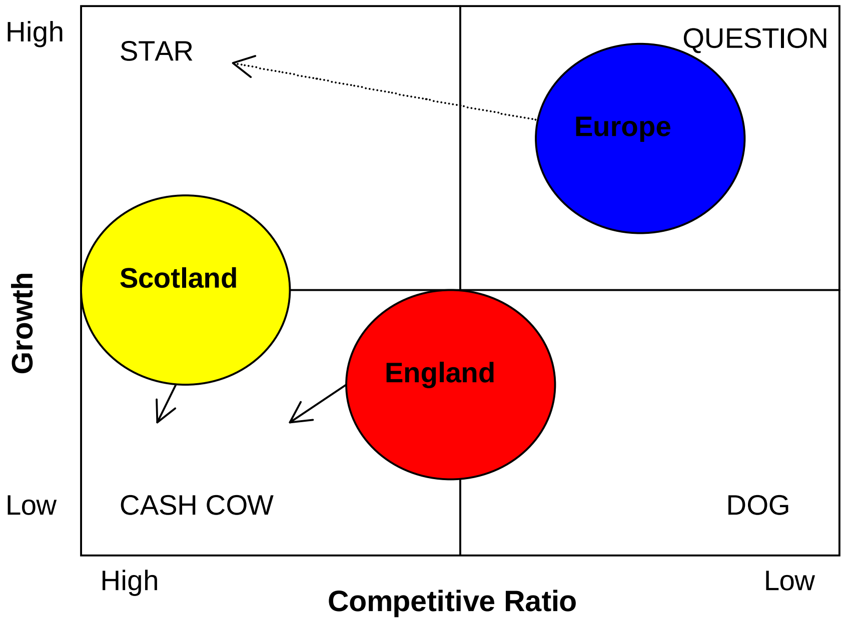
Sections 5 and 6 have dealt with the competitive and market issues, whereas in this section we assess the situation that the firm is currently in using specific analysis tools.

The BCG Grow-Share Matrix

The BCG Grow-Share matrix is useful in analysing whether a firm can use its strengths to support development in new areas. We have already described the firm in question as being a mid-market development capital player, based in Scotland but with a foothold in the English market and a tentative grasp in Europe through a couple of joint ventures. Taking geography as the basis for analysis, and using statistics provided by the University of Nottingham's Centre for Buy-out Research[10], the firm's BCG Grow-Share Matrix can be plotted as follows:

[10] See Appendix, tables C1 and C2 and graphs

Diagram 5
The BCG Grow-Share/Matrix – Geographic Regions



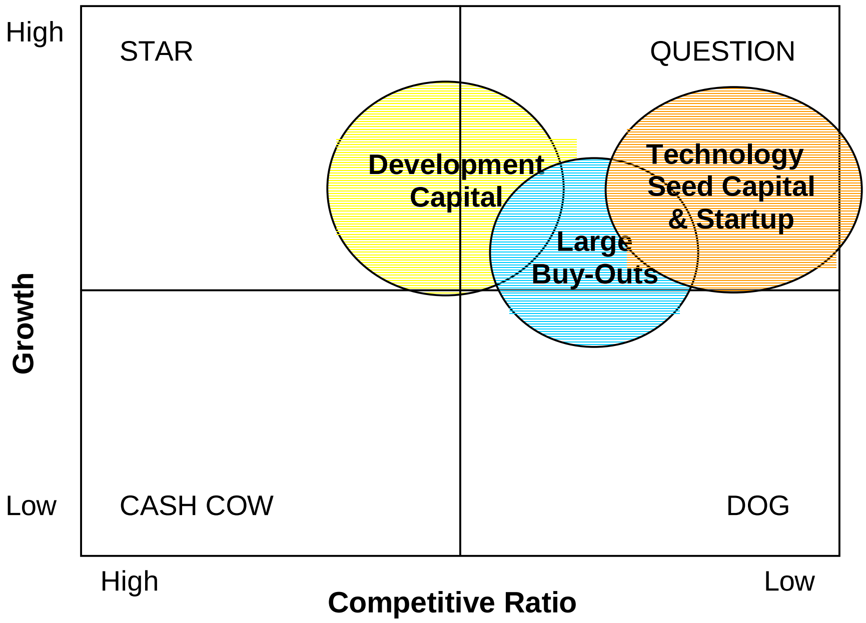
The above also reflects the findings of Indahl & Zinterhofer, that the UK market is becoming more competitive, while the European market offers significant growth opportunities.

The development capital market in the UK as a whole is generally considered to be mature, with levels of growth levelling out, perhaps more so in England than Scotland.

Conversely to the UK market, the European market is considered to be relatively immature, with excellent growth potential. At present, the firm has made only tentative steps to enter this market but should be able to use its strength in the UK to support its ambitions in this direction.

We can also apply the BCG Grow-Share Matrix to analyse the firm's position in various segments of the European Private Equity market, as follows:

Diagram 6
The BCG Grow-Share Matrix – Private Equity Market Segments



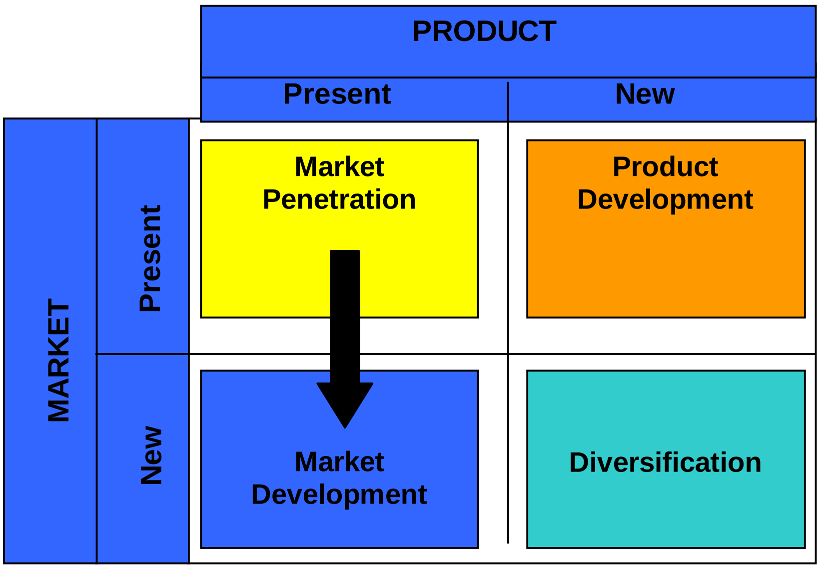
With its experience in the Development Capital sector in the UK, the firm is well-placed to apply its expertise in the potentially high-growth European mid-market development capital sector, albeit that it will face much stiffer competition in this sector on the European stage.

Its low competitive ratio in both the Seed/Startup and Large Buy-Out sector suggests that it might be better to avoid these sectors, certainly in the short term.

The Ansoff Product/Market Matrix

A further analysis tool is the Ansoff Product/Market Matrix, which is useful in highlighting the growth options available to the firm and presenting the potential implications of each option:

Diagram 7
The Ansoff Product/Market Matrix



Using the above chart as an aid, we can evaluate our options in each of the four quadrants, as follows:

- **Market Penetration** would involve increasing our share of the existing mid-market development capital sector in the UK. Given that this is seen as a sector that is going ex-growth, this is unlikely unless some of our competitors pull out. Certainly, the firm should seek to protect what market share it has, but may find it difficult to increase market share.

- **Market Development** involves applying the firm's existing expertise into new geographies. This certainly matches the scenario of moving into the European mid-market development capital sector.

- **Product Development** would involve diversifying into different products in the existing UK market. The options available might be:

    - Expanding into corporate lending, leasing and other banking areas. Given the firm's status as a captive of a large banking group, this is unlikely to be a realistic option.

    - Coming down the deal-size range into smaller, venture capital transactions.

- Going up the deal-size range into the "mega-buyout" market.

The latter two options would involve very different skill sets, cost structures and control implications which would have to be evaluated carefully before taking action.

- **Diversification** would involve a combination of new markets, such as Europe, together with a new product focus. The challenge of making the move into Europe could be seen as significant enough without combining with it the complications involved in moving into new product areas at the same time. To do so would require nerves of steel and deep pockets.

Routes to grow the firm
We should now turn our attention to the options available to achieve corporate growth.

- **Vertical Integration** forwards is not an option for the firm in question. Neither could it integrate backwards, since it is already owned by a bank.

- **Diversification** looks to be a dangerous choice that requires a very serious consideration of the appetite for the challenge, and the availability of the skills and financial resources to succeed.

- This leaves us with **Horizontal Integration**, as discussed above, into new geographical markets using the same "product" focus of mid-range development capital.

The options for Horizontal Integration can be set out as follows:

- **Organic** growth is an option in the UK, since it should be relatively easy to recruit new staff already possessed of the requisite skills and experience. The problem here is whether sufficient market share can be captured in a declining market to make this a worthwhile proposition.

  Organic growth in Europe is becoming easier, as more European nationals are becoming aware of the Private Equity industry and the skills and attitudes required in the industry are percolating through the employment markets in many European countries. The key is to know where it is most appropriate to locate such new teams.

- **Alliances** look like a sensible option, in that they allow a relatively risk-free mode of entry into unknown markets. The key is to identify appropriate alliance partners and retain with them a shared vision and strategy of how to exploit the opportunities presented.

- **Acquisition** of existing European Private Equity firms is a possibility, now that some small houses have become established. However, there is evidence that those independent houses that have started up in Europe have tended to focus on the lower end of the deal size range (seed and start up), which falls outwith the firm's current preference.

- The final option is that of **Poaching** – recruiting entire teams that have been set up and trained by our competitors. The key here is to target the best teams and get them on board without overpaying them, whilst still incentivising them sufficiently in order that they perform and so that they are not re-poached by other firms. The obvious danger is that the industry starts a game of "musical chairs" with teams jumping ship on a regular basis.

Implementation Framework (7 S's)

Having evaluated where the firm is, what it its trying to achieve and the various options open to it, we can now evaluate how it might go about implementing its ambitious plans for expansion on the European stage. In doing so, we will apply the 7 S's framework that was covered on the MBA course and shall attempt to evaluate how two different types of firm might apply the 7 S's:

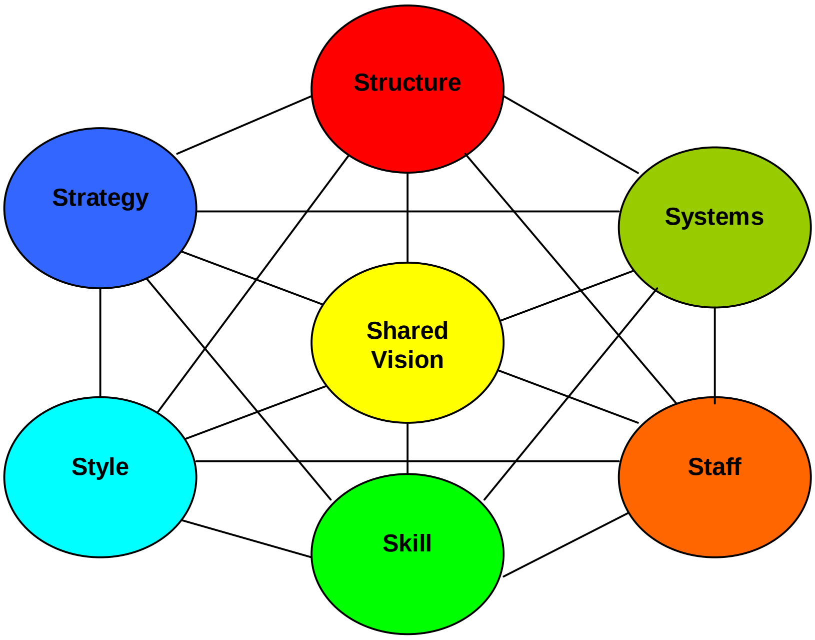
- A high-value, large buy-out firm, targeting major financial transactions in excess of £100m

- A firm operating at the lower end of the deal range

In doing so, we recognise that this presents two ends of the spectrum, and that a range of combinations exists in the middle, meaning that in reality a firm can choose to which extent it focuses its structure, depending on its own history and circumstances.

The 7 S's (Strategy, Structure, Style, Shared Vision, Skill, Systems and Staff) framework is a set of integrated organisation and management concepts which can be illustrated and defined as follows:

Diagram 8
The "7 S's" Framework



Source: MBA Course literature

1. Strategy According to Michael E Porter[11], Strategy is "*the creation of a unique and valuable position, involving a different set of activities*". It involves "*making trade-offs in competing. The essence of strategy is choosing what **not** to do*". Porter says that strategic positions emerge from three distinct sources:

- *Variety-based positioning*, where a firm chooses to offer products or services based on the choice of product or service variances rather than customer segments
- *Needs-based positioning*, where a firm targets a particular group of customers and seeks to serve all or most of the needs of that particular group
- *Access-based positioning*, which is a function of geographic location or customer scale ("*or of anything that requires a different set of activities to reach customers in the best way*")

From this, we can see that a firm targeting the high-value end of the deal range needs to adopt a strategy based on a combination of *variety-based positioning* and *access-based positioning*. Variety-based

[11] Michael E Porter, "*What is Strategy?*", Harvard Business Review, November-December 1996

positioning is determined by the size and nature of the deals it seeks to do, consequently it needs to position itself to be able to service that end of the market by ensuring that it has the cash resources to underwrite transactions, as well as the skills to deliver large and complex financial transactions. Access-based positioning is determined by the scale of the firm's target customers – large domestic companies and multinationals. Accordingly, it has to ensure that it has appropriate relationships with key individuals and organisations. Given the international nature of its target customers, the firm's location is unlikely to be a significant issue, although it must have the ability to place resources wherever they are required at the appropriate time.

On the other hand, firms targeting smaller transaction sizes will find *needs-based positioning* more appropriate. They need to understand in detail the needs, circumstances and business sectors and corporate cultures of their targets, which implies that they will need to employ local nationals, or at least individuals with a high level of language skills living the in the region. Given the geographic locations they will be operating in, such firms will also need to adopt access-based positioning, implying the need for networks of local offices.

2. Structure

In terms of structure, firms targeting larger transactions can afford to be smaller, with a flat heirarchical structure. It is likely that the small number of executives will have similar backgrounds in terms of age, experience, educational background etc, such that it is easier to control the culture and goals of the organisation.

On the other hand, because firms targeting smaller transactions need teams of people of the ground in a variety of locations, there will be an overhead in terms of the number of people required to deliver its services to the diverse range of locations that it serves. This in turn will require a more formal management structure in order to preserve the focus of the firm's strategy, and will require more sophisticated back-up and administrative infrastructures to support the geographically dispersed network of offices.

3. Style

The style of a team involved in large and complex financial transactions will most likely be targeted toward projecting an image of financial success and reliability. This may be reflected in various forms, such as prestige offices in exclusive capital city-centre locations, generous entertaining budgets and hospitality events etc. Contacts among the community of advisers and business introducers will be at national or international level (for example, rather than cultivating contacts among the practice managers of local accountancy firms, a firm should be targeting national and international corporate finance partners of international accountancy firms. Remuneration among smaller teams can also be much more individually-focused, with very high rewards for high performers and a "counselling-out" attitude towards those who take a little longer to deliver.

On the other hand, a focus on smaller, regional transactions will adopt a more egalitarian approach to potential targets. Particularly in the startup high-tech sector there is likely to be an emphasis on "dressing down" rather than "sharp business suits". Office locations are more likely to be based in regional cities, close to the prospective client base, and contacts among advisors and potential introducers will be at the regional level. Staff retention issues among larger and more dispersed teams may be an issue, therefore such organisations may find the need to adopt a "shared pot" policy towards remuneration. This will enable the retention of potentially good staff in new or developing offices.

4. Shared Vision

Theoretically, it should be simpler to develop, impose and maintain a common shared vision and set of goals within a small team of similarly aged and qualified individuals with a focus on large transactions.

However, to maintain congruence within a large team of culturally diverse individuals requires a far greater degree of continuous effort in order to maintain a "corporate culture" across the organisation. Ways of achieving this might include regular "company seminars", corporate newsletters, temporary secondment of staff between offices as well as regular management "tours". Shared vision can also be reinforced by adopting a policy of "sharing" success across the entire organisation by allocating bonuses based on the performance of the entire group rather than on individual performance.

5. Skill — A focus on larger deal sizes will demand very high levels of financial engineering skills and detailed knowledge of international capital markets. Similarly, larger deals require well-developed project management skills, in order to control and co-ordinate dispersed and diverse teams of due diligence providers, such as accountants, lawyers, environmental consultants, market research consultants and so on.

   Conversely, a focus on smaller deals implies the ability to understand local markets and industries to a significant level of detail. Additionally, general business management skills will be much more to the fore, since there will be a greater emphasis on assisting business managers in the day-to-day running of the business.

6. Systems — The support systems required by a relatively small team focusing on larger transactions can afford to be simpler than those needed by a large and geographically dispersed team. With fewer individuals to support, potentially fewer fund providers to report to and potentially fewer investments to control and monitor, a large deal focused team can survive with minimal sophistication in its support functions. Nevertheless, in order to convey a superior style, such a team may choose to invest heavily in such support infrastructures in order to present a “high quality” and “best of breed” image to its target market.

   At the same time, a firm investing significant amounts of cash in a single transaction will have to take greater care over its investment approval process. This implies that its evaluation and approval process can be complicated and the time taken to approve an investment will necessarily be long and drawn out. Given the nature of the market this will be understood by all parties, including fund providers, vendors and management. There may therefore be several levels of investment committees, advisory boards etc that will be involved in the process.

   A dispersed and culturally diverse team does not have the luxury of choosing whether to invest in efficient and effective support infrastructures. It simply must invest in the highest quality infrastructure in order to underpin and support the scale of its organisation and maintain an element of shared vision and common culture within its team. Because its reporting lines are potentially longer, it needs to have robust and reliable systems and controls to enable decisions to be made quickly in order to satisfy the market in which it operates. This implies a heavy overhead to support and there is considerable pressure to "get it right" and react to opportunities with speed in order to stay ahead of the competition.

7. Staff

The backgrounds, qualifications and personal attributes of staff required at each end of the spectrum are also very different.

A team focusing on large and complex transactions, potentially involving a significant international flavour, are very likely to be highly-experienced in such transactions, of a similar age and background and willing to undertake a considerable amount of foreign travel on a regular basis. Their skills will lie in the financial engineering stratum, and their contacts will be at very senior levels among international firms of accountants, lawyers, merchant banks and industrial corporations. They are likely to demand very high salaries, combined with bonus and reward packages based on individual performance; the "eat what you kill, if you don't kill you starve" ethos.

Geographically spread teams, while also requiring high levels of educational qualifications and experience, are much more likely to be locally-based, requiring limited amounts of travel. Their background and experience will be focused on local markets, and they will require more rounded, general business management skills in order to support the less experienced management teams they are seeking to back. They may also need to demonstrate direct experience of particular industrial and commercial sectors in order to win transactions in those areas. This supports the premise that such firms need to adopt "needs-based positioning" to satisfy the particular requirements of their target market. Finally, allied to the need to maintain a sense of shared vision and common purpose across the entire organisation, remuneration and bonuses are likely to be based on team performance, rather than on the performance of the individual.

In conclusion it is clear that different types of firms need to be aware of how their own circumstances and the shape of their target market have profound implications for how they organise themselves to meet the challenge of business expansion and development.

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Table of Diagrams

Appendix A - Index of Terms

This thesis uses certain terminology that might not be immediately understood by a reader unfamiliar with the Private Equity industry. This index of terms is therefore included in order to facilitate a fuller understanding of the text.

Term	**Explanation**
3rd-party fund management	Equity financing firms often raise funds from third parties which will then be invested in equity transactions. The extent to which a firm has, or has not, access to third party funds will determine whether it is seen as a “captive”, “semi-captive” or “independent” manager.
Buy-In/Management Buy-Out (BIMBO)	A variant of MBO’s and MBI’s, where managers from outside the company, together with management from within the company, come together to buy the business from its existing owners.
Buy and Build	Buy & Build strategies are adopted where an industry in a geographical region is fragmented, with several small players each with a small market share of a significant market. Venture capitalists and management teams may buy one or two of the smaller firms initially, with a view to subsequently buying up other firms in order to consolidate the market. The logic is that the combined entity wields greater economic power through achieving economies of scale and can thus begin to generate superior profits. The combined entity then becomes a candidate for flotation, secondary buy-out or trade sale to a larger industrial buyer.
Captive funds	Where an investment firm invests funds provided exclusively by a parent undertaking and does not have any 3rd-party funds under management. Captive funds are typically the private equity of development capital subsidiaries of major banks or other financial

	institutions.
Carried Interest	A percentage of the excess return on an investment fund over a nominated hurdle IRR (see below) will often be returned to the management company and/or its executives in what is called a “carried interest payment”. This is an incentive to the investment manager to achieve as high a return as possible from the funds invested, since he will directly benefit from the return achieved. Carried interest percentages generally range between 10% to 25% of the excess return over the hurdle IRR. The hurdle IRR typically ranges between 10% and 15%.
Co-Invest	Executives of Private Equity are often given the opportunity to invest on a personal basis in the equity of companies acquired by the investment funds they manage. This gives the executives the opportunity to directly benefit from the profits generated by the investments they transact. It also serves as a powerful incentive for the executives to remain with their current employer, as Co-Invest schemes normally include provision for shares to be bought back at cost should the executive leave the firm,
Development Capital	Financing a mature and established business through major growth and development stages of its life cycle, typically pre-IPO, and often involving MBO and MBI transactions.
Exit	The successful disposal of a business, either by way of trade sale, IPO or secondary buy-out.
Fund of Funds	An investment firm that does not itself invest directly in the equity of the companies in its portfolio but instead allocates its funds among a number of other managers who then invest directly.

Gatekeeper	See “fund of funds”.
Independent manager	Where a firm is not reliant upon a parent or associated undertaking for its investment funds but instead secures all, or at least a very significant proportion, of its funds from 3rd-parties.
Initial Public Offer (IPO)	The initial flotation of a business on the stock market.
Institutional Buy-Out	Where a company is acquired by a financial institution rather than by a management team, with the financial institution bringing in its own team to run and manage the business toward a successful exit
Internal Rate of Return (IRR)	A measure of the cash return on an investment over time. IRR represents the interest rate that would have been required to generate the cash received on the realisation of the investment based on the amount of the initial investment.
Leveraged Buy-Out	Where a buy-out transaction is substantially funded by debt rather than equity.
Limited Partnership (LP)	An investment vehicle established to channel funds provided by investors. The LP is a well-established concept in the US and UK (1904 Limited Partnership Act), where the LP vehicle allows assets to be held in the name of the LP rather than the investors. There is a tax advantage in that the LP itself is not subject to tax; instead the tax authorities “look through” the LP vehicle to separately assess the partners on their share of the profits or losses of the LP.
Management Buy-In (MBI)	A transaction where a team of managers from outside a particular company purchases equity control of an existing business.
Management Buy-Out (MBO)	The situation where the existing managers of a

business buy the business from its present owners. Such situations often arise through insolvency or distress of the business itself or of its parent, or when the parent wishes to dispose of non-core subsidiaries in order to focus on core activities.

Private Equity — Investment in the equity of private (ie unlisted) companies. The term "Private Equity" is often used to describe the full range of the unlisted investment industry, covering seed capital, startups, development capital etc. However, the term is more commonly used nowadays to refer to transactions at the higher end of the scale, such as MBO's valued at £100m and over.

Public to Private (P2P) — Where a company is taken off the stock exchange and de-listed, thus becoming a private company again.

Secondary Buy-Out — The sale of a business to another financial backer. For example, an equity provider might provide finance in the seed or startup phase, and then sell on to another equity financier as a development capital deal.

Seed Capital — Financing a business during its embryonic stage, where perhaps it needs funds to develop its products or technologies prior to startup.

Semi-captive funds — Where a substantial proportion of a firm's funds have been provided by its parent but it also has a significant element of its total funds under management which has been sourced from 3rd-parties.

Startup — Financing an embryonic business that has developed a product or concept, enabling it to then begin to market and sell its products.

Trade Sale — The sale of a business to another industrial company rather than through a financial institution or by way of a public offering.

Venture Capital	Generally seen as financing a business through the early stages of its development. Typical transaction values in venture capital would be in the range of £500k to £5m

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Table A - Cross-Border Transactions between European Countries in 1999

Acquiring Country	Austria	Belgium	Finland	France	Germany	Holland	Ireland	Italy	Luxembourg	Portugal	Spain	Other Countries	Total
	Target Country												
Austria	-	1	-	1	12	-	-	6	-	-	-	3	23
Belgium	-	-	-	23	6	8	1	2	5	3	5	17	70
Finland	-	1	-	4	5	2	-	5	-	-	1	1	19
France	-	12	-	2	14	6	-	18	1	1	20	32	106
Germany	25	12	2	36	-	24	1	18	6	-	17	276	417
Holland	3	14	2	16	23	-	1	3	-	5	16	29	112
Ireland	-	-	-	1	-	-	-	-	-	1	-	1	3
Italy	-	3	1	24	11	3	-	-	-	-	8	26	76
Luxembourg	-	-	-	-	3	-	-	3	-	-	-	-	6
Portugal	-	1	-	-	-	-	-	1	-	-	10	2	14
Spain	2	1	1	15	5	1	-	4	-	9	-	10	48
Total	30	45	6	122	79	44	3	60	12	19	77	397	894
% of Total	3.4%	5.0%	0.7%	13.6%	8.8%	4.9%	0.3%	6.7%	1.3%	2.1%	8.6%	44.4%	
Acquisitions by Private Equity/Investment Companies	1	3	-	22	20	-	1	20	-	1	16	N/A	84

Source: *The Translink Deal Review 1999*

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Table B - Economic and Social Data on European Countries

		Population				Government & Legal		Economic						
										Economic Sector Breakdown				
Country	Capital	No	% of working age	Growth Rate	Literacy rate	Type of Government	Legal System	GDP per capita (US$ 000's)	GDP Growth	Agriculture	Industry	Services	Inflation rate	Unemployment Rate
United Kingdom	London	60m	65%	0.25%	99%	Consitutional Monarchy	Common Law, Roman origin	21.8	1.9%	1.7%	25.3%	73.0%	2.3%	6.0%
Austria	Vienna	8m	68%	0.25%	98%	Federal Republic	Civil Law	23.4	2.0%	1.3%	32.4%	66.3%	0.5%	4.4%
Belgium	Brussels	10m	66%	0.18%	98%	Consitutional Monarchy	Civil Law with English influences	23.9	1.8%	1.4%	27.0%	71.6%	1.0%	9.0%
Finland	Helsinki	5m	67%	0.17%	100%	Republic	Civil Law with Swedish influences	21.0	3.5%	5.0%	32.0%	63.0%	1.0%	10.0%
France	Paris	59m	65%	0.38%	99%	Republic	Civil Law	23.3	2.7%	3.3%	26.1%	70.6%	0.5%	11.0%
Germany	Berlin	68m	68%	0.29%	99%	Federal Republic	Civil Law	22.7	1.5%	1.2%	30.4%	68.4%	0.8%	10.5%
Holland	Amsterdam (seat of govt in the Hague)	16m	68%	0.57%	99%	Consitutional Monarchy	Civil Law, incorporating French penal codes	23.1	3.4%	3.5%	26.8%	69.7%	2.2%	3.5%
Ireland	Dublin	4m	67%	1.16%	98%	Republic	English Common Law	20.3	8.4%	5.0%	39.0%	56.0%	2.2%	5.5%
Italy	Rome	58m	68%	0.09%	98%	Republic	Civil Law	21.4	1.3%	2.6%	31.6%	65.8%	1.7%	11.5%
Luxembourg	Luxembourg	0.4m	67%	1.27%	100%	Consitutional Monarchy	Civil Law	34.2	4.2%	1.0%	23.0%	76.0%	1.1%	2.7%
Portugal	Lisbon	10m	68%	0.18%	87%	Parliamentary Democracy	Civil Law	15.3	3.2%	4.0%	36.0%	60.0%	2.4%	4.6%
Spain	Madrid	40m	68%	0.11%	97%	Parliamentary Monarchy	Civil Law	17.3	3.6%	3.2%	33.6%	63.2%	2.3%	16.0%

Source: *The CIA World Factbook* (www.odci.gov/cia/publications/factbook)

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Table C1 - Trends in the UK Buy-Out Market

(see also graphs on next page)

Number of deals in year ---------------->

Deal Range	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 *
< £1m	203	173	135	120	108	77	80	64	64	15
£1m - £5m	290	324	277	301	308	350	379	352	303	70
£5m - £100m	79	95	76	132	167	204	218	231	231	54
>£100m	6	3	4	4	11	10	16	27	35	9
Total:	578	595	492	557	594	641	693	674	633	148

* to end Quarter 1, 2000

From 1998/99 most ranges of deals show signs of a slow down in terms of numbers of deals done.
Deals in the £100m+ range show signs of growth, but overall volumes remain modest.

Source: The Centre for Management Buy-out Research, University of Nottingham, Quarterly Review Spring 2000

Table C2 - Trends in Regional Buy-Out Markets

(see also graphs on next page)

Number of deals in year ----------------->

Region	1996	1997	1998	1999	2000 *
Scotland	60	64	64	52	5
Rest of UK	581	629	610	581	143
Total	641	693	674	633	148

* to end Quarter 1, 2000

- Scotland hit a peak of 64 deals in both 1997 and 1998, but 1999 levels were down on 1996, with 2000 levels looking lower still.
- The rest of the UK hit a peak in 1997, and seems to be declining since.

Source: The Centre for Management Buy-out Research, University of Nottingham, Quarterly Review Spring 2000

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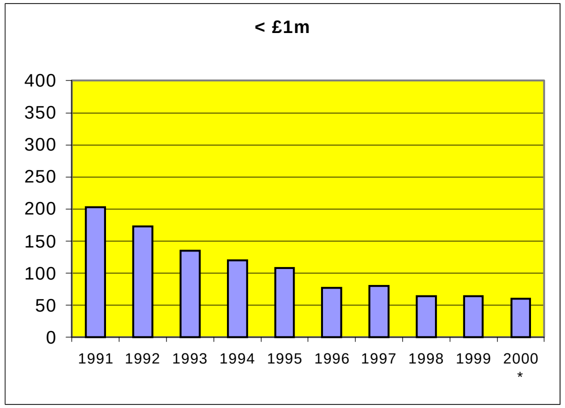
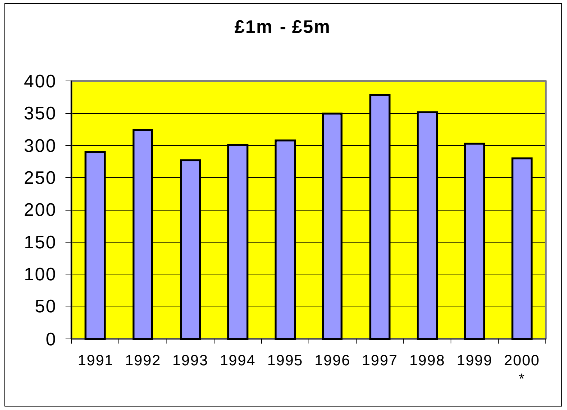
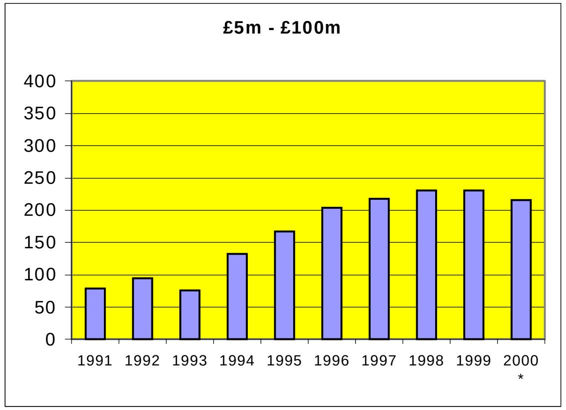
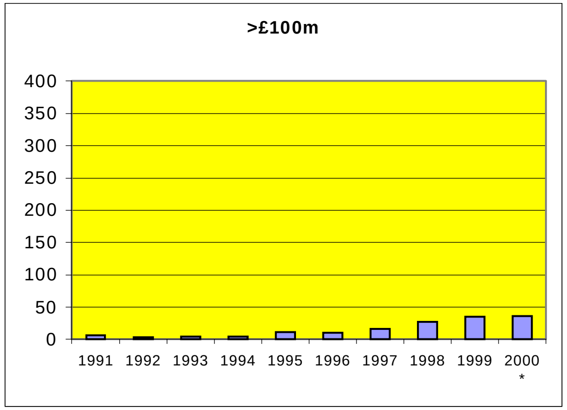
Numbers of UK deals by deal size range (Refer to data in Table C1)









* 2000 Projected. Based on end-Quarter 1 figures.

Source: The Centre for Management Buy-out Research, University of Nottingham, Quarterly Review Spring 2000

Appendix C - Acknowledgements

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