Private Equity in Italy: An Interview with Fabio Sattin

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Lack of domestic growth, NPLs, profitability, disintermediation and emerging technologies are some of the challenges that the Italian banking and financial system need to address in the coming years. But in the meantime, Italy, with its great industrial and entrepreneurial base (the second largest in Europe after Germany) and substantial amount of private savings, is also an extremely attractive opportunity to develop added value. **Mr. Fabio Sattin,** chairman and founder of Private Equity Partners SGR and senior contract professor of private equity and venture capital at Bocconi University in Milan, addressed some of these important issues in an interview with Giada Vercelli at the Euromoney Italy Conference held in Milan on 13 September.

Giada Vercelli: Given the lack of growth in the economy and the tendency of corporates to de-leverage their balance sheets, what are the future challenges the Italian banking system will have to face and what should be done to address inadequate capitalisation, excessive NPLs and the financing needs of Italian corporates?

Fabio Sattin: In the next few years, the Italian banking system will certainly face many critical issues. The way it deals with finding solutions will directly affect, either positively or negatively, Italy's future development. NPLs and the need to recover profitability are two fundamental issues that must be addressed as soon as possible. Consolidation and lack of skills also represent challenges. New technologies are a significant strategic challenge for the future. Traditional structures will not be needed anymore and new technologies will soon give rise to two main issues: how to redeploy surplus labour, and how to develop the necessary skills to survive and compete in the modern world. Moreover, lending procedures need to be enhanced and adapted to the needs of corporations, and the present "asset based" lending approach should be replaced by a more appropriate, but technically more complicated, "cash flow lending" attitude. To do this, different and sophisticated skills, a high level of experience, significant investment, and a lot of training and time are necessary. Unfortunately, there is limited time available for such change so it is mandatory for the Italian banking system to move quickly and with determination to achieve these objectives. In the end, success will be a question of skills, professionalism and training. This is the only structural and long term solution to the current problems facing Italy's banking sector.

GV: Do you believe the current need for adequate skills and professionalism also applies to the private equity industry?

FS: It certainly does. Even private equity and venture capital players sometimes need to review and enhance their skills, but let me say that in Italy there are very good and experienced professionals with a very long history behind them working in this field. The term "carried interest" was invented in Italy. In fact, the origin of the term goes back to the medieval merchants in Genoa, Pisa, Florence, and Venice. These traders carried cargos belonging to other people on their ships and earned 20% of the profits on the "carried" product. It is somehow in our DNA. Benedetto Cotrugli, an Italian medieval merchant, wrote the book The Art of Trade in 1458 (the first English translation with the introduction of Prof. Niall Ferguson will be published by Springer in December 2016). But history aside, even nowadays Italian private equity players have proven themselves to be reliable, professional and skilled in managing financial resources mainly provided by large international institutional investors. We may even say that private equity is probably the most internationalised branch of the Italian financial industry, having dealt with foreign investors for many years.

GV: Another priority of the Capital Markets Union initiative is the encouragement of venture capital and private equity. In your opinion, how and to what extent may the improvement and development of this sector benefit the Italian economy?

FS: Private equity can be a great boost to further develop Italy's creative industrial and entrepreneurial base and can represent a great opportunity for national and international investors. Due to their often small dimension and significant undercapitalisation, Italian companies can highly benefit from being supported by professional private equity investors who can help them during the necessary expansion, consolidation and internationalisation process, managing generational change and, when possible, stimulating and coordinating "buy and build" projects. These are increasing in our country and will probaby represent one of the main drivers for the private equity industry. Private equity players can provide Italian dynamic export-oriented SMEs with much more than money, international contacts and expertise. They can act as "conductors" to allow for their integration or the creation of industrial clusters. They can foster their growth through mergers and acquisitions or by creating the best governance conditions for their flotation on a regulated stock market.

GV: Leaving aside traditional tools, there is a growing interest in alternative sources of funding. Traditional private equity structures, typically closed-end funds, are flawed, as seen after the crisis of 2009. A lot of private equity funds tried to change and adapt their business models to new market conditions. What do you think of this new trend and how could the new alternative instruments be used?

FS: I completely agree with those observations. The technical investment instruments which have been adopted by private equity players mainly operating through closed-end funds, haven't always been able to provide an effective answer to the changing needs of companies and investors. The rigid pre-determined investment and divestment period, which is typical of closed-end funds, and the method of calculation of fees normally adopted, have highlighted significant areas of potential misalignment of interests between investors and fund managers. This has sometimes led the latter not to act in the companies' and investors' best interest, in particular as far as expansion capital and minority investments are concerned, which represent a significant part of the European (especially Italian) private equity market. Real problems emerged with the economic and financial crisis. Since then, some fund managers have tried to mitigate this misalignment of interests by extending the duration of funds, reducing their dimensions and partially remodelling the fee structure. But this is not always enough. Much more needs to be done. New investment vehicles with different characteristics are required. These instruments should be more flexible, adaptable, able to meet the needs and timing of participating companies and entrepreneurs, more aligned with investors' interests, and more suited to modern times.

The market, as always, reacts and adapts to these changes naturally. Even before experts and researchers understand what is going on, it has already begun to change. So new structures appear, even in our country: listed and unlisted holding companies, listed funds, SPACs, co-investment agreements, club deals, direct investments by family offices and sovereign funds, evergreen funds, umbrella funds, SST (subsequent subscription tranche funds), different hybrid funds, including the emerging (also in Italy) and articulated offer of private debt funds, particularly suitable to meet expansion capital needs and often promoted by skilled private equity operators.

Moreover, in a new investment world where providing added value is of fundamental importance, the quality of investors and their characteristics matter, too. And the possibilty to have different investors, more suited to the specific investment considered and selected on a deal-by-deal basis, can also be a great advantage for attracting (and winning) the best investment opportunities, particularly on expansion capital deals. This is obviously very difficult to achieve for a traditional closed-end fund investment structure.

In short, we need many different new instruments with the same objective: identify promising companies and entrepreneurs to invest in, help them in their development and enhancement process in order to obtain an economic return on initial investment according to the most appropriate timeframes and methods, and distribute such a return (if present) among investors and private equity managers.

This is the essence and objective of private equity activity. Closed-end funds only represent one of the many existing vehicles that, for many reasons, are not functioning properly today. But this aspect is not important. If a vehicle is not appropriate, it needs to be changed. Obviously, a change of standard practice and market conditions always leads to some resistance and risks but I believe that today we need something new in order to create the basis for future development, stabilisation and long-term evolution of the private equity industry. However, flexibility and the need for regulation are often conflicting concepts.

GV: How can the changes and new products you have just mentioned be effectively managed to benefit your country, taking into consideration the increasing need for regulation?

FS: Ensuring maximum articulation and flexibility of these new instruments within the confines of a regulatory framework that dictates their correct usage, is the real challenge the private equity industry and regulators will have to face in Italy, a country often affected by uncertain or unclear legislation. Finding the right balance between these naturally conflicting aspects will not be an easy task, especially because new legislation will have to comply with an increasingly internationalised and competitive market. Italy, as many other countries, needs international investors' money. Brexit may represent a great opportunity. After Germany, Italy has the largest and strongest industrial base in Europe. In short: the companies where investment can be made are in our country. Private equity professionals are also present, and have shown themselves, through many years of activity conducted in partnership with international institutional investors, to be expert, honest, reliable and compliant with the best international business and ethical standards. If we capitalise on this and develop a sound and clear platform for investors with clearly defined rules and sound legislation and procedures, there is no reason for international investors to go elsewhere. This is a great opportunity for our country.

GV: As far as new financial instruments are concerned, what do you think about private debt? Does it represent an emerging opportunity for Italy?

FS: Absolutely, I strongly believe that private debt, in all its forms, can play a very important role in Italy's future development, especially if we take into consideration the growing need for companies to become less dependent on the banking system and the subsequent need to develop new financial intermediaries and a more articulated independent financial market. Some signs of this new instrument's future emergence are already visible but the development and success of this segment are strictly linked to the attitude of Italian institutional investors, primarily pension funds. They need to be more confident in Italy and boost the development of private debt by providing finance. To do this, apart from the necessary transparency and clear and adequate governance rules, they need professionalism and adequate know-how. It is essential for Italian institutional investors to develop the necessary skills required to correctly understand and manage this new investment instrument. If this happens, Italian companies, particularly SMEs, will largely benefit from it.