CHAPTER

19 Strategies, business models, and perspectives of private equity and venture capital

19.1 GENERAL OVERVIEW: A WORLD BETWEEN THE GOLDEN AGE AND UNCERTAINTY

After a five-year period of economic growth and a buyout boom, for many countries the last quarter of 2007–2008 marked a turning point in the global private equity environment. The golden age has passed and a new age of uncertainty is starting, but for some it has the sweet smell of opportunity. With an estimated €200 to 300 billion in unsyndicated leverage loans on their books in 2008, it appears that banks were the first buyout players to suffer. As the attention of bankers moved from credit risk analysis to debt syndication, many say they are reaping what they sowed. The credit crunch may have been triggered by the sub-prime mortgage problems, but the consequences run deeper. In five to seven years, the leading role of banks in the corporate banking and corporate finance market evolved dramatically: from principal lenders they became debt producers and brokers on a completely different scale. Financial structuring complexity has driven debt market participants to lose the sense of risk and driven the great renaissance of the high-yield market. Private equity opponents blame big buyout partners and it is true that increased leverage multiples and loosened covenants can sound like a good thing for financial sponsors, i.e., more risk and less discipline.

Apparently, the big buyout sector seems to be the most exposed to risk, and investors tend to oscillate between optimism and pessimism when asked about the effects of the credit crunch. Some argue it is the end of the large buyout era or the end of the golden age of private equity. A large number of investors also fear the United States will be affected by a private equity downturn more than other countries: in terms of capital deployment, fund investors hesitate between the worry of not having their money put to work fast enough and the fear of being too quickly deployed in less attractive and smaller deals. Most agree that if the economic downturn affected operating companies, things would be worse. While default rates still remain at historical lows, this may be simply the result of particularly weaker terms (i.e., few covenants, new repayment scheduling, etc.). Despite the big turmoil it is causing, the change in leverage loan market conditions is welcomed as a healthy and necessary correction by many market players and investors. It might be the end of the golden age but certainly not of the adventure of private equity. The players are simply being reminded that discipline and fair management are not old fashioned European words, but pillars of a competitive advantage for private equity and the financial system.

Private equity investors focus on the long term, and it is hard to find supporters of this market timing approach. However, as this new cycle starts, investors in Europe and the United States have clearly expressed concern about the future IRR leading to an increased focus on investment strategies able to produce higher returns in a less than favorable economic environment. This means the 2009–2010 asset allocation will be both defensive and offensive at the same time; looking for a high standard of quality, a well-suited pattern of investment, and emerging potential targets of considerable interest.

Today investors agree that relevant performance will come from middle market and lower middle market players. Investors (and limited partners) are increasing their focus on teams capable of showing and demonstrating their value creation system. Europe and North America also offer significantly attractive and challenging opportunities with teams that have proven experience in building strong private equity firms to invest through a buy and hold approach adding a true "industrial touch" to their venture-backed companies. In the higher middle-market cluster, a number of teams target both privately held companies and listed companies; more and more listed companies appear as attractive targets for those larger middle-market buyout teams looking for undervalued companies to take private. Great opportunities are available for private equity firms with experience dealing with public companies both in Europe and the United States.

With Europe and the United States in turmoil, investors are turning more and more to emerging markets as the next stop for favorable performance. The growth rate of these markets has little reliance on bank debt making them even more appealing. Choosing the right private equity firms is a key challenge in that area. A rising number of investors are starting to wonder whether the next bubble lies in China, India, or Korea. The Middle East is another region where a number of family-owned investment teams have grown to become strong and experienced investors. However, some important challenges remain in these emerging markets. They include the need for regulatory framework, and a wider capital market, human resources, and political risks. For these reasons, Europe and the United States still remain a preferable market in which to invest because of the very strong private equity firms, teams who live (and to survive) both in good and bad times (the 1998 Russian debt crises, the 2000 tech-Internet bubble, and 9/11).

The newest entry in the private equity market for 2007–2008 are sovereign funds. But while the visibility of this phenomenon is quite new for the fundraising market, the actual sovereign funds investment activity is not. Some of these players have been investing for many years and have become very skilled and professional asset managing teams. But 2007–2008 proved another strong year for the secondary market too. During this time (and 2009 is following this trend) the large majority of sellers accessed the market as part of natural portfolio management activities — even the power stays in the hands of buyers.

19.2 EUROPEAN BACKGROUND

European Union GDP was quite strong in 2007, but 2008 results and 2009 expectation are not positive. In this context and despite global financial crises, European private equity remained strong as reflected by the new record investment amount (even in 2007) and attractive to investors as reflected by the fundraising flows in 2008. Today, the key figures of European private equity are

1. Three countries generated more than the 70% of the deals in 2007 and 2008 (i.e., the UK, France, and Germany)
2. The UK covered more than the 50% of the fundraising amount in 2007 and 2008
3. Thirteen general partners raised more than €1 billion in new fund closings in 2007 alone, thus hosting 50% of the 2007 fundraising
4. One-fifth of the buyout activity was represented by mega deals in 23 European companies

The dynamism of the private equity sector was driven by both organic growth and first time funds established in the last three years in both the venture and the buyout markets mainly by investment professionals with track records built in established private equity firms. In 2007, there were approximately 1,900 active private equity firms making direct investments in Europe alone.

Investments in European companies in 2007–2008 as a percentage of GDP was 0,5% on average. Even the weight of the private equity value in the overall economy varied across countries: between 0,1 and 1,2% in Sweden, the UK, and the Netherlands at the upper end and Greece, the Czech Republic, and Portugal at the lower end.

After an exceptional 2006, fundraising scaled back by approximately 30% to €79 billion in 2007 and €65 billion in 2008. Nevertheless, this was close to 10% above the total funds raised in 2005, and substantially higher than the €20 to €48 billion collected yearly between 1997 and 2004. The UK hosted more than half of the 2007 fundraising while France and Germany were next with 8,3 and 7,2%, respectively. For the first time Greece was in the top five countries in terms of fundraising, which was primarily due to the structuring of the Marfin Investment Group (a Greek buyout private equity firm). As in the past (even for 2007), the fundraising amount was driven by buyouts and 13 funds raised more than €1 billion in 2007.[1] However, by the number of independent funds raised the picture was more balanced between two segments of the market: 58 buyout funds versus 46 venture funds reaching final closing. Altogether 141 private equity funds reached final closing in Europe in 2007.

The type of investors behind the 2007–2008 fundraising — for example, the traditional British LP type — continued to lead the ranking: pension funds, banks, and insurance companies. Similar to 2000–2006 as well as in 2007 and 2008, pension funds were the number one source of funding, mainly due to the UK pension funds activism across the world.

In 2007–2008, the average fund size for private equity funds that reached final closing in Europe was €112,8 million, whereas for the buyout cluster it was only €928,7 million. Data are not so different without the UK sample. While most funds did not have a specific sector focus, there were eleven ICT-focused funds reaching final closing in 2007 with an average fund size of €140,2 million, six life sciences-focused funds with an average fund size of €132,1 million, and five energy and environment focused funds with an average fund size of €111,18 million. The ICT-focused funds were managed primarily from Poland, the UK, and France, with the life sciences funds raised mainly by the UK and the Netherlands, and the energy and environment funds mainly managed in the UK and France.

If we consider the stage distribution by percentage of amount in 2003–2007, 60% was made by turnaround and buyouts, 30% by expansion, and 10% by seed (1%) and start up (9%). Percentages change dramatically if we consider the distribution by percentage of number of investments, whereas 33% is covered by expansion, 30% by start up, and 24% only by turnaround and buyouts.

The companies targeted for investments were predominantly, as in 2006, in the 1,000–4,999 employee bracket by amount invested. Regarding the number of employees for the European companies that had access to private equity financing in 2007–2008, 32,1% of the companies employed below 19 staff members, while 31,2% employed 20–99.

On the divestment side, exits decreased by the amount divested at cost and by number, and the emphasis was put on sales to other private equity firms, which accounted for nearly one-third of the total amount divested. This is the first time divestment methods exceeded trade sales even if by a small margin. Divestment by European private equity firms decreased by 18,3% at €27,1 billion in 2007. Trade sales have increased in the €7,5 billion to 7,6 billion range, but ranked only second as an exit channel in 2007. Sales to other private equity investors took the lead, doubling their share to 30,4% at €8,2 billion. Divestments by public offering were below the five-year European average in 2007, and they moved closer to zero in 2008.

Similar to investments, the UK remained the main platform for private equity exits even when aggregating figures by country of location of the private equity firms in charge of the divestment or by country of location of the portfolio company. Similar to the ranking of countries by investment amounts, the most targeted divestment markets after the UK were France and Germany with more than €4 billion divested at cost in 2007 for each of the two countries.

When looking at exits per market segments, trade sales led the way for venture capital exits with a 30,1% share of the €5,1 billion venture divestments, while secondary sales led the way for buyout exits with a 34,6% share of the €20,4 billion buyout divestment in 2007.

19.3 STRATEGIES AND BUSINESS MODELS OF PRIVATE EQUITY FIRMS

To analyze strategy within private equity firms it is useful to identify business models that are common in Europe. A focus–ownership–positioning (FOP) approach is helpful to distinguish the

- Focus of investment made by the private equity firm, related to the country/countries area of investment
- Ownership of private equity firms, which conditions the style of investment and the long-term profit goals
- Positioning of the private equity firm on the market, related to the competitive strategy to select investment

Focus, ownership, and positioning are the three dimensions of a business model in the private equity industry and every private equity firm has a different combination of them that affects the competitive strategy and profit results for investors.

19.3.1 The focus of investment

The focus of investment has a relevant impact on the scale, on the team, and on the network the private equity firm has to manage and defend. The geographic area focus is the first step in identifying a strategy and building an organization; in comparison with other (even financial) services, the private equity industry is totally "human and human network based." This means a process of diversification through geographic areas is quite difficult and slow as skills are not easy to find in markets such as equipment, factories, and other tangible assets.

It is possible to distinguish three different ways to use this focus:

1. Domestically
2. Internationally (i.e., pan-European, pan-American or pan-Asiatic)
3. Globally

The most common strategy is domestic focus — if the size of the country is large enough and makes it possible and rational — because of the natural linkage between the background of the management team and its expertise and presence in the social and economic network. On the contrary, private equity firms following international or global focus are structured as a network similarly to big consulting companies. Private equity firms following international or global focus can manage the multi-country dimension in two different ways:

1. Many funds investing in many countries (i.e., like Permira, Apax partners, etc.)
2. One fund (or more) for every country (i.e., 3i, Blackstone, IFC, etc.)

Private equity firms following a global focus can act through direct investment with many funds (the so called "mega fund" strategy, like KKR) and direct investment in other funds (the so-called "fund of funds" strategy). Only the first strategy can be mentioned as a "pure" private equity strategy because of the ability to invest and stay in venture-backed companies, whereas the second strategy can be considered a financial strategy and not a "pure" private equity strategy.

The focus generates a sort of symmetry between the investment policy and the size of investment. Private equity firms can be divided into three categories based on their size/average investment ticket:

1. Small-size players invest between €1 and 5 million in each deal, typically small buyouts and expansion capital transactions. These players are mostly local, i.e., based in the country of the management team.

2. Medium-sized players invest between €5 and 20 million in each deal. Some of these players are sponsored by industrial companies or are

connected to foreign financial institutions, again the majority of these vehicles are local.

3. Large private equity players invest in equity tickets in excess of €20 million. Many of these are international or global private equity firms with widely available resources to invest, but most are branches of global funds with an established presence in a relevantly sized country.

19.3.2 Ownership of private equity firms

Owning a private equity firm is not neutral to strategy because there are both profit goals and styles of management within the investment. Using the ownership concept, it is possible to distinguish five different categories/strategic models of private equity firms owned by:

1. Banks (or financial institutions)
2. Corporations
3. Professionals (i.e., the so-called "independent" private equity firms)
4. Governments
5. Private investors

Private equity firms owned by banks or financial institutions promote funds from financial institutions willing to operate in the private equity market through a dedicated vehicle. It is quite common in Europe because of the concept of the Universal Bank, which creates specific legal entities when the business is risky or relevant in terms of capital expenditure, like the private equity case. As a natural consequence, the activity of the bank-owned private equity firm is strictly related to the strategy of the financial group. The pros of this model are the brand name usage and leverage, the reputation effect, support coming from the network of the financial group, synergies with corporate lending, and the very high potential of fundraising. The cons of this model are the potential divergence from a "pure" profit goal (i.e., private equity sustains and subsides the corporate lending) and the potential lack of an independent strategic view. Typically, bank-owned private equity firms are quite strong in private equity where their financial know-how and expertise are required and relevant for the competitive advantage rather than the necessary industrial knowledge and hands-on approach for buyouts and pure expansion financing.

Corporate owned private equity firms promote funds from a corporation aiming to operate in the private equity market or for profit and for sustaining the core industrial business. The nature of such private equity firms is strictly related to the strategy of the corporate group. The pros of this model are again the brand name usage and leverage (similar to bank-owned private equity firms), the reputation, the network of the corporate group, deep industrial knowledge, and the potential ability to manage venture-backed companies. The cons are the potential low level of financial skills and the financial constraints coming from the corporate reputation; for example, a downgrade of the corporation can generate a negative effect both on the fundraising and on the ability to raise money for each deal. Typically, corporate-owned private equity firms are better suited for private equity investment requiring industrial know-how and presence through a strong hands-on approach like seed financing, and start-up, early stage, and restructuring financing.

Professional-owned private equity firms promote funds from a group of managers or professionals coming from industrial or consulting backgrounds. Consequently, the investment made by the firm is generally related to the previous sector of activity of professionals and the leverage and strong know-how of the managers. The pros of this strategic model are the personal reputation of the managers, the strong network of the professionals, in-depth industrial knowledge, the potentially high ability to manage venture-backed companies, and a great sense of independence. The cons are the absence of a strong organization behind the managers and the lack of resources due to the absence of a banking or industrial group creating synergies. Typically, professional-owned private equity firms excel through a pure hands-on approach into private equity deals, whereas using leverage and financial abilities are not so relevant. Medium- and small-size equity tickets are quite common for this strategic model.

Government-owned private equity firms promote funds by a governmental entity also in joint venture with other private investors and sometimes using a dedicated country law (i.e., SBIC in the US). The investment process is generally driven by the goals of the governmental entity, whereas the mix of profit and social return can have a different balance and results. The pros of this strategic model are the possibility of reducing the expectation of IRR and to increase risk, the possibility of reducing the size of each equity investment, and the easiest entrance in very risky sectors such as seed and start-up financing. The cons of the model are the potential lack of top human resources, the divergence from a pure and explicit profit goal, increasing write-offs and defaults, and the exposure to political cycle risk. Typically, government-owned private equity firms excel at a geographic focus dedicated to emerging or developing countries and at a policy of joint ventures with private investors to make the intervention into small-size equity tickets easier.

Private equity firms owned by private investors promote funds from family businesses or from a group of families to manage their wealth. The nature of this last strategic model is related to investments generally driven by the goals of the family with the support of external managers in charge of the "family office." Consequently, by definition, the pros of the model include the ability to efficiently manage private wealth, the independence from the financial system, and the use of a family network. The cons are the potential lack of top human resources, the divergence of opinion between family members, and the absence of a strong organization structure as seen in professional-owned private equity firms. Even the size and the reputation of the family owning the private equity firm could be relevant to the scope of the investment; a family office vocation generally leads the private equity firm to invest in small and medium-sized equity tickets, whereas the importance of the family network is an advantage in deals such as turnaround and family buyouts.

19.3.3 Positioning of the market

The positioning of the private equity firm in the market is a crucial decision for every fund regardless of focus or ownership. Positioning is defined as identifying the cluster(s) in which to invest money and allocate resources in the portfolio. Asset allocation and identification of market positioning generate consequences in terms of dedicated human resources and knowledge required. Positioning is a medium-long term choice of asset allocation that is difficult to change in terms of high costs to sustain the position to change the managerial team. The positioning issue can be placed into different groups (i.e., "strategies" involving the positioning itself) that highlight different solutions for managing the asset allocation by specializing:

1. Within stages
2. Within sectors
3. Within areas
4. Through an incubator approach
5. Through an alternative approach

Specialization within stages is the most common strategy followed and implemented by any focused or owned private equity firm. This specialization means the private equity firm chooses to allocate the portfolio in one of the stages of development of the firm, and the private equity firm recruits human resources and creates knowledge only on this cluster. The potential benefit of diversification is reduced, but the fund benefits from strong control of the business. Specialization within stages is also driven from different "business communities" and job profiles inside every stage that make the combination of management–business–investment simpler.

Specialization within sectors is not as common as a private equity firm strategy. In this strategic model the private equity firm chooses one industrial sector and recruits human resources and creates knowledge. Typical examples are biotech, telecoms, fashion, etc. The potential for diversification is strongly reduced, but the fund benefits from the strong control of the sector. Specialization within sectors is typically driven from the background of the managers and their relationship in the sector but, compared to the specialization within stages, the risk is higher because the fund allocates the whole amount of money only in one sector implying a bigger risk during economic downturn or changes in the sector's competitive pattern.

Specialization within areas is not a strategy typical of global funds aiming to enter and stay in new markets. In this model, the private equity firm chooses one area and invests in whatever sector and stage belongs to the area. The potential of diversification is extremely high — even linked to the size of the geographic area chosen by the private equity firm — but the fund takes great risk because of the very limited knowledge about the firms and the evolution of the country in case of entry strategy. The specialization within areas model is typically driven by gambling on the development of a country for profit goals, and it is commonly used by government-owned private equity firms operating at international or global levels.

Specialization through an incubator approach is a strategy related to seed and start-up investments. It tries to reduce the trade-off between risk and return, which is dramatically high in seed and start-up stages and is sometimes unsustainable for a profit-oriented investor. An incubator strategy is offered by the private equity firm with an infrastructure (i.e., plants, machinery, real estate, technology, etc.) and knowledge about developing ideas and research projects that a single entrepreneur/inventor would not be able to manage without strong enhancement and support. That means the private equity firm reduces the costs for the new ventures and has a stronger control on the results and on the potential return. The infrastructure (the incubator) is an investment for the fund, but it is has positive results and a more sustainable risk–return profile.

Specialization through an alternative approach is an emerging strategy of investing in alternative businesses. An alternative strategy is not driven simply from a profit goal but from the desire of the private equity firm to develop a "new vision" related to social and mutual goals. For these reasons the target of alternative funds are social services, employment opportunities for underprivileged groups of people, arts, social-health services, social housing, protection of nature, etc. The common rationale of this investment is to take an activity not (or badly) managed from the government and produce both a profit and a social return. This new concept is called "venture philanthropy" and it is sustained by a greater number of investors — mostly high net worth individuals — looking for new frontiers of investment and for a sustainable and socially performing use of money.

Box 19-1 What is venture philanthropy? (EVPA working definition, 2006)

Venture philanthropy is an approach to charitable giving that applies venture capital principles, such as long-term investment and hands-on support, to the social economy. Venture philanthropists work in partnership with a wide range of organizations that have a clear social objective. These organizations may be charities, social enterprises, or socially driven commercial businesses with the precise organizational form subject to country-specific legal and cultural norms. As venture philanthropy spreads globally, specific practices may be adapted to local conditions, yet it maintains a set of widely accepted key characteristics. These include:

1. High engagement — Venture philanthropists have a close hands-on relationship with the social entrepreneurs and ventures they support, driving innovative and scalable models of social change. Some become board members in these organizations, and all are far more intimately involved at strategic and operational levels than traditional non-profit founders.
2. Tailored financing — Similar to venture capital, venture philanthropists take an investment approach to determine the most appropriate financing for each organization. Depending on their own missions and the ventures they choose to support, venture philanthropists operate across the spectrum of investment returns. Some offer non-returnable grants (and thus accept a purely social return), while others use loans and mezzanine or quasi-equity finance (thus blending risk-adjusted financial and social returns).
3. Multi-year support — Venture philanthropists provide substantial and sustained financial support to a limited number of organizations. Support typically lasts at least three to five years, with an objective of helping the organization to become financially self-sustaining by the end of the funding period.
4. Non-financial support — In addition to financial support, venture philanthropists provide value-added services such as strategic planning, marketing and communications, executive coaching, human resource advice, and access to other networks and potential founders.
5. Organizational capacity-building — Venture philanthropists focus on building the operational capacity and long-term viability of the organizations in their portfolios, rather than funding individual projects or programs. They recognize the importance

(*Continued*)

of funding core operating costs to help these organizations achieve greater social impact and operational efficiency.

6. Performance measurement — Venture philanthropy investment is performance-based, placing emphasis on good business planning, measurable outcomes, achievement of milestones, and high levels of financial accountability and management competence.

Source: *European Venture Philanthropy Association (EVPA)*

19.3.4 Managing the value chain of private equity firms

The combination of the three sides of the FOP model generates multiple options and choices to implement strategy for private equity firms. The future and perspectives of private equity and venture capital will be examined in this chapter (i.e., an exam of possible winning and losing strategies for the future), but the focus now is to find how private equity firms can match an efficient business model with the different choices available from focus, positioning, and ownership.

To analyze the spectrum of private equity firms, it is useful to apply the traditional value chain model designed by Michael Porter in 1985 because of the great coherence within the equity investment business. The value chain scheme distinguishes primary activities and support activities inside the organization of a specific firm. The primary activities are essential to produce and deliver the product, whereas the support activities enhance the process empowering through firm infrastructure, human resource management, technology development, and procurement. Both primary and support activities, variously combined together, help create value for the firm and generate the competitive advantage by following a certain coherent strategy.

The same approach can be used to understand the private equity firm and to measure the consistency of the chosen FOP. In this case, the primary activities are identified by the phases of the managerial process, as identified in Chapter 7: fundraising, investing, managing and monitoring, and exiting. Support activities can be identified by tax and legal know-how, network management, industrial know-how, and corporate finance delivery (see Figure 19.1).

Tax and legal know-how is a fundamental competence for deal making to execute transactions and for corporate governance consulting support. Tax and legal moves from a pure add-on and peripheral around the core of equity investment to a relevant skill used to dominate a high-quality delivery process. Network management has a broad significance because there are multiple tools

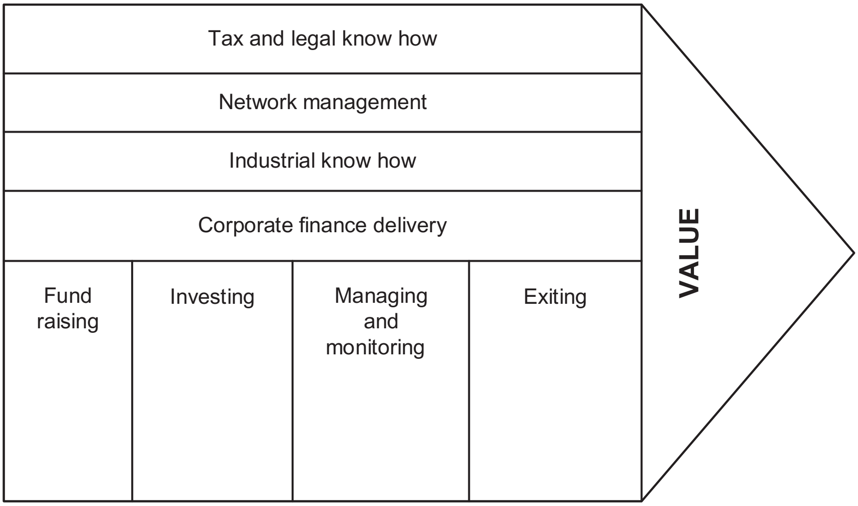

FIGURE 19.1

Value chain of private equity firms.

to manage the links and connections within the economic system. Network management is defined as the ability to interact with potential customers and suppliers of the venture-backed company to gain concrete advantages on the cost and revenue side. Network management also means to be the leader of a certain community (i.e., chemical sector, IT sector, medical sector, etc.), relevant to recruit management, and run investment and drive the proper lobbying activities. Industrial know-how becomes relevant not only to play a leading role within the venture-backed strategy, but also to advise and mentor entrepreneurs to assume the right choices. Furthermore, industrial know-how is crucial to identifying better potential acquirers to manage the exiting phase. Lastly, corporate finance delivery surrounds many private equity deals because both of them involve leverage and merger and acquisition (M&A) techniques to promote acquisitions to expand the venture-backed company.

The use of the value chain must be done as a fundamental assessment of the robustness of the private equity investment company profile and organization to follow a certain strategy and face competition in the market with a sustainable return. For example, bank- and corporate-owned private equity firms benefit from belonging to big groups in terms of strong management of support activities like networking and tax and legal as well as for primary activities like investing and exiting. But while bank-owned private equity firms are quite strong in corporate finance delivery and fundraising arenas, they do not have industrial know-how. This means they cannot follow a hands-on strategy or, if they do, they have to insert reputable managers to fill this gap. Corporate-owned private equity firms, on the other hand, have an advantage in the support activities of network and industrial know-how, but they are quite weak in corporate finance delivery. That means positioning in a finance-intensive deal could be very dangerous if they do not assess a well-suited organizational solution to fill the gap. Private equity firms internationally or globally focused multiply the option to master most (even all) of the primary and support activities by enlarging the potential of competitive advantage. In doing so they face the risk of losing the link with local network and communities if the scale of investment were local and/or small and medium sized.

19.4 PERSPECTIVES AND DESTINY OF PRIVATE EQUITY AND VENTURE CAPITAL

The great success of private equity and venture capital is to be able to change and transform itself to find new and efficient (even creative) solutions to sustain company liabilities. The 2007–2009 financial crisis marks a significant downturn in equity investment (big buyouts, stock exchange, and profit driven) and it launches global brainstorming about the future and new destiny of private equity and venture capital.

The story (and perhaps, the future too) of private equity and venture capital suggests that both strategies and business models are driven by a different combination of the three fundamental tools to create value in equity investment: multiples, leverage, and industrial growth.

Multiples are stock exchange driven and represent the explicit benchmark for entry and exit price for all equity transactions leading to sublime opportunities (1999–2000 and 2005–2006) and to dramatic pitfalls (2001–2002 and 2007–2008). Leverage is the oldest and simplest tool to multiply the value the venture-backed company creates and to place power combined with the certification effect coming from the private equity investor to introduce huge amounts of debt sustainable only at a certain level of interest rate. Industrial growth (i.e., the EBITDA growth) is the core variable of the venture-backed company's value creation, and is the most time-consuming and energy-absorbing activity to be managed and piloted by the managers and the private equity firm. The use and combination of the three variables depends on the cluster of private equity investment. In seed financing and, many times, in start-up EBITDA growth is the key variable to manage because of the impossibility (in the seed case) and the strong constraints (in the start-up case) to raise debt and the very difficult usage of IPO for the exit. In big buyouts both leverage and multiples can be successfully used to create value for the equity investment. However, the combination of the three variables is related to the strategy of private equity firms, their style of management, and investor expectation of IRR. For private equity and venture capital, the lesson learned from the 2007–2009 financial crises is to come back to a strong use of industrial growth because of the great drop in multiples and use of leverage at a very cheap price.

If coming back to fundamentals, coming back to companies, and coming back to an enhanced hands-on approach is a sign for the future, it is relevant to identify and forecast the options private equity firms have to succeed in the economic system as whole. These options can be classified into five groups:

Big buyouts and mega deals — Even though the end of those transactions has been declared definitely, they will come back in the future. The economic turmoil leading to a credit crunch and a strong de-leveraging of many structures and vehicles in which to invest makes it impossible today to deliver big equity tickets to the market. But, very big transactions are a fundamental engine for the economic system when privatization, financing of infrastructure, and financing of large corporations becomes urgent and relevant. In the past big buyouts were used to restructure and acquire big corporations, but they later were mindlessly used for the self-interest of investors. The wise use of private equity will come back when new campaigns of privatization are launched or when infrastructures governments will be unable to finance are financed again by private investors. This new perspective has the same equity ticket size, but the aims and the approach are mostly finance based and hands-off driven. Returns will also be different, and the time horizon of investment will be longer.

Mid-cap transactions — They financially fuel Europe, because of the great number of them in many leading countries. If the temptation (and the explicit strategy many times) for private equity firms in the past was to use the same pattern for big deals to finance mid-cap transactions, it will be necessary to come back to focus on EBITDA growth combined with a cautious and wise use of leverage and multiples when it makes sense in the company's perspective. The needs of mid-cap companies are growing in variety ranging from corporate governance restructuring, developing internationalization, and developing R&D and restructuring. The private equity firms will match a greater number of profiles and apply different formats to solve companies' problems and needs. Private equity firms with an international focus could be a great support if they give and share their international network to sustain international development of venture-backed companies, and they enhance technological transfer for a sustainable R&D process. Private equity firms with a domestic focus will cooperate and integrate their offers with the corporate banking and corporate finance sectors to contribute to venture-backed companies.

Small cap transactions — The financing of SMEs is the unsolved issue in private equity world. Many SMEs really need private equity intervention to grow, but their size makes the equity investment unprofitable. This occurs because the time and costs required for due diligence and the entire process of investment (i.e., scouting, investing, managing and monitoring, exiting) are more or less the same regardless of the company's size but there is a minimum threshold in terms of sales that private equity firms need to reach to break even. Variables relevant to calculate an exit price are lower than for bigger companies, but it is more difficult to find a buyer for SMEs than for bigger companies because of the very specific activity of smaller companies. Consequently, it is not profitable for private equity firms to invest in SMEs, which leaves many small because they cannot afford to grow without equity. The solution to break this very dangerous loop is smart government intervention consisting of a wise participation in joint ventures with private investors in which the government fixes the guidelines and activates controls and the private investors do their job carefully. To make these deals successful, the government must fix the expected performance and there must be an upside for the private investors. This multiplies the return for the private investor and small equity tickets can afford to grow.

Seed and start up — These businesses are risky with very high risk–return profiles combined with a need for tremendous amounts of money to launch research projects in the seed cluster. They avoid private investor finance to keep from losing growth and innovation opportunities. Only medium-long term perspectives, a non-aggressive expectation of return, and a disposal of relevant amounts of money are key variables private equity firms want. Until now, only sovereign funds had those variables because of the very specific nature in which investors and managers are the same and they are funded by the government. But the track record of investment in sovereign funds in Europe is not long enough to clearly judge the outcome. Governmental intervention again and the design of ad hoc rules seem to be the right solutions to enhance private equity firm intervention in these sectors.

Venture philanthropy — These private equity firms decide to use capital investment to satisfy the intermediate needs of social fragility. They also support the idea that different needs require different solutions. Some solutions need (above all the extreme) public operations and/or donations, whereas others (related to the social fragility) require market forms that match the economics to the social interest. It is important to match the specific need to the most adequate instrument. This type of intervention appeals to the so-called gray area of social fragility, part of which is an ever increasing range of population characterized by profound (yet not extreme) hardship. Hardship is defined as needing housing, an occupation, health as well as inter-personal relations specific to work prospects, crises and family problems, loneliness and lack of social contact, and an increasing uncertainty about the future. Not able to qualify for government welfare programs, and similarly unable to access the free market, this segment of population does not meet its needs. Venture philanthropy promotes new and more efficient models of social services to satisfy this new increasing population segment. These models provide market-like solutions and, for this reason, they should be sustained by customer contributions as well, matching social impact with the economic sustainability. The supported social enterprises are positioned in the intermediate market segment, in between public and private, offering good quality products and services at controlled prices. The promotion of these social enterprises needs two main factors: the presence of social entrepreneurs and the availability of private capital. Social entrepreneurs must be able to develop the idea/project and to supervise with efficient criteria the necessary financial resources for its implementation. The availability of private capital, that is "patient" and responsible, or rather the availability of investors who believe in the concept of social responsibility of the wealth and are willing to promote it by putting their capital at the disposal of innovative projects and accepting the concept of simple capital preservation at a high social return is important.

The future we see is not just related to the options players in and out of the market will use to implement private equity useful for the economic system, it is also be based on actions and decisions policy makers take. In the first part of this book it was shown how policy makers intervene differently in many countries and how it was successful for the growth of private equity and venture capital. Today is not the time for spending but for wisdom and the smart use of power and well-written rules. In an environment of regulation, the destiny of private equity and venture capital is related to taxation rules and smart solutions/schemes to sustain the open options previously highlighted. A durable and stable policy of taxation incentive to promote equity raising among SMEs, to sustain

R&D, and to invest abroad are the basic pillars for growth. But it must be combined with a more incisive action that promotes tax transparency (American limited partnerships and small business investment companies) for private equity vehicles subject to their investment in sectors considered relevant/critical for a specific country. A more aggressive policy of incentive for investors could be used to attract off-shore resources (produced in-shore) that could be used for private equity and venture capital to promote development and growth. The quest of efficient joint ventures between public and private partners to balance risk and return will accelerate intervention in small and medium transactions. And last, the challenge in Europe is related to the creation of efficient synergies between non-profit and profit investors to grasp growth options that otherwise will die into a gray area that runs from the universities and research centers to small and potentially very big entrepreneurs.