Faculty of Economics and Business Administration

PRIVATE EQUITY: HOW DOES IT WORK?, FINAL BACHELOR'S PROJECT

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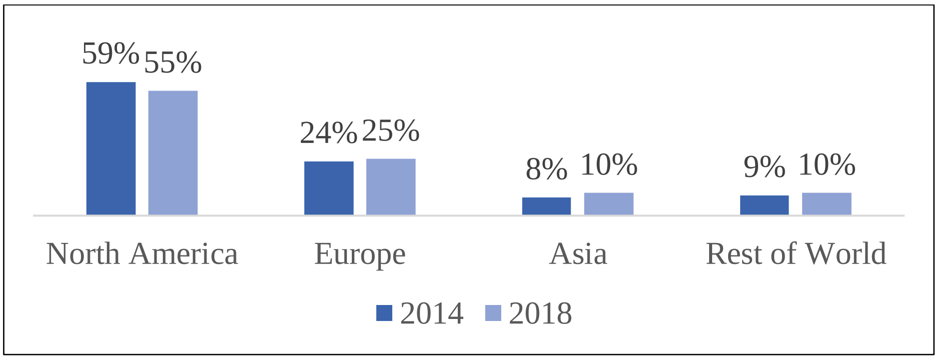
INDEX

FIGURE INDEX

ABSTRACT

Private Equity or "PE" funds (also called "financial sponsors" or "GP" or "General Partners") are becoming nowadays more and more popular between the different asset classes and alternative investments especially. Moreover, these funds are starring the biggest deals in the M&A (Mergers and Acquisitions) space in all the sectors and industries during the last years. There has been many large and sounded private equity deals in Spain recently, such as: KKR acquiring Telepizza, EQT buying "Parques Reunidos", Advent International purchasing an important participation in "Vitaldent", The Carlyle Group acquiring a minority position in Cepsa (Mergermarket, 2020). In addition, private equity firms are fundraising larger amounts of money than ever before to buy companies during the upcoming years (Bain, 2020). Consequently, thanks to this dry powder (this expression makes references to the amount of money that the funds have ready to invest in a determined moment of time, in other words, the money committed by its investors but not used by the fund) we will continue to read new private equity deals in the economic newspapers. Additionally, PE-backed companies (this concept refers to the companies that have been acquired by financial sponsors) has risen from 4,000 in 2006 to 8,000 in 2017 in the US, while at the same time the number of public companies (listed enterprises) decreased from 5,100 to 4,300 (McKinsey, 2019). Furthermore, global investors (except North America) have been increasing their exposure to financial sponsors during the last years. *(see figure 1)*

Figure 1*: Proportion of aggregate capital invested in private equity by investor location, 2014 vs 2018*



Source: Preqin

It is of the utmost importance to understand this business in order to comprehend the current financial industry. Although there are people against this type of funds, the reality is that private equity capital helps a lot to the society; not only providing liquidity to the private market but also growing the revenues and margins of the existing PE-companies. What is more, the internationalization of these companies is one of the top strategies executed by the PE funds, as an example we can observe the PE-backed company Goiko Grill (owned by L Catterton) starting an internationalization process with a new restaurant in Paris, France (Mergermarket, 2020).

This paper will focus on giving a deep understanding of the business model of a private equity fund and showing how these funds make money offering significant returns to their LPs (Limited Partners - Investors in a Private Equity fund) in comparison with other asset classes. In order to obtain solid conclusions of the topic, statistical and financial analyses will be provided. Apart from that, some interviews with PE professionals are going to be presented in this paper to have a deeper understanding of the topic. The outcome of the results confirms that the industry of private equity helps a lot to the society and offers a great profitability to the money of the investors.

Moreover, this paper will illustrate the reader with many actual cases in order to make easier and more interesting the lecture of it.

Key words: Private Equity, Mergers and Acquisitions, Alternative Investments, Investment Funds, Leveraged Buy Outs, Growth Capital

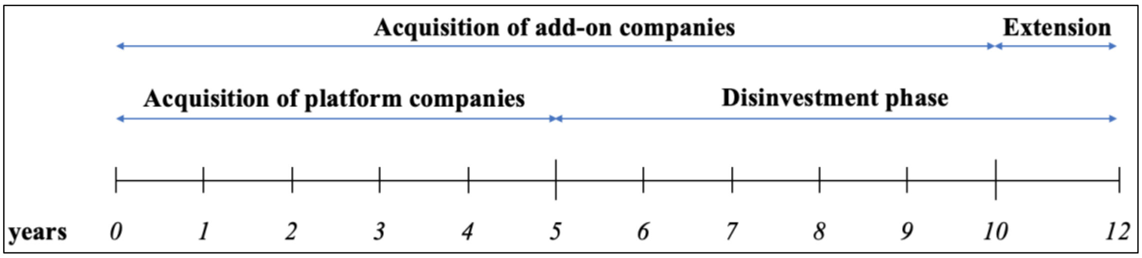
1. INTRODUCTION

A Private Equity fund is a type of alternative investment fund that invests in companies that are not listed in the stock market in most of the cases, this is why it has this name, because it invests in equity that is private. In some cases, private equity funds can invest in listed companies in order to do a conversion from public to private, and then the fund would be able to have a greater control with no need of depending from public equity regulators or news affecting the public market.

The beginning of Private Equity started when J.P. Morgan in 1901 (the man, not the Institution) bought Carnegie Steel Co. from Andrew Carnegie and Henry Phipps for $480 million. Immediately after that, Phipps created a fund called Bessemer Trust that invested in private companies. Later, after the liberalization of investment funds and tax decreases in US in the 1980s, it started to appear the first institutional private equity funds that nowadays are most of the well-known and large alternative investment firms, such as: KKR, The Carlyle Group, The Blackstone Group, Bain Capital, … One of the first and most sounded LBOs was the acquisition of RJR Nabisco by KKR in 1988 in a $24,7bn public to private deal, after a hostile takeover war of many corporations, banks and managers (Doo, A., 2019). This deal was the plot of the book and movie "Barbarians at the gate".

Although economic cyclicality has always altered private equity activity for several reasons (e.g. available money from investors, interest rates, enterprise prices changes in the private market due to recessions) the M&A space has witnessed a continued increase during the last decade in the number of alternative asset managers due to the long term vision of the investments and the popularity of them. The typical life of a private equity investment is between 3 and 5 years; so if a fund executes 2 deals (platform companies) per year and the fund targets 10, the fund life is minimum 10 years. As an economic downturn does not last more than 10 years, a private equity fund is more resilient to a change in the economic cycle in comparison with the stock market or other asset classes. Anyways, a deep analysis of this comparison will be provided. For the moment, it is shown a representation in time of how a PE fund works. *(see figure 2)*

Figure 2: *Life of a PE fund*



Source: own elaboration

The birth of the life of a fund is traced by the first investment of it, being this year the vintage year of the fund. This term is very common in the industry in order to compare different funds in time and obtain conclusions thanks to quartiles comparison. 2018 and 2019 have been undoubtedly the vintage years for many PE funds, as investment firms have been working very hard to have their funds raised before the next economic downturn. For instance, Cinven has been able to raise €10bn in 2019 to invest in European companies (Cinven, 2019). Overall, the PE industry has $3,41tn of AUM nowadays (McKinsey, 2020).

The general objective of this paper is to understand this industry and demonstrate with numbers how it obtains good returns on their investments. In the first place, the paper will start with a description of the private equity business model. Secondly, it will show the three different ways of making money in this business with an example of how a private equity deal would be structured in a simple LBO model to be easily understandable by the lector. After that, an extend analysis of the economic cyclicality will be shown in order to identify the risks for the upcoming years and a possible economic downturn in comparison with other asset classes. In addition, five interview highlights will be described. At the end of the paper, a final conclusion will be reached.

1.1. Private Equity in the investment spectrum

As an investor, there are a lot of different possibilities and vehicles to invest in. Private Equity is just another one. In order to understand better this asset class it is necessary to know how to locate it.

When an investor wants to study the market in order to choose the best investment possibilities with the highest returns taking into account the risk, there are two different investment strategies to choose:

- Classical investments: stocks, bonds or cash.
- Alternative investments: private equity, hedge funds, real estate, commodities, derivatives, cryptocurrencies, …

Traditionally, stock and/or bond investments have been the most popular ones during the last years, but investors want to diversify their money and find a different asset class to invest, this has been one of the reasons of the appearance and success of the modern private equity firms.

2.PRIVATE EQUITY BUSINESS MODEL

Although the main ideas of private equity have already been covered as an introduction, understanding the business model of a PE firm is essential to comprehend this type of investments and their returns.

2.1. Structure

The creation of a fund generally works the same whether the fund is raised by independents as a new firm, as part of a big investment bank or hedge fund, or by an established firm such as KKR. The main parts of the creation of a new fund to consider are:

1. **Finding investors**: if we are talking about a new investment firm, this is the hardest part because the new investment team do not have a proven track record in which the investors can trust to put their money in. On the contrary, as time goes by and the firm has already raised different funds with good returns the activity of finding investors is much easier obviously. The typical investors in a private equity fund are pension funds, banks, insurance companies, fund of funds, UHNWI, charitable foundations, university endowments and family offices. Normal individuals cannot invest in a PE fund as the minimum investment ticket is very high, regarding small funds this figure can be around €250k and, millions of euros in mega funds.

2. **Data room preparation**: in order to give a proper explanation of where the fund is going to invest and all the possible details, it is necessary to create a data room with many documents: Due Diligence Questionnaire or DDQ (document elaborated by the private equity fund in which answers possible questions for potential investors), Private Placement Memorandum or PPM (document that investment funds use when raising money to disclose the characteristics under which that fundraising will take place), investor presentation, previous track record, CVs of the partners and investment team, legal documents, …
3. **Investment phases**: as previously explained, the average fund life is 10 years, of which 5 years are to invest the money and the other 5 to disinvest. The 4 main phases of an investment are: sourcing, executing, monitoring and exit. These investment phases will be explained in the point 2.3.
4. **Fees**: in order to pay salaries, bonuses and costs of the firm there are two or, three fees sometimes:
    a. Annual fee: depending of the size of the fund this fee is usually between 1 and 2%. This fee covers the costs of the fund (office rent, salaries, …)
    b. Subscription fee: some funds have a very little one-off fee at the beginning of the fund, usually around 1%.
    c. Carried interest: as the PE professionals want to be aligned with their investors, they have a success fee depending on the returns, this is where the actual money is earned if the fund has great returns. As an industry standard, this fee is around 20% of the returns after the fund life.

2.2. Types of PE funds

Although there are many types of investment funds in the private market (private debt, fund of funds, real estate, infrastructure, …) we will focus only in private equity. In this paper there will be differentiations taking into consideration different measures.

According to the size and investing mandates of the funds we can observe 5 different type of private equity funds and/or investments in the market nowadays:

- **Business angels**: a person (not a company) who contributes his money, experience and contacts to new companies created by entrepreneurs in order to obtain a shareholding and a future profit. Example: Juan Roig (Founder of Mercadona).

- **Search funds**: private equity investment vehicles intended to finance the search and acquisition of only one company with growth potential. The difference with traditional financial sponsors is that a search fund invests only in 1 company. Example: Sachem Partners
- **Venture capital**: It is one of the main forms of financing early stage startups, those that are in their growth phase and that have already used other sources of financing such as FFF (Friends, Family & Fools) and seed capital (Understanding differences in startup financing stages, 2020). Example: Samaipata
- **Growth funds**: invest in companies that are in subsectors that are growing in the medium and long term. Normally, this type of funds does not use great proportions of debt in acquisitions and they do not require to be a majority shareholder always. Example: Tresmares Capital PE fund
- **LBO funds**: on the contrary, LBO funds use great proportions of debt in their acquisitions to boost their returns as their portfolio companies are already very mature. Although these funds can have very high returns, they also have higher risks obviously. A LBO is a process used in the acquisition of companies through the support of external capital, which to a greater or lesser extent complements the buyer's funds to carry out the acquisition of the target enterprise. The essential guarantee of the debt is the same business that is purchased, its assets or the projected cash flows. Example: KKR LBO fund

According to the size of the companies in which they invest there are different types of private equity funds. In order to differentiate the dimensions of the companies the annual revenue is the metric to be used. However, it can be measured with other metrics.

- **"Main street"** (annual revenue from €0m to €5m): Small and Medium Enterprises (SMEs) that are maybe too small to be acquired by a PE fund. Nonetheless, sponsors that follow a buy & build strategy (inorganic growth strategy that consists in buying many add-on companies in order to obtain synergies and economies of scale in the platform company. It is widely used in the private market as it increases the IRR of the investment) and search add-on opportunities (also referred as follow-on acquisition, are companies bought by the fund and merged with a platform company) could be interested in this segment of the market. Moreover, technological and similar companies within this revenue range are great investment opportunities for small venture capital funds.

- **Lower middle market** (annual revenue from €5m to €50m): it refers to the smallest companies of the middle market. Usually, they are family businesses. Companies in this segment of the market account for an important part of the market, being of the utmost importance for the Spanish and international economy. This type of enterprises is very attractive to the private equity sector, as it allows to make great improvements in their day-to-day operations and management thanks to a professionalization process. As a consequence, great returns can be achieved in this segment of the market by most of the private equity firms competing in this extensive area. Furthermore, entry multiples of the lower middle market are considerably lower, allowing the financial investors to obtain returns thanks to multiple extension. A recent transaction witnessed by the Spanish lower middle market has been the merge and acquisition of Imegen (previously owned by Qualitas Equity Partners), Genycell Biotech and Health in Code by Alantra Private Equity in December 2019 (Mergermarket, 2020).
- **Middle market** (annual revenue from €50m to €500m): is a market consisting in companies with an important business experience, in different countries sometimes. The financial investors who target this type of enterprises are medium to big PE funds normally with an international presence thanks to big investment teams that operate in different country offices. During 2017, the French Buy Out fund called Ardian acquired Berlys and Bellsolà (companies dedicated to the production and supply of bread, pastry products, bakery and savoury snacks) in a single transaction with Alantra Private Equity and Artá Capital (both Spanish PE funds) as co-investors (Mergermarket, 2020).
- **Upper middle market** (annual revenue from €500m to €1bn): this part of the market refers to very established and professionalized companies that have been operating for several years normally. They account for a very small percentage of the total number of companies of the market but large market shares obviously. It is needless to say that valuation entry prices are very high in comparison with the lower middle market and middle market. For instance, the GPs Towerbrook Capital Partners, Peninsula Capital and Torreal acquired in 2017 the Spanish

company Aernnova operating in the aerospace sector, selling aircraft parts to Airbus or Boeing for example (Mergermarket, 2020).

- **Large market** (annual revenues of +€1bn): it consists in very big companies operating internationally with high barriers of entry normally and, sometimes listed in the stock exchange. One of the most recent examples in Spain is the acquisition of Areas (operating in the travel catering market) to Elior Group by PAI Partners (Mergermarket, 2020).
- **Mega market**: this part of the market is rarely visited by the PE funds because of the limited existing number of companies and their incredible size. As an illustrative and historical example in the world of private equity, a real estate-focused private equity fund of the Blackstone Group acquired Hilton Hotels Corp. in 2007 in a $20bn deal (Mergermarket, 2020).

Considering the investment strategy of the financial sponsors, there are some categories to take into consideration:

- **Sector focus**: funds that only invest in companies in a specific sector because the fund managers consider that they will have higher returns due to their knowledge of a particular industry. Example: ArchiMed in the healthcare sector
- **Restructuring or special situations**: funds that acquire undervalued companies facing financial issues due to any atypical event. Even though these funds have a lot of risks for obvious reasons, they can achieve very high returns. This type of funds usually invests in equity and debt at the same time. Example: Sherpa Capital Restructuring Fund
- **Impact and ESG funds**: the impact or social investment is one that is executed with the objective of promoting solutions that improve society and the sustainability of the planet's resources. Example: Creas Inversión

2.3. Phases of a PE investment

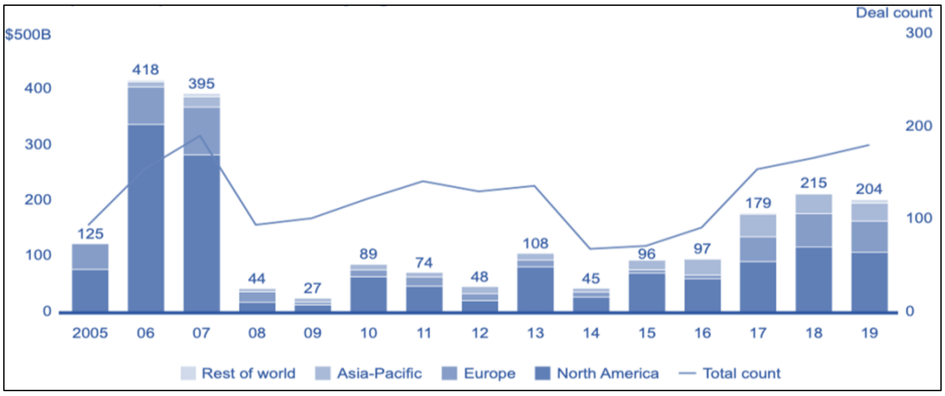
2.3.1. Sourcing

This is definitely the most difficult part of a private equity investment. It consists in finding target companies to acquire and analyzing opportunities.

- Concerning the **type of seller**:

- **Strategic player**: it refers to a corporate investor. An actual example could be: Portobello (a Spanish PE fund) buying BT (provider of telecommunication services) business in Spain to its parent company of Great Britain (Mergermarket, 2020).
- **Another PE fund**: this is when a GP sells one company to another PE fund. As an example: Realza Capital (Spanish financial sponsor) sold a majority participation in "Plénido" Dental Group to Portobello Capital (Spanish financial sponsor) (Mergermarket, 2020).
- **Reverse IPO** (from public to private): when a listed company is bought by a PE fund and the company goes private. An example can be the acquisition of Telepizza by KKR and co-investors (Artá Capital, Altamar Private Equity, Safra Group and Torreal) (Mergermarket, 2020). The following chart illustrates the number of public to private deals from 2005 to 2019: *(see figure 3)*

***Figure 3**: Global public to private deal value, by region*



Notes: includes add-on companies; based on announcement date; includes announced deals that are complete or pending, with data subject to change; geography based on target's location

Source: Bain

- **Carve-out**: this is referred to a situation in which a division of a big company is sold separately to a financial sponsor, this type of transaction could be considered as a special situation due to the fact that the big company does not considerate profitable enough the division sold. An example is the acquisition of a platform of 11 data centers of Telefónica by the financial sponsor Asterion Industrial Partners (Mergermarket, 2020).

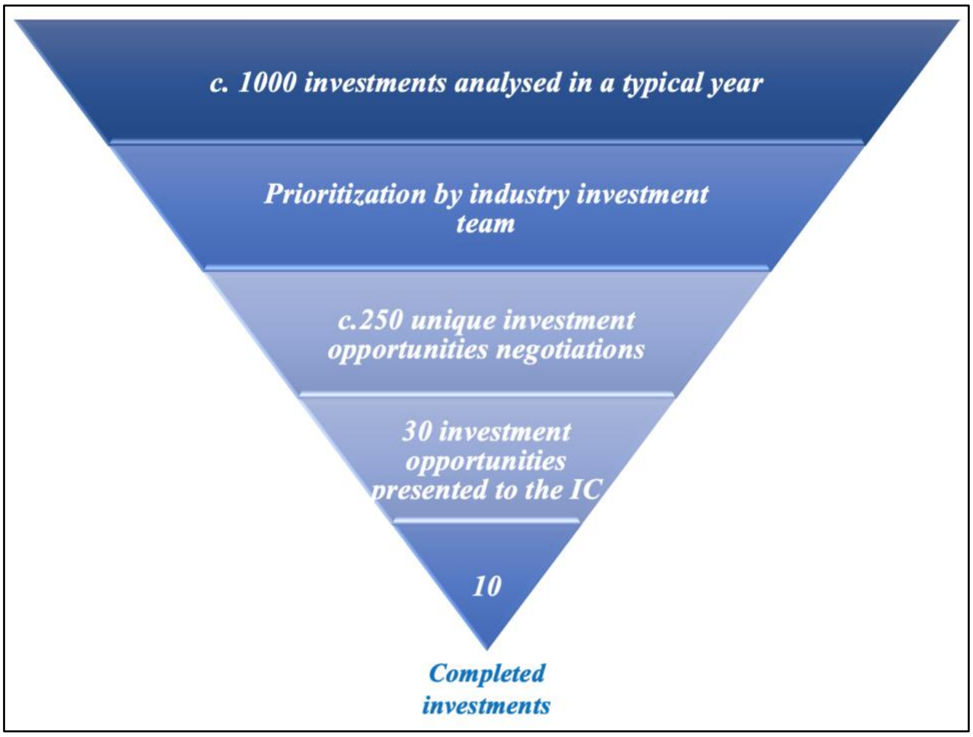
- **Investment criteria**. Although there are diverse type of PE funds targeting different type of companies, they always follow similar strategies:
    - Out-of-favor industries
    - Under-managed companies
    - Under-valued assets
    - Non-core businesses
    - Substantive minority investments
- Regarding the **deal flow** (the deal flow is the concept that refers to the amount of investment opportunities that a GP has) **possibilities**:
    - **Proprietary deal flow**: thanks to the network and the efforts of the partners and the investment team target companies can be found. However, this is a very difficult process, as the search could be very long and exhausting due to the reason that they have to look for companies that fit their investment strategy and the consideration that the company owners should be able to sell their participations obviously. Not only this, the investment should be considered profitable in the long term for the fund. The reason why a proprietary deal flow is better is because of the reason that it guarantees lower initial prices and better returns in the future as there are not more PE competitors in the process. Sometimes, M&A advisors can offer proprietary investment opportunities to a single General Partner, without any bidding process.

      In addition, there are many national private equity managers operating in their lower middle market that create an international alliance among different funds from different countries in order to cooperate transnationally with some important sourcing tasks that could be very difficult to do it each fund on its own. Let's take an actual example: 3 leading European PE managers with similar characteristics (H2 Equity Partners from the UK, Ireland and Benelux; Auctus Capital Partners from the DACH area and; Sherpa Capital from Spain and Portugal) have created and strategic alliance in order to cooperate and create value. For example if a platform company (initial acquisition that serves as a starting point for acquiring more companies in a similar industry and merging all of them) from Sherpa Capital is in an internationalization process in Germany and Switzerland, Auctus can help them with the negotiation of a leasing process for new properties or in the sourcing part of finding an add-on opportunity thanks to their local network or full local support in the local language (Optimum Alliance, 2019). Other example can be acquisition of 25% of the Spanish manager MCH Private Equity by the French one Eurazeo, with the purpose of working together (Mergermarket, 2020).

- **M&A advisor**: as having 100% of proprietary deal flow is almost impossible for PE funds, they depend on third parties to have new investment opportunities, that is to say, M&A advisors propose companies (that the owner/s want/s to sell) to financial sponsors, in a bid process normally. As previously mentioned, as there are different PE funds regarding the size of the target companies, there are also M&A advisors specialized in a determined part of the market. For example, the big investment banks (JP Morgan, Credit Suisse, Goldman Sachs, Morgan Stanley, Barclays, Citi …) provide advisory to big PE funds (KKR, Cinven, Advent, Apollo, Ares, Blackstone…) that acquire companies with very high EBITDAs. In the Spanish middle-market we can see M&A advisors (Arcano – M&A, Alantra – M&A, Deloitte, KPMG, …) advising financial sponsors in this part of the market (Artá Capital, CorpFin, MCH Private Equity, Portobello Capital, …). The cause why M&A advisors are a worse option for funds is that prices are higher due to the usual bid processes in which the fund that offers the highest price is the one that buys the company. The price paid is typically the Enterprise Value (the simple formula of the EV is: Equity Value + Financial Debt – Cash. However, some adjustments such as pension liabilities can be considered for the calculation of it).

A good way to represent graphically the deal flow opportunities is a funnel or inverted pyramid. *(see figure 4)*

Figure 4: Deal flow inverted pyramid



Source: own elaboration

- On the topic of financial valuation, some facts should be explained. While searching new investment opportunities is essential, it is also necessary to analyze them. This is the task in which the investment team along with the partners decide if it is a better investment or not. A first look to the financials and the strategic part are the first things to take into consideration.

2.3.2. Execution

In order to give a brief description of the execution part, a list of the key items will be provided before the proper explanation of the entire process. There are some steps to follow in an acquisition process after the initial contact of the buyer and seller:

1. **Non-Disclosure Agreement (NDA)**: a simple contract in which both parts agree on keeping information private and confidential.
2. **Indicative offer (IO)**: a first price is reached, what is also called non-binding offer.
3. **Letter of Intent (LOI)**: initial terms of the transaction.

4. **Due Diligence (DD)**: investigation of several topics on the target company, undertaken by third parties.
5. **Sales and Purchase Agreement (SPA)**: final terms and prices are accomplished, and the deal is executed.

To have a better understanding of the process a longer and easier explanation will be provided. After the sourcing process, the proposed investments go to the next process in which the fund does:

- **Deep analysis of the financials and strategy of the company**

  The company valuation is one of most important parts in the analysis, and, although the purpose of this paper is not the company valuation analysis, a brief list of the most common methods to value a company is needed to have a proper understanding of how the private equity industry works:

  - **LBO** (Leveraged Buyout): financial model in which the transaction is analyzed thanks to a complete study of the debt repayment, free cash flows and EBITDA growth.
  - **DCF** (Discounted Cash Flow): one of the most sounded methods that consists in forecasting the future cash flows of a company with a discount rate.
  - **Comparable transactions**: in order to value a company, taking a look at the market is crucial to know how the last similar transactions were valued and which was the final price. The challenge of this method is finding a representative number of past transactions of similar companies with the same size. In addition, in the private market it is very difficult to know the final terms of the last transactions as it is not obligatory to publish them. Nevertheless, M&A advisors can help the PE fund in this task.
  - **Comparable listed companies**: method in which a list of comparable listed companies is elaborated to compare their value in the public market among themselves and the target company. Although it is hard to locate comparable companies in the stock market with similar sizes than the companies in the private space, a liquidity discount can be applied to the valuation (normally between 20% and 30%).

  Regarding the **analysis:**

- **Investment memorandum** (IM) elaboration: presentation that contains all the essential information to understand a proposed transaction:
  - **Executive summary**: brief description of the proposed transaction and capital structure.
  - **Investment thesis / recommendation**: why it is recommended to invest in company X.
  - **Company overview**: some basic facts about the company and summary details about its business.
  - **Industry overview**: specify how the industry works, especially for committee members that are not familiar with the proposed industry. In addition, a Porter's five forces analysis is always a good idea in this case to see the rivalry among the existing competitors.
  - **Investment positives / investment concerns** (bulls / bears): as the reasons to make an investment can be very easy to understand, the risks are not that simple. This is why, the PE fund managers should always understand the concerns of an acquisition, because the perfect investment in PE does not always exist. Moreover, the economic cycle should always be considered; a bullish market refers to a positive sentiment of the investors about the growth and, a bearish market is just the opposite.
  - **Financial summary**: this is the part in which the company valuation and financial analyses are shown, especially the important data like: assumptions, credit metrics, free cash flow forecasts and EV multiples.
  - **Investment returns / sensitivity analysis**: after having shown the company valuation by all means the investment committee should know the projected returns of the investments based on the previous assumptions. In order to measure the profitability of a PE investment, there are different ways:
    - **IRR** (Internal Rate of Return): it measures the profitability of an investment taking into consideration the time in a compound basis. The way to calculate it is the following one:

$$IRR = (Y / X)^{1/n} - 1$$

Where:

- Y = equity value of the PE fund's investment at exit calculated
- X = initial cash equity invested by the General Partner (including potential loans)
- N = exit year of investment

- **MoC** (Multiple on Cost) / **MoM** (Multiple on Money): measures the profitability of an investment in x times between the cost of the investment and the exit. The way to calculate it is the following one:

  $$\text{Money Multiple} = (Y/X)$$

  Where X and Y have the same definitions as above
- **RVPI** (Residual Value to Paid-In-Capital): the residual value is the outstanding worth of the fund at a given point in time, the Paid-In-Capital is the money that the LPs have given to the fund.
- **DPI** (Distributions to Paid-In-Capital): the total returns that the LPs receive.
- **TVPI** (Total Value to Paid-In-Capital): the total value is the sum of the residual value and distributions.

(LP Corner, 2020)

The typical returns of PE are c.25% IRR and c.2,5x MoC.

- Key issues for more analyses: as doing an investment memorandum of a private company is very difficult due to the absence of public information, an extensive due diligence is needed in order to understand better the transaction. Frequently, a background check of the company management team is undertaken in order to verify that the key people at the target company have not had any legal or personal issue in their personal lives to be known by the PE fund analyzing the investment opportunity.

The reason to do this presentation is to present it to the Investment Committee (IC), which will decide if the company is going to be acquired or not. In addition, the Investment Committee can also propose to change the capital structure of the transaction or any change. This executive body is composed of senior and very experienced professionals (normally) working in the financial sponsor company. For instance: a PE focus on healthcare investments can hire a doctor or pharmacist of great reputation to contribute technical knowledge and experience to their Investment Committee.

- **Due diligence process**: the GP hires an advisor, normally a Big4 (Deloitte, KPMG, EY, PwC) and the goal of it, is investigating a company in order to evaluate all the costs, concerns and benefits of the possible transaction. In other words, it is basically a full check to be sure that there is not any problem that should worry the acquirer. There many types of due diligence processes:
    - **Legal**: this due diligence is of the utmost importance to the acquirer, it contains a lot of important and sensitive information such as: current and past lawsuits, legal problems, tax troubles, …
    - **Commercial**: the object of this process is, basically, checking the strategy of the target company and see if it fits the investment criteria of the PE fund.
    - **Financial**: it aims to deliver a thorough comprehending of all the company's financial statements. Not only past statements, but also future projections.

  There are also other types of due diligence: environmental, human resources, assets, administrative, customer, intellectual property, … Anyway, any of these can be part of other one, for example in the case of a pharmaceutical company the intellectual property due diligence can be part of the legal one.

- **Transaction structuring**: in a complete LBO or M&A process there are a lot of negotiations and discussions. Once the seller has been found there are plenty of things to do:
    - **Negotiating the price**: process in which both parts agree a first price of the transaction. However, this first price can be totally different to the final one due to possible inconveniences appearing during the entire M&A process.

- After having analyzed the company (financially and strategically) and having coordinated the external due diligence teams involved in the investment, the PE fund managers would continue to the next step: elaborating the **capital structure** in which there can be different possibilities:
    - Regarding the **equity**: the ideal transaction would imply a majority participation (>50% of the company) in order to have a complete control over the company. There are some possibilities concerning equity strategies:
        - **Equity bridge financing (EBF)**: type of funding which consists in asking for money to debt providers in the first moments of the investment and not the investors, in order to increase the IRR and transaction flexibility.
        - **Co-investor**: the fund manager can partner with other/s organizations (other financial sponsor, a PE fund of funds, a family office, a strategic investor, or any financial institution) in the case that the company is too large for a single GP (example: Advent and Cinven buying Thyssenkrupp's elevators division in March 2020) (Mergermarket, 2020).
        - **MBO** (Management Buy Out): process in which the management team of the company and the financial sponsor acquires the participations of the current shareholders. This type of transaction is very standard, in fact, there is a French PE fund specialized in it: MBO Partenaires
        - **MBI** (Management Buy In): an external management team acquires some shares of the target company of the financial sponsor along with it.
        - **OBO** (Owner Buy Out): the process is quite similar to the previous ones, the only difference is that the person who acquires more shares of the company is the owner.

- **BIMBO** (Buy In Management Buy Out): it is a mix between the MBI and MBO, it has all the advantages of both transactions.

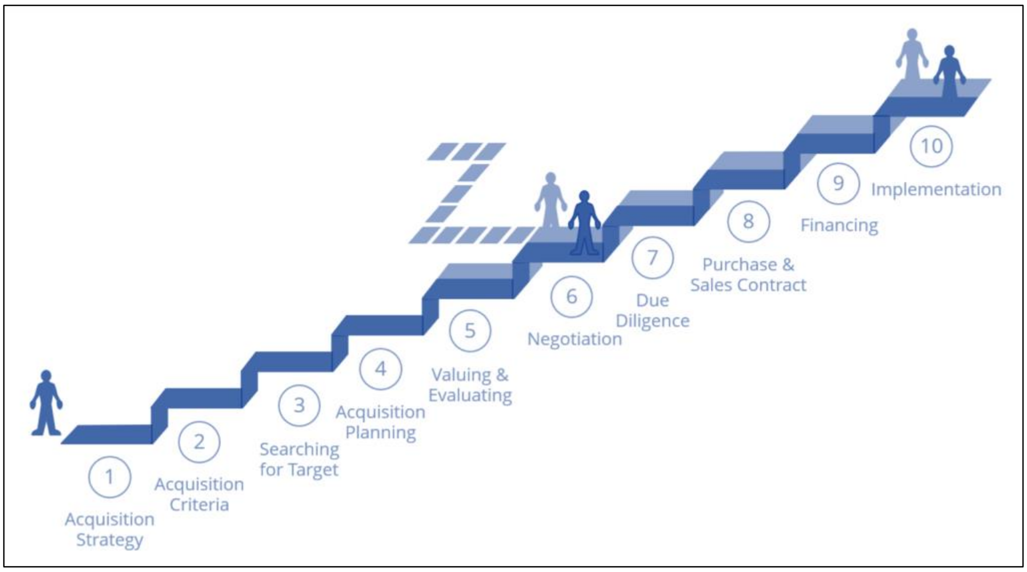
In order to motivate the management team, financial sponsors are used to allow them to be part of the transaction buying at a lower price. The purpose of this process is that the management team members invest their own personal wealth encouraging themselves to work harder in the company. The way this financial instrument is the following: if a PE fund makes 2,5x MoC after selling a portfolio company, the management team will make much more, let's say 4x MoC; but if the GP loses money the management team members will probably loose most of their personal investment in the company. It is pure operational leverage. The mathematical formula that measures the differences in prices between the management and the financial sponsor is called the **envy ratio** and the instrument is the **ratchet**.

- Taking into account the **debt**: it is needless to say that in a deal the debt is a very important part and, although the PE fund does not usually invest in the debt of the company it has to structure it. There are different approaches having to do with the debt:
  - **Debt tranches** or portions:
    - **Senior debt**: it is the less risky one and the first one to be paid regarding priority. It is provided by a bank or a syndicate of banks. Interest rates are very low (ex: London Inter-Bank Offered Rate - LIBOR + 2-3%). Normally, it is structured in different tranches (ex: term loan A, term loan B, …) and the period to repay it very long (6-9 years)
    - **Subordinated / junior debt** (high-yield bonds): it is riskier that the senior debt and has also less priority to be paid. It is provided by bond holders. Interest rates are higher due to the fact that it is a riskier investment. Furthermore, the initial interest

  rate can change depending on the EBITDA the company reaches in moment X of time.
  - **Unitranche**: the banks sometime offer a mix of different types of debt to compete with other debt providers. The interest rate depends on the agreement.
  - **Mezzanine**: it is the riskier debt of all the tranches and the last one to be paid. It is provided by mezzanine funds and the interest rates are obviously the higher ones (c.8%). The repayment of debt and the interests can be paid in money or in a different financial instrument thanks to the PIK (Payment In Kind) option. Some pure private debt fund names are: Oquendo Capital or Capza, but most of this type of funds are integrated in biggest private investment firms, such as Alantra or Tikehau in the Spanish private space for example.
  - **Vendor financing**: a vendor loan refers to the practice in which the seller finances part of the acquisition in a debt agreement. The interest rates are around 5% and 10%.

- **SPV** (Special Purpose Vehicle) / **SPE** (Special Purpose Entity) funding: it is a legal entity created by the PE fund in order to isolate financial risks in the case that the invested company goes bankrupt. If these entities were not created a bad investment could ruin a GP. Moreover, these entities have to be created because of the European and Spanish legal regulation of financial assistance, in a process in which the financial sponsor creates a "*NewCo*" and merge it with the new portfolio company.
- When the deal has been negotiated and an agreement has been reached the **lawyers** prepare the contracts and resolve all the legal issues regarding the acquisition process.
- Deal closed. *(see figure 5)*

Figure 5: Deal process



Source: Corporate Finance Institute

2.3.3. Monitoring

As having an important stake in a company implies seating in the board of directors and deciding about the strategy and plans, all the PE funds play an important role in their respective portfolio companies obviously. This phase can be more or less important depending on the strategy and percentage of ownership of the GP in the company. If the fund is the only stakeholder and has a "hands-on approach", it will try to change many things and stablish new plans in the company in order to improve the financial results and obtain better returns in the exit. Additionally, international private equity alliances previously mentioned can be very useful in some cases (internationalization, expansion and buy & build strategy). Some examples to contemplate are:

- **Change of management**: if the fund managers notice that the management team is not good enough, they can fire it, hiring a new one. This measure has always been very criticized by the popular opinion, especially if the company is a familiar one. For instance, The Carlyle Group fired part of the management team of Codorniú as the fund managers decided that other persons could implement in a better way the Carlyle investment and exit strategy (Mergermarket, 2020).
- **Professionalizing the family business**: the target companies in the lower middle market are obviously very small with an old and/or familiar strategy sometimes. For example, let's imagine a familiar and small company from Elda, Alicante that

manufactures shoes and it has always relied on the same leather supplier because it is a friend of the family, without knowing that there are other leather suppliers in the market with a better quality and lower prices.

Other examples can be: implementation of a proper human resources policy strengthening the commitment and discipline, costs savings, creating or improving the corporate website, developing internal processes and technology systems, …

- **Internationalization**: when the national market of a specific sector is not growing, a company has only two options to increase its EBITDA (because this number is what will make the exit more successful or not due to the multiple Enterprise Value / EBITDA): inorganically or organically; as sometimes an acquisition can be a bureaucratic process with a challenging post M&A integration a worthier option can be start selling the products or services offered in other countries. As an example, we can observe the internationalization of "Angulas Aguinaga" (which operates several brands: Krissia, La gula del norte, …) thanks to the Spanish PE fund Portobello Capital (Angulas Aguinaga, 2020) (Mergermarket, 2020).
- **Expansion**: this case contemplates an EBITDA increase of the portfolio company thanks to a production and sales increase without the need of buying any external company. The name of this tactic is organic growth. Although the expansion strategy is quite similar to the internationalization one, it does not require selling in new countries.
- **Buy & build strategy**: once a portfolio company has been acquired a way to increase its EBITDA is acquiring similar companies (add-on acquisitions) and merging them with the platform (the company which will absorb the rest), this is called an inorganic growth strategy.

2.3.4. Exit

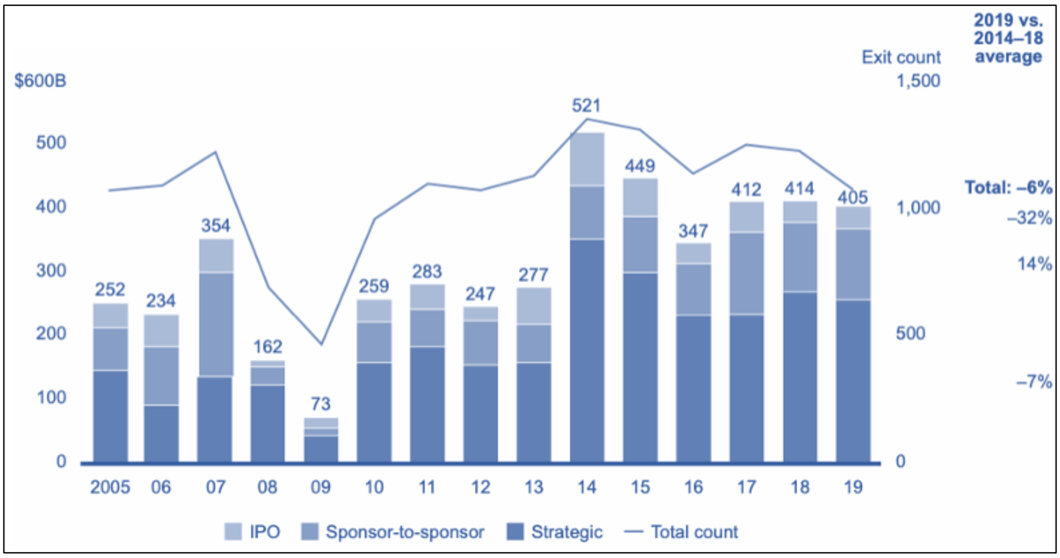
Although an acquisition at a low price is important to have great returns, the exit is also quite important, in fact, after a cheap acquisition and a proper monitoring, a poor profitability could be obtained due to several reasons: unattractiveness of the subsector of the company because of the economic cycle, bad reputation of the company and/or ethics, poor exit negotiations, lack of dry powder in the PE market, regulation damaging the company operations, … This is why sometimes PE managers decide to transfer at a fair price a company from one fund to the following one of the same investment management company, as the fund manager decides that the company still has many possibilities to continue growing and having better exit options in the future. This type of transaction is named **rollover**. As an example: Bridgepoint acquired a first participation in 2006 in Dorna Sports (organizer of the Moto GP global championship) to CVC Capital Partners and, in 2018 it was sold from one fund of Bridgepoint to the following one of the same financial sponsor manager. Even though Blackstone and KKR were interested in the company, Bridgepoint did not consider any offer good enough. The fund hired the following investment banks and M&A advisors: Citi, Lazard and Bank of America; in order to elaborate fair valuations for the rollover (H., C., 2019)

Regarding exit strategies:

- **IPO** (Initial Public Offering): the PE fund hires an Equity Capital Markets (ECM) advisor to sell the company or part of it in the public markets to any type of investor. Some examples could be: the $2.9bn IPO of Avantor (chemical and healthcare company) from New Mountain Capital (financial sponsor) (Mergermarket, 2020), Aston Martin (car manufacturer) from Investindustrial (PE fund) (Mergermarket, 2020).
- **Sale to strategic player / corporation**: it consists in selling the GP participation to a corporation. This option is one the best ones because the corporate will offer a higher premium (difference between the offer price and the fair value) due to the appearance of synergies. We have witnessed in February 2020 a cross-border deal in the lower middle market: the sale of Cegasa Portable Energy to the listed Mexican company "Autlán" by the Spanish financial sponsor Sherpa Capital for €26,3m (Mergermarket, 2020).
- **Sale to a financial sponsor**: sometimes, selling a company to other PE fund could a very good option if it exists a bidding process. In the mega funds market a transaction has been closed in the private equity real estate market in February 2020: Blackstone (PE group) acquired iQ Student Accommodation (real estate company) for $6bn from the PE fund of Goldman Sachs (financial group) and Wellcome Trust (pharmaceutical NGO) (Mergermarket, 2020).

  These three exit strategies are the most common ones. In order to show the amount of them the following chart is shown, which illustrates how IPOs were down, while sponsor to sponsor deals and sales to strategic buyers kept pace. *(see figure 6)*

***Figure 6**: Global buy out backed exit value, by channel*



Notes: bankruptcies excluded; IPO value represents offer amount and nor market value of company

Source: Dealogic

- **Liquidation**: in the case that the PE fund has not been able to run the business properly a company closing could be an alternative. A real case may be the possible liquidation of Marypaz shoes by Black Toro Capital (Spanish financial sponsor focus on restructuring and special situation transactions) (Muñoz, A., 2019).
- **Dividend recapitalization** (only partial exit): it refers to the situation in which the General Partner receives a dividend by the company by augmenting the debt of the business. As one would expect, dividend "recaps" have developed a bad reputation popularly, however, they are still commonly used.

2.4. Actors in the PE scene

With the purpose of illustrating how complex is this industry a list of players is provided here below according to different categories:

- **PE professionals**: there are many different people working at a PE fund:

- **Partners**: they are the people with more hierarchy in a fund. They normally own the company managing the funds and they receive most of the success fees. Typically, in the lower middle-market the partners are also the founders. As might be expected, the partners of a fund are the ones most responsible for the quality of the investments and fundraising.
- **Investment team / front office**: professionals responsible for all the investment phases (sourcing, execution, monitoring and exit) of the fund. These professionals come from working in investment banking / corporate finance or strategic consulting most of the times, as it is quite difficult to start working in PE without any full-time professional experience. In addition, it is very hard getting a job position at a financial sponsor due to: the limited number of PE funds, the strong competence because of the high salaries paid, the small size of the investment teams and the fact that a GP does not hire investment professionals every year. Frequently, PE funds hire headhunters in order to find possible investment professionals.
- **Finance and investor relations / back office**: professionals in charge of managing the legal duties, operations, investor relations, reporting and finance of the fund.

- **Advisors and third parties**:
  - **Fundraising**: regarding the raise of a GP, there are many parties intervening in it. There can be a division between two different ones:
    - **Advisors**: companies that help the PE in fund raising money from individuals with a great wealth in exchange of fees (usually). This type of companies are private banks, wealth managers or private placement agents.
    - **Institutional financial investors**: insurance companies, pension funds, foundations, fund of funds, family offices (investment companies operating the money from rich families) and banks. As an example, we can observe the investment from Banco Santander in the Spanish manager Tresmares Capital (Ferrer, P., 2019)
  - **Investment and disinvestment phases**: during these phases there are plenty of advisors that help the funds in exchange of fees:
    - **Investment banks / corporate finance companies** (Merger & Acquisitions, Equity Capital Markets, Debt Capital Markets and

Leveraged Finance professionals): as mentioned in the beginning of this paper, these advisors help the PE funds in the sourcing investment phase. Apart from this, they also help the funds in more things: structuring the transaction, issuing bonds for financing the acquisition if necessary, finding add-on opportunities, setting up a bidding process to sell the company, making the company public, … but the most important part is that they are always proposing the best corporate movements for the fund, because at the end of the day the fund is the client.

  - **Corporate lawyers**: as any acquisition has a lot of contracts, agreements and legal details, legal advisors are essential.
  - **Debt providers**: banks and private debt funds basically.
  - **Auditors**: in any M&A transaction there are a lot of advisors implied in it, and auditors are part of it. They are responsible for checking all the financial statements and confirming legally that they are correct.

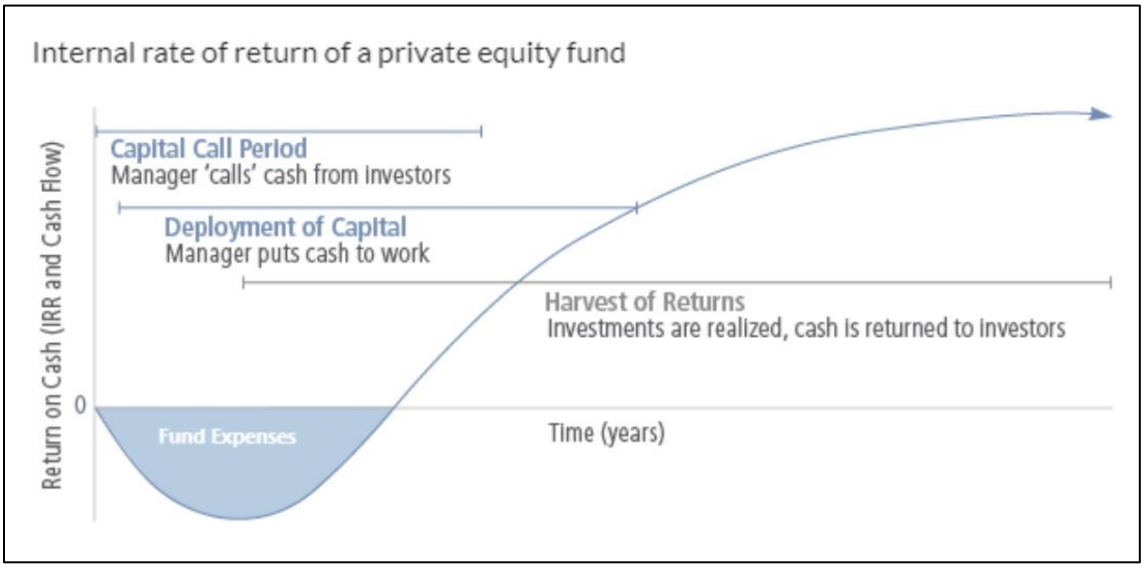
- **Monitoring**:
  - **Consulting companies**: as one of the tasks of a PE fund is monitoring the activity of their portfolio investments, they normally hire consulting companies to improve the processes and/or establish new businesses in the company. Furthermore, most of the top consulting companies (McKinsey, Bain and Boston Consulting Group) elaborate private equity reports every year, as they depend a lot from this industry.
- **Others**:
  - **Private Equity Associations**: there are many private equity associations that promote the industry thanks to many networking events and conferences. In Spain there is one called Ascri (“Asociación Española de Capital, Crecimiento e Inversión” or Spanish Association of Capital, Growth and Investment) and it was created in 1986. More than 100 international and national private equity and venture capital firms operating in Spain are part of the association, apart from many corporate advisors (law firms,

investment banks, headhunting firms, …) and investors (ASCRI, 2020)

- **Software and technology providers**: as all the information regarding the private equity market is quite confidential and difficult to obtain, there are some providers helping the funds in order to obtain M&A and PE information. A selection of the key providers and databases is: Mergermarket (M&A), Pitchbook (PE), Preqin (PE), S&P Capital IQ (general finance), FactSet (general finance), Thomson Reuters (general finance), eFront (PE), Dynamo (Altvia), …
- **Regulators and tax authorities**: although the private equity industry is not a very regulated industry because of the difficulty to understand it properly, the professionals working in it pay a lot of taxes due to the high salaries paid. Consequently, the PE industry contributes a lot to the society in terms of taxes. In fact, according to several news, one single partner working at a top international PE firm in Madrid paid €23,2m of taxes as he received €50m in concept of carried interest (Ortín, A., 2018). Taking into consideration that most of the international mega PE funds (which make mega acquisitions) have an office in Spain, there are various Spanish investment professionals receiving carried interest and paying lots of taxes to the country.

Due to all the direct and indirect jobs that there are in private equity, it appears the J-curve. This concept means that a fund will always have an MoC below 1,0x during its first years due to all the fees that are paid to execute transactions and to run the day-to-day of the fund. *(see figure 7)*

Figure 7: *J-Curve of a PE fund*



Source: Independent Access Partners

3.HOW DO PRIVATE EQUITY FUNDS MAKE MONEY?

Now that a great explanation of how the PE industry works has been provided, it is necessary to enter into a deep analysis of how these funds make money, being three different ways. Furthermore, a simple LBO will be presented to show with numbers a hypothetic LBO transaction.

3.1. Three methods

A PE fund can make money thanks to three different strategies: EBITDA growth, deleveraging and multiple arbitrage:

3.1.1. EBITDA growth

As the price of the company is determined by the multiple of Enterprise Value / EBITDA, if this last figure is higher at exit the PE fund will have better returns with the transaction. This way of making money is the most difficult one, as it means having a "hands-on approach" and spending time with the strategic plan and day-to-day operations. In order to increase the EBITDA, the financial sponsor can make many things:

- **Supporting the management team** in their existing strategy or developing a new one thanks to their experience from other portfolio companies and third party advisors assistance.
- **Increasing the scale**:
  - Improve access to capital markets through sponsor's relationship.
  - Complete add-on acquisitions (inorganic EBITDA growth).

Nevertheless, if a company operates in a subsector growing at double-digit it would not be so necessary to employ a lot of time monitoring the portfolio company.

3.1.2. Deleveraging

As previously mentioned, the Enterprise Value is (basically): equity + financial debt – cash, if a PE fund reduces the debt of the company with the free cash flow available the equity participation of the fund will be higher. The financial sponsors that strongly follow this strategy choose companies with high cash conversion and structure the transaction with big amounts of debt. The main risk of this strategy is that when difficult economic times come the debt repayment becomes quite challenging to be made, apart from the bad reputation of the fund that is created. Moreover, when interest rates are very high making money deleveraging the business could be arduous. Although the deleveraging strategy has received many critics by the society, it requires to be brave enough due to the high risks involved. There are some ways to potentiate this strategy:

- Seek opportunities to monetize part of the assets
- Drive cash flow generation
- Control cost of debt
- Net working capital reduction
- Tax optimization

3.1.3. Multiple arbitrage

This strategy does not require complicated tasks, it simply consists in selling the company at a higher multiple than the multiple at entry. It is pure negotiation and good luck regarding the economic cycle. Nonetheless, there can be a little bit of strategy on this: if a PE fund invests a long time in searching investment opportunities (proprietary deal flow) and does not rely a lot on M&A advisors, it will buy at low multiples guaranteeing an important multiple arbitrage and hedging itself against a change in the economic cycle.

(see figures 8 and 9). Additionally, if a company is expected to grow a higher rate it can be sold at a high multiple because at the end of the day the multiple of EV / EBITDA refers to the future revenue expectations, this is why it is so different in the different industries and also due to the fact that each industry has a different average EBITDA margin.

Figure 8*: Median EV/EBITDA multiple at entry and exit, for global buyouts*

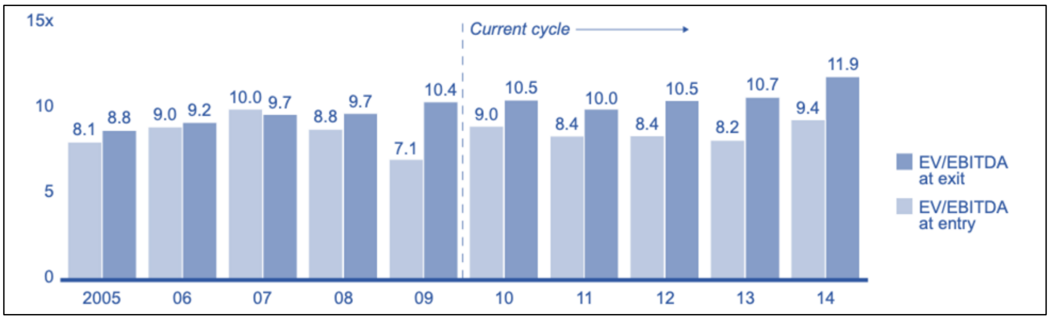
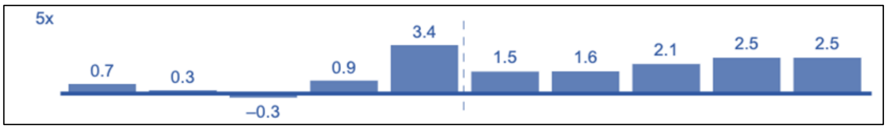


Figure 9*: Spread or delta of entry to exit multiple*



Notes (figures 8 and 9): exit multiples and spread post-2015 not shown due to large of unrealized deals; deal universe includes approximately 3.200 realized and unrealized buyout deals with at least $45m in invested capital, with original capital allocations between January 1, 1998 and October 28, 2019

Sources (figures 8 and 9): CEPRES Platform; Bain analysis

3.2.LBO example

As we already have a great perception of how a PE fund makes money and how does it work, we will continue with a hypothetic LBO model.

As financial modelling is a mix of art and science, a LBO model is not an exception. Many assumptions and figures are considered to elaborate a LBO model:

- **Entry multiple** (EV / EBITDA): looking at similar transactions, revenue growth expectations of the company and sector, and the quality of the enterprise; an acquisition multiple can be deducted and inserted in the model. This multiple will give an implied enterprise value at entry based on the EBITDA.

- **Interest rates** of the debt tranches: as previously explained there are many debt tranches depending on their risk and interest rate evidently. The figures are obtained after negotiating with all the debt providers.
- **Capital structure / sources and uses of funds**: it is basically a table in which the proportion of equity and debt available to finance the acquisition are measured. It is needless to say that the amount of sources will always be equal to the amount of uses of funds. In this part, the proportion of equity and debt will be achieved.
- **Revenue growth**: information to get this number can be obtained from different sources: equity research documents of the company or similar companies, macroeconomic research, industry or market research, M&A advisors, management team, historical numbers, …
- **EBITDA margin** (% of sales): companies in the same industry tend to have similar EBITDA margins. But, obviously, there can be difference depending on the management quality and strategic plans.
- **Capital Expenditure or CapEx** (forecasted as % of sales): it is the investment in capital goods that will help the company in selling more. An example can be an investment in a new machine of a factory. Usually, PE-backed companies do not use great amounts of CapEx, as they prefer to use the cash flow in repaying the existing debt, rather than acquiring new things.
- **Depreciation & Amortization** (forecasted as % of CapEx or % of sales): it is normally projected taking the CapEx into consideration, as it is the amount of money that the assets of the company loose value. If the percentage in comparison with the capital expenditure is low, it means that the company is growing.
- **Change in net working capital** (forecasted as % of absolute change in sales): it measures the company management of the main current assets and liabilities of the balance sheet. Normally, if this number is negative is means that the company is growing.
- **Exit multiple** (EV / EBITDA): to assume this number, it is needed to take a look at the economic cycle and possible future multiples. Taking into consideration that during downturns they will be low and vice versa. This multiple will give an implied enterprise value at exit based on the EBITDA.

Anyway, the model is just a numerical representation of a transaction. An excel spreadsheet can support any number or assumption, the most difficult part of it, it is to really believe the numbers and that the company will be sold at a similar multiple, EBITDA and debt level in comparison with the model. In addition, it is better to have a conservative approach at the time of elaborating a financial model.

A LBO model can very tough and challenging if it is elaborated with the maximum detail, in fact, a proper LBO model for an actual transaction should have many things: sources & uses of funds, operating assumptions, forecasts of the three financial statements (profit & loss account, balance sheet and cash flow statement), a debt schedule with all the debt tranches and their respective covenants, transaction fees, fixed assets analysis and forecast, valuation ratios, exit scenarios and sensitivity ratios, …

However, a simple and clean LBO is provided to a have clear and easy learning of how a LBO works: *(see figures 10-14)*

Figure 10*: Sources and uses of funds of a LBO*

SOURCES AND USES OF FUNDS

Sources		**Uses**	
PE fund equity	1.287,5	Purchase price	2.500,0
Net debt (unitranche)	1.250,0	M&A fees	12,5
Total sources	**2.537,5**	Sponsor fees	12,5
		Financing fees	12,5
		Total uses	**2.537,5**

Source: own elaboration

***Figure 11**: Assumptions of a LBO*

ASSUMPTIONS	
Entry assumptions	
EBITDA 2019A	250,0
Entry EV/EBITDA	*10,0x*
Implied EV	2.500,0
Net debt	1.250,0
Implied equity value	1.250,0
Cash position	200,0
Operating assumptions	
Revenue growth YoY	*5%*
EBITDA margin increase YoY	*1%*
D&A (% CapEx)	*90%*
CapEx (% sales)	*5%*
Change in NWC (% abs. ch. in sales)	*4%*
Interest rate % (unitranche debt)	*4%*
Tax rate %	*25%*
Exit assumptions	
EBITDA 2023E	389,0
Entry EV/EBITDA	*11,0x*
Implied EV	4.278,6
Net debt	571,3
Implied equity value	3.707,3
Cash position	200,0

Source: own elaboration

Figure 12: *Profit & loss account of a LBO*

PROFIT & LOSS ACCOUNT					
	2019A	***2020E***	***2021E***	***2022E***	***2023E***
Sales	**1.750,0**	**1.837,5**	**1.929,4**	**2.025,8**	**2.127,1**
growth YoY %		*5%*	*5%*	*5%*	*5%*
Costs	(1.500,0)	(1.556,6)	(1.615,2)	(1.675,7)	(1.738,2)
EBITDA	**250,0**	**280,9**	**314,2**	**350,2**	**389,0**
margin %	*14%*	*15%*	*16%*	*17%*	*18%*
D&A	(80,0)	(82,7)	(86,8)	(91,2)	(95,7)
CapEx %		*90%*	*90%*	*90%*	*90%*
EBIT	**170,0**	**198,2**	**227,4**	**259,0**	**293,2**
Interests	0,0	(58,0)	(52,6)	(46,3)	(39,1)
EBT	**170,0**	**140,2**	**174,8**	**212,7**	**254,2**
Taxes	(42,5)	(35,0)	(43,7)	(53,2)	(63,5)
tax rate %	*25%*	*25%*	*25%*	*25%*	*25%*
Net profit	**127,5**	**105,1**	**131,1**	**159,6**	**190,6**

Source: own elaboration

Figure 13: *Debt schedule of a LBO*

DEBT SCHEDULE					
		2020E	***2021E***	***2022E***	***2023E***
EBIT		**198,2**	**227,4**	**259,0**	**293,2**
Taxes		(49,5)	(56,8)	(64,8)	(73,3)
Tax rate %		*25%*	*25%*	*25%*	*25%*
NOPAT		**148,6**	**170,5**	**194,3**	**219,9**
D&A		82,7	86,8	91,2	95,7
CapEx		(91,9)	(96,5)	(101,3)	(106,4)
sales %		*5%*	*5%*	*5%*	*5%*
Change in NWC		(3,5)	(3,7)	(3,9)	(4,1)
absolut change in sales %		*4%*	*4%*	*4%*	*4%*
Free Cash Flow		**136,0**	**157,2**	**180,3**	**205,2**
	2019A	***2020E***	***2021E***	***2022E***	***2023E***
BoP	0,0	1.450,0	1.314,0	1.156,8	976,5
Debt repayment	0,0	(136,0)	(157,2)	(180,3)	(205,2)
EoP	**1.450,0**	**1.314,0**	**1.156,8**	**976,5**	**771,3**
Interest payments		(58,0)	(52,6)	(46,3)	(39,1)

Source: own elaboration

Figure 14: *Exit of a LBO*

EXIT		2019A	2020E	2021E	2022E	2023E
PE fund cash flows		(1.287,5)	0,0	0,0	0,0	3.707,3
MoC	*2,9x*					
IRR	*30%*					

Source: own elaboration

4.ECONOMIC CYCLES IN PE

4.1. How financially resilient is the PE industry?

As might be expected, any investment can be very dependent from the economic cycles and, private equity is not an exception. However, the long-term view of the private equity funds makes this type of investments less cyclical than other type of investments. Furthermore, the fact that private companies do not need (legally) to publish the same amount of information than listed companies and the existence of equity research analysts reports, make the valuation of private companies less conditional to short term events. Moreover, private companies do not have to comply with the same heavy and arduous bureaucratic regulation than public companies do.

There are some factors that make a private equity investment more or less dependent from the economic cycle:

- **Sector**: although there are not bad sectors but bad company managers, the different industries play a very import role, regarding the cyclicality of them we can make a simple division of three different categories:
    - **Cyclical sectors**: basic materials, consumer cyclical, financial services and real estate.
      For instance, PAI Partners and Permira acquired the Spanish apparel retailer Cortefiel Group in 2005 (just before the financial crisis) and it has been suffering financial losses during many years. In 2017 Permira sold

its participation and CVC Capital Partners entered in the shareholding structure of the company, renaming the group to Tendam and changing the management team and corporate strategy. Nowadays, the company has a very low leverage (2,8x EBITDA) and it is increasing the EBITDA (Martín, C., 2019).

- **Sensitive sectors**: communication services, energy, industrials and technology.

  The energy fund of Qualitas Equity Partners (Q-Energy) sold Fotowatio Renewable Ventures (FRV) in 2015 to Abdul Latif Jameel Energy with great returns (Efe, 2015).

- **Defensive sectors**: healthcare, consumer defensive and utilities.

  As an example, the fourth fund of Ergon Capital Partners bought in 2019 an important participation in the Spanish company Palex Medical to the Spanish GP Corpfin Capital. As we are currently facing an economic downturn most of the funds are keen to acquire companies in the healthcare sector due to the stability of it. Corpfin has been able to have a holding period of only 3 years because of the attractiveness of the sector in which Palex operates (Mergermarket, 2020).

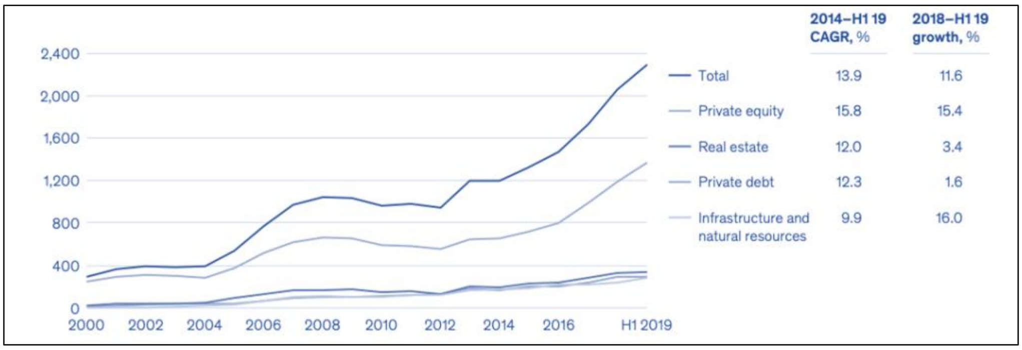
- **Size of the company**: even though there are General Partners in all the segments of the market, it is easier to sell a company in the lower middle market due to the fact that a company in this part of the market can be acquired by many investors: an strategic investor, a big General Partner as an add-on investment, a lower middle market PE fund (which are a lot) as a portfolio company and, retail and institutional investors in an Initial Public Offering (IPO). Nonetheless, if the company is too big and it is not a good time in the stock market, selling it could be difficult because there are not as many mega funds as lower middle market funds in order to considerate them as possible buyers.
- **Moment of acquisition**: depending on the time that the company was acquired the investment can be more or less profitable. For example, if a company is acquired just before a recession or economic downturn the acquisition price would be very high and the debt very difficult to be repaid during the bad economic moment.

  For example, the financial sponsor Cerberus Capital Management acquired 80% of Chrysler after its failed merge with Daimler AG (owner of Mercedes Benz) in

2007. After the financial crisis in 2008 the car company went bankruptcy. Finally, the PE fund was able to achieve some gains due to the Fiat entrance in the company in 2014 and the outstanding performance of the financial division of Chrysler (Isidore, C., 2007).

- **Interest rates**: as all the M&A transactions (especially LBOs) are financed with many debt providers, if the interest rates increase, the PE returns will be lower because of the little possibility of making money deleveraging the business. In addition, when interest rates increase, the debt providers (especially banks) lend less money and with more restrictions and covenants. Consequently, if a financial sponsor wants to buy a very good company in a mature sector with stable cash flows (which makes deleveraging a great important part of the total returns) in a moment with high interest rates, the fund will not very interested because of the low possibilities of making money deleveraging company.
- **Appetite in the PE sector** (dependent from the fundraising quality of the funds): as PE funds are very dependent from fundraising, their investments also do. For example, nowadays most of the PE managers have already fundraised new funds for the following years thanks to the liquidity and excess of cash of investors in 2019. Consequently, the dry powder of the PE market (much more than the rest of private funds) is incredibly high, making the M&A global activity very active, in fact, stocks of dry powder reached a new high in the private market, *(see figure 15)* especially private equity funds.

Figure 15*: Global capital committed and not deployed, 2000-H1 2019, $bn*



Source: Preqin

However, if a GP wants to sell a portfolio company in a moment of very low dry powder in the market, it will be more difficult, as there will be less buyers interested in the process, making lower the final price due to a poor number of bids in the selling process.

Although the financial logic says that all these previous motives could make generate a private equity investment great losses or gains, it is just what it should happen. But a lot of gains can be materialized in an investment that in theory and at first view was not attractive. This is why the world of investing is a mix of art and science.

Having said that, there are obviously many private equity investments that end up in very low returns or even losses (rarely) due to many reasons previously described. Nevertheless, this is not a big concern for the private equity industry because taking into consideration that a PE fund acquires 10 portfolio companies and sells 2 or 3 of them with a 1,0x MoC return or less and, sell the rest with a MoC of 2-3,5x, the fund will deliver a c.2,0x MoC overall in the fund. It goes without saying that in a GP there are portfolio companies that can go bad, just normal or excellent. Thanks to the diversification in time, a PE fund obtains almost always positive returns. In order to illustrate the lector with a numerical example, a diversification analysis with some assumptions is provided: *(see figure 16)*

Figure 16: *Diversification analysis*

PE fund
Size: €1.000m

	Equity investment	MoC	Proceeds
Portfolio company 1	€ 100m	3,5x	€ 350m
Portfolio company 2	€ 100m	3,0x	€ 300m
Portfolio company 3	€ 100m	3,0x	€ 300m
Portfolio company 4	€ 100m	2,5x	€ 250m
Portfolio company 5	€ 100m	2,5x	€ 250m
Portfolio company 6	€ 100m	2,5x	€ 250m
Portfolio company 7	€ 100m	2,0x	€ 200m
Portfolio company 8	€ 100m	1,0x	€ 100m
Portfolio company 9	€ 100m	0,8x	€ 80m
Portfolio company 10	€ 100m	0,8x	€ 80m
	€ 1000m	**2,2x**	**€ 2.160m**

Source: own elaboration

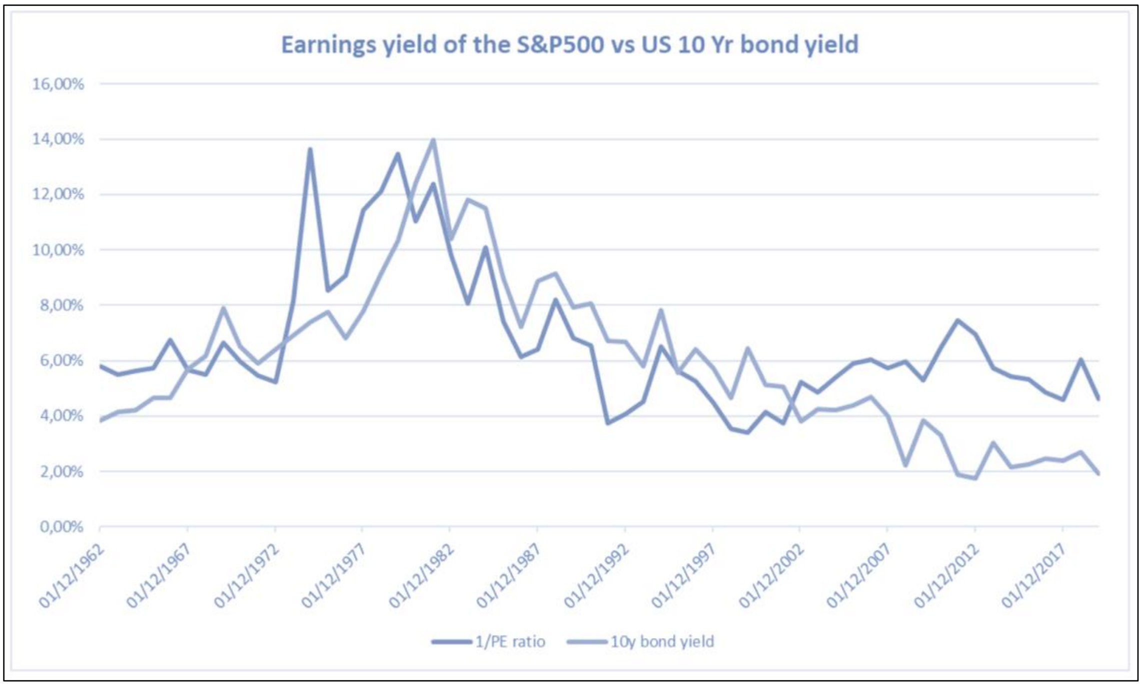
Taking this analysis into account, it is very difficult for a financial sponsor to make losses (taken as a whole) because of an economic downturn or recession, as a GP acquires 2 companies (as an average) per year and can buy add-on companies during the 10 years of the fund, this diversification in time works as an hedge against challenging financial moments.

As a matter of fact, it is very difficult to make losses overall in a PE fund, there are very few cases of financial sponsors disappearing, and if they do it, it is just because they make low but positive returns and their investors prefer to put their money (reserved to the private market and/or private equity) in other GP. But there are also other reasons for a PE fund manager to close, for example the Spanish financial sponsor Thesan Capital focused on restructuring companies disappeared because of legal problems with the Spanish tax authorities (Altozano, M., 2016). Taking everything into consideration, investing in a private equity fund could appear to be risky but is not that risky considering that it is quite difficult to make losses, which can be very different in comparison to other asset classes…

4.2. Comparison with the rest of asset classes

As previously mentioned, private companies do not have the same valuation volatility as listed companies that are extremely dependent from global events affecting the economy. During the last 10 years most of the international indexes have been growing continuously mainly because of the low interest rates that have allowed the companies having a very low cost of debt with cheap financial liabilities. This fact has permitted the companies increasing their sales and margins at a very high speed. Nonetheless, some central monetary institutions (the Federal Reserve, the Bank of Japan, the European Central Bank, the Bank of England, …) have started increasing interest rates in 2018 (in order to avoid inflation) (Roberts, J., 2018), what has a very important consequence: investors move their money from public equities to fixed income (as interest rates from fixed income securities are increasing); which results in a decrease in the share prices of public equities. In order to demonstrate this, a chart with the relation between public equities (measured with the price to earnings ratio, typically used in the public equities world, of the S&P 500) and interest rates (measured with the US 10year bond yield) is shown. *(see* *figure 17).* During the last years we can see a noticeable delta due to the internationalization of the business world and the lower dependence from specific national bond yields. In addition, other political factors such as the covid-19 crisis can also affect the public equities market obviously.

Figure 17: *Interest rates and global public equities*

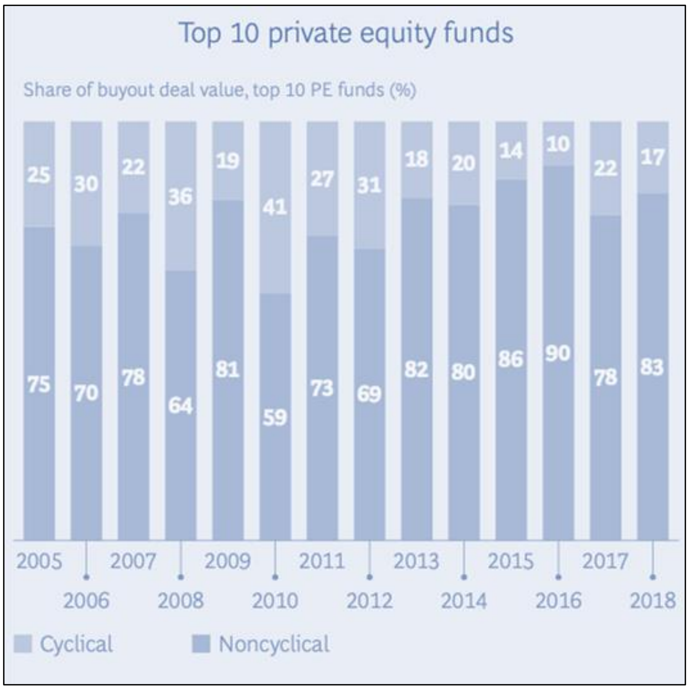


Source: Bloomberg

This problem does not affect investments in private equity in the same proportions, because of many reasons:

- Whereas **private equity returns** can be obtained thanks to 3 different ways (EBITDA increase, deleveraging and multiple arbitrage) public equity funds can only obtain returns as a result of the offer and demand of a company in the stocks, they cannot negotiate a sale as the price is listed. Additionally, they cannot decide about important decisions in the company as public equity funds do not usually have majority positions.
- Biggest PE funds are building their portfolios taking into consideration a possible future recession and / or economic downturn, in order to be **resilient** enough. Allowing themselves to generate good returns in the worst financial scenarios. *(see figure 18)*

***Figure 18**: Firms and building relatively recession-proof portfolio*



Industry	Average share of buyout deal value (%) 2005–2007	2016–2018	Delta (percentage points)
Restaurants, hotels, and leisure	5.9	2.9	–3.0
Retail	5.6	2.5	–3.1
Semiconductors	4.5	0.0	–4.5
Energy	3.0	6.5	3.5
Consumer durables	2.5	0.1	–2.4
Industrial	2.1	4.0	1.8
Transportation	1.3	0.4	–0.9
Materials	0.6	0.0	–0.6
Total cyclical	**25.5**	**16.5**	**–9.1**
Commercial products and services	21.5	27.1	5.6
IT/software	21.1	27.9	6.8
Healthcare/pharma	11.3	10.6	–0.6
Media	8.1	1.3	–6.9
Utilities	5.3	0.0	–5.3
Consumer Nondurables	2.9	2.8	–0.1
Financial services	2.8	11.5	8.6
Other	1.4	2.3	0.9
Total noncyclical	**74.5**	**83.5**	**9.1**

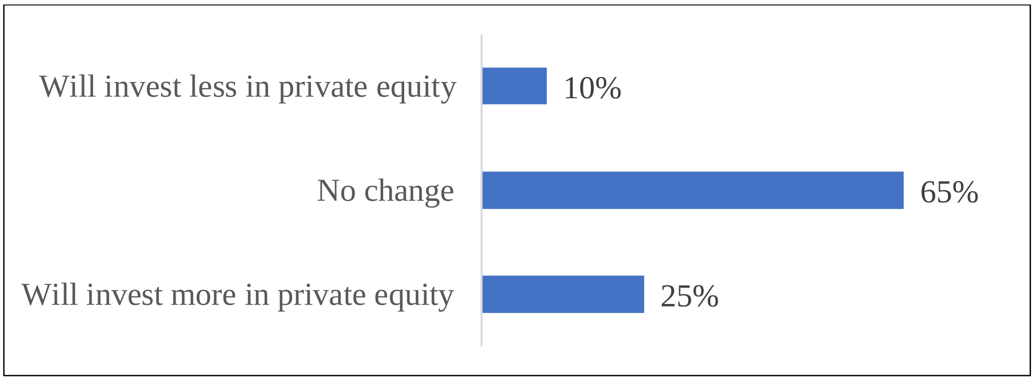
Note: "other" includes agriculture, containers and packaging, other consumer products and services, and textiles, PE funds included: The Carlyle Group, Blackstone, KKR, Apollo Global Management, CVC Capital Partners, Warburg Pincus, EQT, Neuberger Berman Group, Silver Lake and TFG. Darta includes completed deals only. Because of rounding, not all percentages shown add up to 100.

Source: Pitchbook; Boston Consulting Group

In fact, a Mergermarket survey reported that 42% of senior PE executives had expanded their firm's exposure (increasing the diversification and therefore decreasing financial risks) to new asset classes and that 54% planned to do so going forward (Preqin, 2019).

- The **valuation of private companies is subjective** and not extremely dependent from global events. For instance, any natural disaster has a lot of impact on public equities, decreasing most of the share prices although the companies have nothing to do with that. An example can be the effect of the Covid-19 crisis in global stocks; even though there are companies that do not suffer it in the real economy (defensive sectors) they are suffering in their share price, such as Bayer, company which most of its revenues come from the healthcare sector has seen a 20% decrease of its share price (Bloomberg, 2020). Do you really think that the fair equity value of this company is 20% lower because of the Covid-19 crisis? Obviously, no.
- While private equity are **activist investors** in their portfolio companies, most of the existent public equity investors, especially in Europe, do not have a hands-on approach, they do not help their portfolio companies in their day-to-day operations. This is one reason why 90% of the investors will keep putting their money in PE funds, or even increasing their exposure. *(see figure 19)*

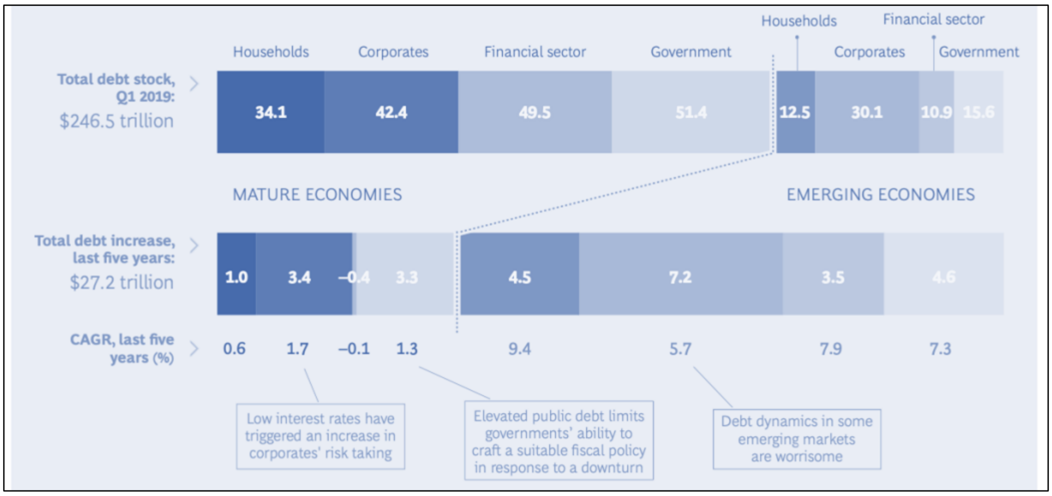
Figure 19*: Investors' plans to alter their level of private equity investments in response to the cycle*



Source: Preqin

- **Debt levels are not rising too much**. Not unexpectedly, most of the private equity firms make gains on account of deleveraging their portfolio companies. However, debt is always a big concern which can make an investment very profitable or a complete disaster. This is why after the global financial crisis in 2008 most of the companies in the mature economies has not increased their debt enough to worry about it. *(see figure 20)*

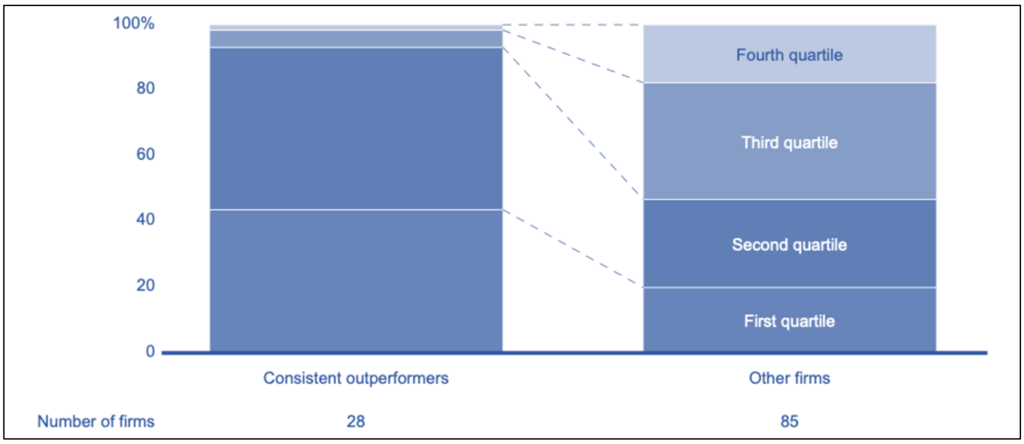
Figure 20*: Debt levels by industries in mature and emerging economies. Q1 2019 vs last five years*



Source: Global Debt Monitor, IIF; Boston Consulting Group

- **Excellent private equity managers will always be excellent, but not public equities managers**. On the one hand, all funds overall from Blackstone have provided a 19% IRR in the last 20 years (Phillips, M., 2017), including huge recessions and biggest economic downturns. On the other hand, a lot of famous and "excellent" public equity investors have not been able to do that, such as "Francisco García Paramés",who was called "the Spanish Warren Buffet", that reached an average annual return of 14,24% from 1999 to 2014 (Fondium, 2017), but he has made 17,10% losses since 2016 (Sánchez, S., 2019). Other example can be the bad performance of Warren Buffet (one of the most famous investors and richest persons in the world thanks to public equity investing) in 2019, who reached worse returns than the S&P 500 index (Sherman, E., 2019). Taking these facts into consideration, I do not want to say that Paramés or Warren Buffet are lazy or mediocre investors in public equities, what I want to say is that having always excellent and constant returns in public equities in the long run is almost impossible due to the fact that the stock markets do not allow long-only public equity funds having positive returns every year, as recession years make that almost all the company share prices decrease. However, it is possible to consistently outperform in private equity. *(see figure 21)*

Figure 21*: Performance of buyout fund (vintage 2000-2016) for firms that have raised more than $5bn since 2000*



Note: consistent outperforms defined as firms with at least 80% of their funds with 2000-2016 vintages in the top quartiles

Sources: Preqin; Bain

Although some numbers and analyses have been provided in order to demonstrate that private equity investments have less risk and are less prone to generate losses, I would like to show a case study.

In 2007, just before the financial crisis boomed, Blackstone acquired Equity Office Properties (EOP), the largest manager of office buildings of 2007 in the US, in a $39bn EV deal with a big proportion of debt. Apparently, an acquisition of a real estate company with a great debt percentage just before a global financial crisis originated by excessive debt risks in the real estate market, was not a very good idea. Nevertheless, EOP did not suffer the real estate bubble as a result of the hands-on approach of the Blackstone investment team and the fact that the company was not listed, allowing it to more dependent and less regulated. What is more, EOP was acquired at a moment in which the real estate company prices were the highest ones in history. Nonetheless, Blackstone was able to sell it at a price that tripled the original one in the acquisition of 2007, making a $7bn profit (Yeh, N., 2018) (Grant, P., 2019).

With the intention of showing the advantages of private equity investments I consider that it is necessary to show how listed real estate companies and the stock markets performed during the global financial crisis in 2008 while Blackstone was making 3,0x MoC thanks to a real estate company. *(see figure 22)*

Figure 22*: Real Estate historical performance*

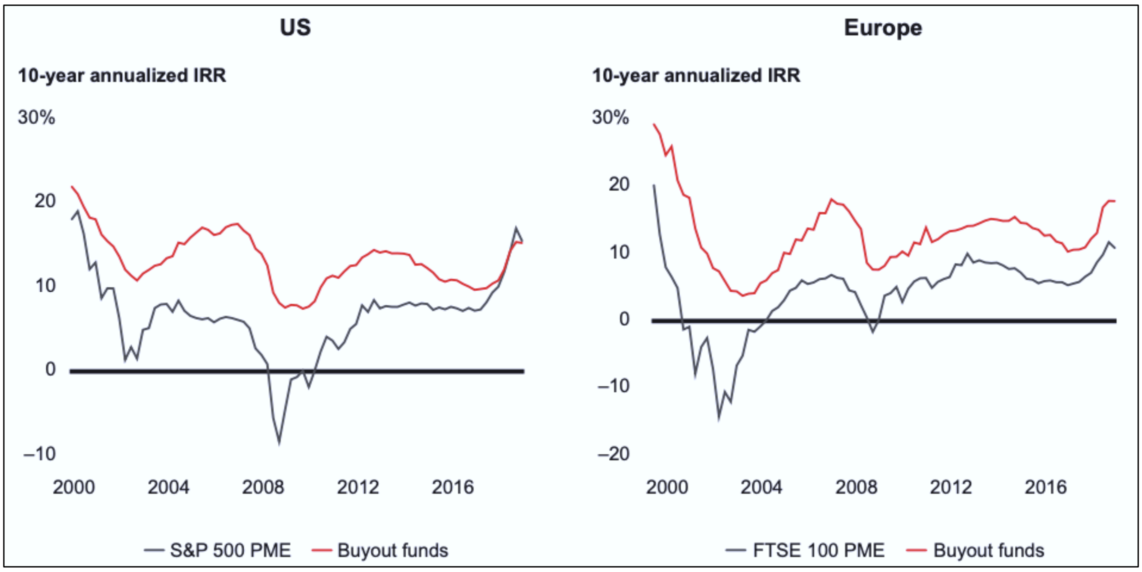
ANNUAL PERFORMANCE (%)

Year	MSCI World Real Estate	MSCI World
2019	23.97	28.40
2018	-5.56	-8.20
2017	15.58	23.07
2016	3.79	8.15
2015	1.05	-0.32
2014	15.05	5.50
2013	3.55	27.37
2012	29.69	16.54
2011	-6.40	-5.02
2010	21.24	12.34
2009	33.94	30.79
2008	-47.59	-40.33
2007	-4.96	9.57
2006	40.90	20.65

Note: The MSCI (previously known as Morgan Stanley Capital International) World Real Estate Index is a free float-adjusted market capitalization index that consists of large and mid-cap equity across 23 Developed Markets countries. All securities in the index are classified in the Real Estate Sector according to the Global Industry Classification Standard (GICS®).
Source: MSCI

Additionally, in order to demonstrate how private equity investment are much more financially resilient to economic downturns two charts will be shown. *(see figure 23)*

Figure 23*: The public-private convergence in returns over the past decade has largely been a US phenomenon*



Note: PME is a public market equivalent based on the Long-Nickels methodology

Source: State Street Private Equity Index

5. HOW DOES THE PRIVATE EQUITY INDUSTRY HELP THE SOCIETY?

Even though there many people criticizing private equity funds with no objective or solid arguments, these funds are financial vehicles that help a lot to the society. Some examples are:

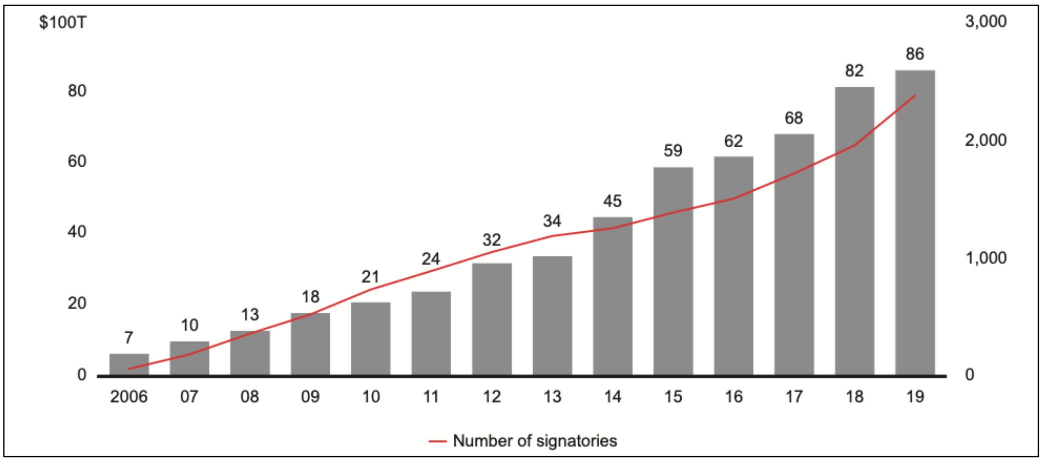
- **Taxes** (personal and Company): thanks to PE funds, there are a lot of private companies around the world that grow at a higher pace than the rest on account of the experience of the investment professionals managing them. This results in higher EBTs (Earnings Before Taxes) and obviously in higher tax payments to the applicable tax authorities. Moreover, investors in GPs pay a 23% tax on capital gains (something that in public equities cannot be done due to the nature of PE funds, which disappear when the last portfolio company is sold and a public equity fund never dissolves, allowing the public equity investors to pay 0 taxes). Apart from that, PE investment professionals can make a lot of money thanks to the carried interest (success fee), which is taxed as a personal tax in Spain (for the time being) and probably at the highest tax % possible. Consequently, the Spanish tax authorities collect hundreds of millions of euros every year owing to PE investment professionals, investors and portfolio companies.

- **M&A activity**: as PE transactions are very complex processes, it requires a lot of M&A professionals (investment banks and/or corporate finance companies, audit companies, corporate law firms, consultancy companies, …) as previously described. Therefore, if the PE industry would not exist, a lot of indirect jobs would completely disappear.
- PE funds make the **business world** much more competitive and ready for economic downturns. As all the financial sponsors (especially the lower middle market funds) make great improvements in the day-to-day operations and corporate strategy of the companies, they tend to be much more competitive and well-organized. In order to verify this, I would like to show an statement made by a Chief Executive Officer (CEO) of a PE-backed company after the exit of a GP: Dirk Engehausen (Schleich CEO) said, after the exit of Ardian, "without Ardian's active support, this development would not have been possible at this speed and consistency", as the toy company was able to increase its revenues and improve its company position in the market (Ardian sells Schleich to Partners Group, 2019).
- PE funds support **corporate meritocracy**. Although there are sometimes that financial sponsors fire staff or even the management team from their portfolio companies, they do it because there are other professionals that deserve more that jobs than the previous ones, encouraging productiveness and hard work.
- **PE-backed companies have better growth rates than non-PE-backed companies**. As PE managers prefer to generate returns thanks to EBITDA increase in order to not depend from multiple arbitrage or deleveraging, as they are much riskier, this fact will allow most of the PE firms to generate solid proceeds and prepare for the next bad financial moment. According to an analyst from the Blackstone Group and a researcher from the Harvard University (Gianfrate, G. & Loewenthal, S., 2015): "roughly 70% to 80% of value creation for leading investment private equity firms now comes from EBITDA growth, whereas multiples and deleveraging account for just 10% to 15% on average."
- **PE helps the society in the worst moments**: as soon as the Covid-19 crisis has arrived in 2020, many PE-backed companies have decided to give their best and contribute all they can to the cause. For example, Dunlop (owned by the PE fund EQT) is working as much as it can to provide essential PPE for the protection of

Covid-19 for the hard-working men and women in healthcare and industrial cleaning, to NGOs and the food supply chain (EQT, 2020). Some portfolio companies from the Spanish PE funds Corpfin Capital are also helping as much as they can: Preving Group created a platform in which a lot of contrasted information about the Covid-19 can be seen and, “Grupo5” helped in the temporal hospital of IFEMA in Madrid qualified to fight the disease. (CorpFin, 2020)

- **ESG criteria is increasing its popularity in the PE industry**: not only there are many private equity funds focused only on sustainable investments (as previously described), but also most of the normal financial sponsors are considering the ESG criteria very important. More and more private equity investors are committing to ESG principles. *(see figure 24)*

***Figure 24**: AUM of principles for Responsible Investment signatories*

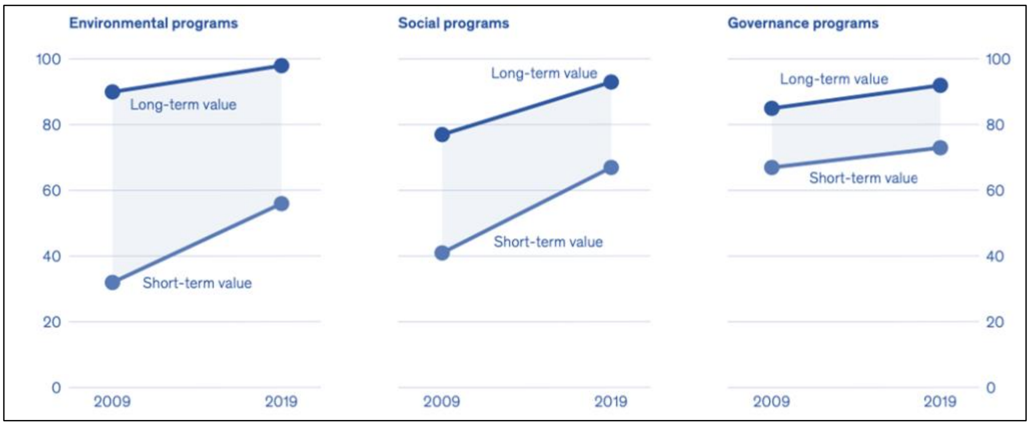


Note: data as November 2019

Source: Principles for Responsible Investment

What is more, most of the PE funds that follow ESG strategies agree that it is a value creation mechanism. *(see figure 25)*

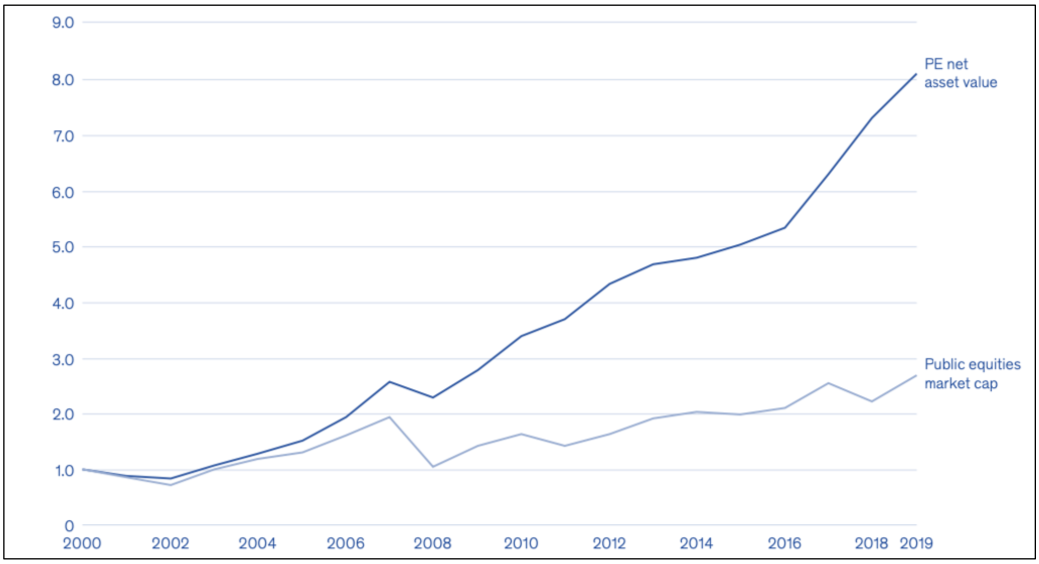
***Figure 25**: share of respondents who say given program creates value, %*



Source: McKinsey

- A country with a lot of PE funds is a **national economy** much more competitive ready to participate and be leader in the international market. GPs usually make their portfolio companies grow thanks internationalization processes. This allows a national balance of payments improve, increasing the exports.
  In Spain this is especially important, as the national economy has been able to grow at higher paces than other countries thanks to the superior number of exports recently.
- **Liquidity to the private market**. Naturally, the public market has always had and will always have much more liquidity than the private market for obvious reasons. Before the expansion and multiplication of financial sponsors, this difference was highly perceptible. However, after the increase of the number of GPs, the private market activity has been observing the incredible growth of the liquidity in this space. The explanation is quite easy, as the number of players in this market has extraordinarily increase, the liquidity too. Nowadays, if the owner of a company wants to sell it because of any reason, it is much easier than a couple of years ago. As previously explained, private equity dry powder is higher than ever before, existing much more investment opportunities in the private market than the public one. In fact, the value of PE companies has grown more than eightfold since 2000, outpacing public market equities. *(see figure 26)*

***Figure 26**: Global private equity net asset value and public equities market capitalization. Indexed to 2000*



Notes: Net asset value is defined as AUM less dry powder

Source: The World Bank, Preqin

- **Returns to LPs**: although most of the people that criticize PE managers say that these funds are only for rich people, this is totally false. The thing is that only investors with large quantities of money can invest in this type of funds because of the minimum required to invest (this depends on the fund, but in the smallest funds this figure is usually around €250k and millions of euros in the biggest funds), but a great percentage of the private equity investor base, are pension funds, which invest the retirement money from any person. Even though the people are not aware of this, a pension fund from the firefighters, policemen or any other profession can be investing in PE funds.

6. INTERVIEWS WITH PE PROFESSIONALS

Despite the fact that many statistical and financial figures have been shown in order to explain how the PE industry works, how it makes money and helps the society, I consider that making personal interviews with professionals that are and have been working in the industry during many years also helps a lot to this paper.

With the purpose of having different views of the PE industry I have decided to interview 5 different professionals with different positions in the Spanish Private Equity industry. Even though I have had the opportunity of making extensive interviews, only some key points from each professional will be highlighted to make this lecture more effective.

- **Ramón Carné Casas**: he is Managing Partner at Artá Capital and, prior to joining this fund he was Partner at Mercapital Private Equity. Ramón has 28 years of experience in the private equity industry in Spain. Ramón studied Industrial Engineering at ETSEIB and has a MBA from the INSEAD Business School. These were the most relevant moments of the interview with him:
    - **What are the advantages for a company when it is acquired by a GP?**
      Bringing value beyond money. Presence on the board and governing bodies to support their strategic development. Each case is different but can help in: improving the organizational structure, budget policy and budget monitoring. Apart from that, new corporate development guidelines and interest alignment with the management team are factors that improve the image of financial sponsors.
    - **How do you see the future of private equity in the Spanish lower middle market?**
      It is already very established with a significant number of PE firms operating in it. Although GPs will spend more time monitoring their portfolio companies due to the Covid-19 crisis, a lot of new investment opportunities at very attractive prices will appear.
    - **What are the advantages of a PE fund as an investment compared to other asset classes?**
      It offers a diversification in assets that are uncorrelated with the fluctuations of public equity markets. In addition, it has higher and more consistent returns than the stock market.
- **Ignacio Calderón Prats**: Partner at Tresmares Capital. He also worked at Qualitas Equity Partners as Investment Director and in the M&A industry as advisor at Lazard and Banco Santander. Ignacio studied at CUNEF. He underscored the paper of the PE industry in Spain:
    - **What are the advantages for a company when it is acquired by a GP?**

First of all, Ignacio talked about the importance of differentiating growth and buyout funds for this question. As growth funds follow a "hands-on" approach most of the times, same outperforming strategies executed by him have been: professionalization of companies operations (as the average size of Spanish companies is much lower than the rest of countries), buy & build acceleration process in the lower middle market, internationalization processes thanks to the global network of the fund, improved recruiting, solving succession issues, creating strategic alliances, implementing financial discipline, …

In addition, he also mentioned that PEs are helping the best Spanish companies in growing and being European leaders, creating a bigger and stronger business community in our country. Taking into consideration that during the past generations, best Spanish companies were acquired by American or German multinational companies, what made the Spanish business environment less competitive and smaller.

- **What are the advantages of a PE fund as an investment compared to other asset classes?**

  Taking into consideration that the most important factors for an investor are: returns, risks and liquidity; GPs offer great returns in the long run but with higher risks and less liquidity than other assets classes, making private equity investments very good for a x% of the total portfolio of an investor depending on his risk level and liquidity requirements.

- **Eduardo Díez Anaya**: Founding Partner at "Argo Asesores Financieros". With more than 20 years as M&A advisor in Spain, Eduardo has been able to work with many important financial sponsors: 3i, Alantra Private Equity, Apax Partners, Corpfin Capital, MBO Partenaires, MCH Private Equity, Portobello Capital, … He studied Business Administration at ICADE. Eduardo gave a special emphasis to many facts during the interview:
  - **How has the dry powder rise impacted in the M&A space of the Spanish middle market?**

    As Eduardo has a lot of years of experience, he explained the evolution of financial sponsors in Spain from the late 90's to these days:
    - *Regarding the M&A activity: there has been a clear growth of the number of PE transactions and M&A movement in consequence.*

Many international funds have installed regional offices in Spain and a great deal of national funds have been originated.

- *Concerning advisors: from lawyers to corporate finance professionals, there has been a remarkable increase in job positions in this kind of firms, in fact, most of the advisors have teams dedicated to private equity transactions. What is more, the activity has expanded due to the professionalization of the corporate world thanks to proficiency and qualification of PE firms, and the underground economy in Spain has decreased.*

Additionally, PE funds have obtained a great reputation in the M&A space after many years operating in it, as they were seen as "vulture funds" in the 00's. At that time, owners were not prone to sell companies to financial sponsors as they thought that the funds were going to: divide and sell them in different pieces, fire most of the people and similar strategies seen in Hollywood movies that are completely false in the Spanish lower middle market.

- **What are the differences between working for a fund and a corporate player as clients?**

  PE funds have created a different type of M&A transactions that corporates were not able to, as GPs prefer to cooperate with the management team allowing them to own also part of the company and work together.

  Furthermore, working with a fund is much easier and profitable as a M&A advisor, due to the fact that PE investment professionals have great transaction experience and are always buying and selling companies, which make them very attractive as client because they pay a lot of fees to their respective advisors.

  Eduardo also highlighted the importance of the network cooperation between the advisor and the fund, this is to say, the M&A space is a world of personal relations and there are some auction processes that the winner is not the one who offer a highest price but the bidder with a best personal relation with the seller.

- **What are the advantages for a company when it is acquired by a GP?**

Eduardo (as well as Ignacio Calderón) said that financial sponsors play a very important role in Spain growing the national companies, making them international and better companies. As during the previous year of the PE popularity expansion, most of the buyers of Spanish companies were American or German multinationals. In conclusion, GPs help a lot to the national economy.

- **Álvaro González Ruiz-Jarabo**: Investment Director at Qualitas Equity Partners in the Private Equity Fund of Funds. Previously, he worked at some M&A firms, such as Morgan Stanley or Banco Santander. Álvaro studied Law and Business Administration at ICADE, where he is currently a visiting professor. As a Fund of Funds investment professional, he underlined the following points:
  - **What are the most important factors to determine if a PE fund is good enough?**

    Even though selecting the best PE funds to invest can be quite difficult, here are five essential factors:

    1. *Investment strategy: sector, size of portfolio companies, value creation drivers, …*
    2. *Investment team: turnover of the team, amount of years working together, academic and professional background of the investment professionals (previous professional experience in investment banks or consulting companies, universities where they have studied, …).*
    3. *Track record: previous returns (MoC and IRR) and value creation drivers in the past*
    4. *Investment base: check if the investors are qualified and professional enough or just retail investors with great amounts of money.*
    5. *Terms and conditions: amount of fees.*
  - **Do you think there are ways with which a PE fund can perform well in times of economic slowdown or recession?**

    Absolutely, as PE investments have a long-term view and are not dependent from the volatile public prices. However, the best ways to surpass a bad financial moment could be: low leverage of portfolio companies, low entry prices thanks a proprietary deal flow, effective *monitoring and investing in companies that operate in non-cyclical or defensive sectors.*

- **What advantages does a PE fund offer as an investor compared to other asset classes?**

  Despite the fact that PE funds are very illiquid investment vehicles, they offer outstanding returns in comparison with other classes thanks to their long-term investments, independency from the stock markets and value creation levers (deleveraging, EBITDA growth and multiple arbitrage).

- **Lorenzo Guerra Bautista**: Associate at Creas Impact Investing. Lorenzo studied at CUNEF and has previous professional experience at KPMG and UBS. During his interview, Lorenzo accentuated some aspects regarding ESG principles of private equity and impact investing:
  - **How does an impact fund contribute to society?**

    An impact fund contributes to the society in two ways:
    - *The same way as a normal private equity fund (EBITDA growth, network of the fund, …)*
    - *Focus on solving social specific problems, such as: structural unemployment of young people, global environment, migration problems, poverty, …*
  - **How do you see the future of impact investing?**

    Lorenzo definitely thinks that the ESG and impact investing is following an incredible rising trend of AUM, which will make this type of investments very strong in the future. As current impact funds will be able to show longer track records in the upcoming years, fundraising will be easier for this type of financial sponsors.

    Additionally, these investments are much more financially resilient to non-impact ones. On the other hand, younger generations are much more prone to invest in GPs with important ESG principles, which will lead a solid increase of these funds.
  - **What advantages does a PE fund offer as an investor compared to other asset classes?**

    In the first place, he talked about the big disadvantage of the illiquidity that financial sponsors have. Nevertheless, they have better returns and especially less volatility in comparison with public equities.

7. CONCLUSIONS

After all the analyses and numbers shown in this paper, a proper list of conclusions is needed:

- **Private Equity is becoming more popular than ever and we should understand this industry to comprehend the current financial and business world.** While the net asset value of private companies has surprisingly increased during the last two decades, the equity value of listed companies has remained steady. In addition, investors have seen private equity funds as the perfect way to make their money profitable, increasing their exposure to this industry obviously.
- **Private Equity is the biggest market in the private investment space**: even though the rest of private funds (private debt, real estate, infrastructure and natural resources) have seen how their AUM have really increased, private equity funds much more.
- **Financial Sponsors are financially resilient to economic downturns**. As they can generate value thanks to three different mechanisms being activist investors in their portfolio companies, this allows them to have a better performance in comparison with public equity managers.
- **The PE industry helps a lot to the society**: although there many people criticizing the industry, it really contributes to the society in the best and worst moments: paying a lot of taxes to the authorities, increasing the M&A activity, making the business world more competitive, encouraging corporate meritocracy, supporting their portfolio companies, assisting the healthcare sector in the crisis of Covid-19, promoting ESG strategies, improving the national balance of payments, enlarging the liquidity in the private market and generating great returns to their LPs obviously.

8. BIBLIOGRAPHY

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