Palamon case study essay sample

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In February 2000, Louis Elson looked over the London skyline and reflected on the international private equity industry and the investment processes that would be necessary for success in this increasingly competitive field. Elson, a managing partner of the UK-based private equity firm Palamon Capital Partners, was specifically considering an investment in TeamSystem S. p. A., an Italian software company. Palamon was interested in TeamSystem for the growth opportunity that it represented in a fast-changing market. Palamon had an opportunity to purchase a 51% stake in TeamSystem for (euros) EUR25. 9 million. In preparing a recommendation to his colleagues at Palamon, Elson planned to assess TeamSystem's strategy, value the firm, identify important risks, evaluate proposed terms of the investment, and consider alternative exit strategies.

International Private Equity Industry

The international private equity industry was segmented into three sectors. Venture capital funds made high-risk early-stage investments in startup companies. Generalist private equity funds provided expansionary funding or transitional funding that allowed small companies to grow and eventually go public. And leveraged buyout funds financed the acquisitions (often by management) of preexisting companies that had the capacity to take on debt and make radical improvements in operations.

Private equity funds raised capital primarily from individual investors, pension funds, and endowments that were interested in more attractive risk/return investment propositions than the public capital markets offered. Funds existed all over the world, but, not surprisingly, North America had the

largest number of funds and largest dollar value of capital invested as of 1999.

This case was prepared by Chad Rynbrandt from interviews, under the direction of Robert F. Bruner, with the assistance of Sean D. Carr. Some details have been simplified for expositional clarity. The cooperation of Palamon Capital Partners is gratefully acknowledged, as is the financial support of the Batten Institute. Copyright 2001 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. To order copies, send an e-mail toNo part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation.

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Europe and Asia had the next largest private equity industries. Exhibit 1 presents the number and dollar values of private equity funds by global geographic region. Most private equity markets saw rapid growth in the 1990s. In Europe, the amount of new capital raised grew from EUR4. 4 billion in 1994 to EUR25. 4 billion in 1999. Correspondingly, the amount of capital invested by the funds more than quadrupled from EUR5. 5 billion to EUR25. 1 billion over the same period. Exhibit 2 summarizes the amount of new capital raised and the amount invested through the 1990s. Some key players in the

midmarket sector in Europe included Duke Street Capital (EUR650 million fund based in the United Kingdom), Mercapital (EUR600 million fund based in Spain), and Nordic Capital (EUR760 million fund based in Sweden). Large investment banks such as Dresdner, Deutsche Bank, and Banca de Roma also had notable private equity presences.

Louis Elson and Palamon Capital Partners

Louis Elson began working in private equity in 1990, when he joined E. M. Warburg, Pincus & Co. Soon after joining the firm, he began focusing on European transactions and, in 1992, decided to relocate permanently to Europe. Elson became a partner of Warburg, Pincus in 1995 and was an integral part of a team that built a (U. S. dollars) USD1. 3 billion portfolio of equity investments for the firm. The portfolio contained more than 40 investments in seven different European countries. In late 1998, Elson and another of his partners, Michael Hoffman, saw a unique window of opportunity in the European private equity industry. They believed that the European economic landscape was changing in a way that benefited smaller, middle-market companies. Therefore, Elson and Hoffman recruited two additional partners and began laying the foundation for what would eventually become Palamon Capital Partners. By August 1999, Elson and Hoffman had raised a fund of EUR440 million. They accomplished that despite macroeconomic obstacles like the Russian debt default by marketing their unique pan-European private equity experience.

With the fund closed, Elson and Hoffman grew the Palamon team to nine professionals. They hired people with experience in private equity, investment banking, corporate finance, and management consulting.

Consistent with Elson and Hoffman’s original vision, the Palamon team used their breadth of experience to build a portfolio of investments that would provide investors with a unique risk profile and substantial long-term returns. Essentially, Palamon was a generalist private equity fund that served the segment of investor that was interested in less risk than venture capital, but more risk than the leveraged buyout funds. Accordingly, Palamon targeted a 35% return on a single portfolio investment, and 20% to 25% blended net return on a portfolio, with an investment horizon of approximately six years. Louis Elson said:

Our investors include large American public sector pension funds, corporate pension funds, major financial institutions, and large endowment funds. They look for us to beat the return on the S&P Index by 500 basis points per year on average. We have the best chance of getting funded again if we can beat this target, adjusting of course for risk. We look to pick up good businesses at attractive prices, and then add value through active involvement with them. Like other generalist funds, Palamon’s investment strategy was to make “ bridge” investments in companies that wanted to move from small, private ownership to the public capital markets. Unlike many private equity funds, however, Palamon did not restrict itself to one specific European country, nor did it limit its scope to one industry. Instead, Palamon focused more

broadly on small-to-midsize European companies in which it could acquire a controlling stake for between EUR10 million and EUR50 million. For companies that fit Palamon’s profile, the transition from private to public ownership required both funding and management ability. Palamon,

therefore, complemented its financial investments with advisory services to increase the probability that the portfolio companies would successfully make it to the public markets. Elson was optimistic about Palamon's investment strategy. As Elson sat in his office, Palamon was finalizing its first investment, a Spanish Internet content company, Lanetro, S. A., and had three other investments (including TeamSystem) in the pipeline.

Investment Process

Palamon's investment process began with the development of an investment thesis that would typically involve a market undergoing significant change, which might be driven by deregulation, trade liberalization, new technology, demographic shifts, and so on. Within the chosen market, Palamon looked for attractive investment opportunities, using investment banks, industry resources, and personal contacts. The search process was time-consuming, with only 1% of the opportunities making it through to the next phase, due diligence, which involved thorough research into the history, performance, and competitive advantages of the investment candidate. Typically, only one company made it through that final screen to provide Palamon with a viable investment alternative.

Palamon brought its deal-making experience to bear in shaping the specific terms of investment. Carefully tailored agreements could increase the likelihood of a successful outcome, both by creating the right incentives for operating managers to achieve targets, and by timing the delivery of cash returns to investors in ways consistent with the operating strategy of the target. Deal negotiations covered many issues including price, executive

leadership, and board composition. Once a deal had been completed, Palamon then offered value-added support to management.

To close the process, Palamon searched for the best exit alternative, one that would help them fully realize a return on the fund's investment. Classic exit alternatives included sale of the firm through an initial public offering in a stock market, and sale of the firm to a strategic buyer. Exhibit 3 provides more detail about Palamon's process and the firm's investment screening criteria.

TeamSystem, S. p. A.

Palamon's theme-based search generated the opportunity to invest in TeamSystem, S. p. A. In early 1999, even before Palamon's fund had been closed, Elson had concluded that the payroll servicing industry in Italy could provide a good investment opportunity because of the industry's extreme fragmentation and constantly changing regulations. History had shown that governments in Italy adjusted their policies as often as four times a year. For Palamon, the space represented a ripe opportunity to invest in a company that would capitalize on the need of small companies to respond to this legislative volatility. With the help of a boutique investment bank and industry contacts, Palamon approached two leading players in the market. Neither company was suitable to Palamon, but both identified their most respected competitor as TeamSystem. Palamon approached TeamSystem directly and found a good fit. Due diligence was done and, by the end of the year, a specific investment proposal had taken shape. It was the one Elson now considered.

TeamSystem was founded in 1979 in Pesaro, Italy. Since its founding, the company had grown to become one of Italy's leading providers of accounting, tax, and payroll management software for small-to-medium-size enterprises (SMEs). Led by cofounder and CEO Giovanni Ranocchi, TeamSystem had built up a customer base of 28, 000 firms, representing a 14% share of the Italian market.

TeamSystem offered its customers a compelling value proposition. The company's software integrated a business's financial information and automated tedious and complex administrative functions. The software also enabled SMEs and their financial advisors to stay on top of the frequently changing regulatory environment. To that end, TeamSystem continually invested in development to keep its software current. Customers were given access to product upgrades in exchange for a yearly maintenance fee that the company collected (in addition to the initial purchase price of the software). TeamSystem had excelled in customer service and developed loyal customers. Nearly 95% of its customers renewed their maintenance contracts every year.

In 1999, TeamSystem generated sales of (Italian lira) ITL60. 5 billion (EUR31. 3 million) and EBIT (earnings before interest and taxes) of ITL18. 5 billion (EUR9. 5 million). Those results continued a strong pattern of growth for TeamSystem. Since 1996, sales had grown at an annualized rate of 15% and operating margins improved. As a result, EBIT had grown at an annualized rate of 31. 6% over the same period. Exhibit 4 provides additional detail on TeamSystem's historical sales and profitability from 1996 through 1999. Exhibit 5 contains balance sheet information for the same period.

As Elson looked through the numbers, he noted the current lack of debt on TeamSystem's balance sheet. In his opinion, that represented an opportunity to bring TeamSystem to a more effective capital structure that might lower the company's cost of capital. Elson also noted the " pro forma" label on both financial statements. TeamSystem, given its private ownership and multicompany structure, did not have audited consolidated financial information for the previous five years.

Industry Profile

The Italian accounting, tax, and payroll management software industry in which TeamSystem operated was highly fragmented. More than 30 software providers vied for the business of 200, 000 SMEs with the largest having a 15% share of the market (TeamSystem ranked number two with its 14% share.) All of the significant players in the industry were family-owned companies that did not have access to international capital markets. Exhibit 6 shows 1998 revenues for the nine largest players.

Analysts predicted that two things would characterize the future of the industry— consolidation and growth. Consolidation would occur because few of the smaller companies would be able to keep up with the research and development demands of a changing industry. Analysts pointed to three acquisitions in 1998–99 as the start of that trend. As for growth, experts predicted 9% annual growth over the period 1999–2002. That growth would come primarily from increased PC penetration among SMEs, greater end-user sophistication, and continued computerization of administrative functions.

The Transaction

After reviewing TeamSystem's past performance and the state of the industry, Elson returned his attention to the specifics of the TeamSystem investment. The most recent proposal had offered EUR25. 9 million for 51% of the common (or ordinary) shares in a multipart structure that also included a recapitalization to put debt on the balance sheet:

Palamon would invest ITL50. 235 billion (EUR25. 9 million) in the ordinary shares (i. e., common equity) of TeamSystem S. p. A. Those shares would be purchased from existing shareholders of TeamSystem. Giovanni Rannochi would maintain a 20% shareholding, while noncore employees would be diluted from holdings ranging from 3% to 8% to just 1% each after completion.

More than half of TeamSystem's ITL28. 5 billion of cash was to be distributed to existing shareholders via two dividend payments before Palamon's investment: an ITL8. 5 billion dividend to existing TeamSystem shareholders in April 2000, and an ITL6. 5 billion dividend to be paid at time of closing. A cash balance of ITL13. 5 billion would remain.

With Palamon's assistance, TeamSystem would borrow ITL46 billion from Deutsche Bank, in a seven-year loan, offering a three-year principal repayment holiday and an initial cost of 1. 0% over base rates (Italian government bonds). Shareholders would receive the proceeds of the debt at time of closing in another special dividend.

Excess real estate would be sold by TeamSystem, thus removing the distraction of unrelated property investments. A group of existing

shareholders had made an offer to purchase ITL2. 1 billion of real estate at book value if the transaction closed.

The sources and uses of funds in the transaction are summarized in Exhibit 7. An income statement and balance sheet for TeamSystem, pro forma the transaction, are given in Exhibits 8 and 9. Palamon, as a majority shareholder, would have full effective control of TeamSystem, although the existing shareholders would have a number of minority protection rights. For example, Palamon would be unable to dismiss Ranocchi for a two-year period. But Palamon would have the ability to deliver 100% of the shares of the company to a trade buyer should that be the appropriate exit. Furthermore, more than 40% of the cash to be paid to the departing shareholders would be held in escrow for a period of at least two years, under Palamon's control.

Valuation

To properly evaluate the deal, Elson had to develop a view about the value of TeamSystem. He faced some challenges in that task, however. First, TeamSystem had no strategic plan or future forecast of profitability. Elson only had four years of historical information. If Elson were to do a proper valuation, he would need to estimate the future cash flows that TeamSystem would generate given market trends and the value that Palamon could add. His best guess was that TeamSystem could grow revenues at 15% per year for the next few years, a pace above the expected market growth rate of 9%, followed by a 6% growth rate in perpetuity. 1 He also thought that Palamon's professionals could help Ranocchi improve operating margins slightly. Lastly,

Elson believed that a 14% discount rate would appropriately capture the risk of the cash flows.

That rate reflected three software companies' trading on the Milan stock exchange, whose betas averaged 1. 44 and unlevered betas averaged 1. 00. The second challenge Elson faced was the lack of comparable valuations in the Italian market. Because most competitors were family-owned, there was very little market transparency. The nearest matches he could find were other European and U. S. enterprise resource planning (ERP)2 companies and accounting software companies. The financial profiles of those comparable firms are contained in Exhibits 10 and 11. Looking through the data, Elson noticed the high growth expectations (greater than 20%) for the software firms and correspondingly high valuation multiples.