Private Equity and Venture Capital. Market Evolution and Operational Profiles: The Role of Financial Intermediariess

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Abstract

Purpose: *This paper investigates risk capital investment activities, in particular Private Equity and Venture Capital in the Italian financial system in comparison with the Albanian reality. It looks like a topic that apparently seems complex, but it is a simple mechanism that has spread, especially in recent years,*

Methodology: *The paper is a descriptive study of the literature of private equity and venture capital. Qualitative methods are used in the development of the paper, browsing mainly foreign literature, by reviewing different scientific papers. Firstly, the authors address the topic of Private Equity and its importance in the market, the improvement and the development of this concept, the relevant investor categories* *and the main types. After this description, the author will analyze the investment process of Private Equity, comparing the Italian market which is very developed and the Albanian market which has only introduced various initiatives at an institutional level concerning banks and businesses.*

Findings: *Comparing to Italian financial system the authors conclude that in the Albanian financial system these investments are still very rare, in fact only a few banks and ALSE carry them out. This is mainly due to the distrust that exists between people but also to the lack of familiarity with using these tools.*

Value: *This study can serve as a starting point for more in-depth studies in this field. The study also, contributes to a better understanding of this type of investments which in Albania are very rare but we think it is time to use them as an alternative to traditional forms of investment.*

Keywords: *Private Equity, Venture capital, Sustainable finance, financial market.*

Introduction

Risk capital can be defined as the portion of a company's capital contributed as equity by the entrepreneur (or by the partners in the case of a company). Since it is representative of participation in the entrepreneurial project it is also fully subject to business risk. According to Forestieri, M (2009) it can be distinguished from debt capital since the latter refers to the portion of a company's capital made up of credits granted by third parties. Risk capital does not have a minimum remuneration associated with it. According to Liuc Papers the remuneration of risk capital (for example shares) depends on the operating result achieved, while bonds give the right to reimbursement of capital and the payment of interest regardless of the operating result of the company. Furthermore, in the event of significant losses of the company with the consequent start of the liquidation procedure, first are reimbursed the creditors (for example the bondholders) and then, with the residual means, the holders of the risk capital are reimbursed (for example the shareholders). For this reason, it is stated that risk capital holders have residual rights, as their satisfaction with the company's value occurs only after the satisfaction of other capital holders. An increasing role for risk capital is essential for the prospect of consolidation of the financial structure of companies. The breadth of the unlisted venture capital circuit is made up of venture capital and private equity. By venture capital we mean the investment in the risk capital of newly established companies, while the term private equity defines the case of already existing companies when the financing is used for the strengthening of the company, the reorganization of the ownership structure or the acquisition of new businesses.

Literature review

Within this phase the following moments can be identified:

- deal flow: research and screening of investment opportunities by the operator, thanks to the support of the business plan.
- due diligence: in-depth evaluation of the company.
- closing: signing of the investment contract and shareholder agreements.
- monitoring of investment.

The deal flow

The first phase is called deal flow, according to *Strategy Punk* (2021), also known as deal origination, consists in the process of identifying investment opportunities. It's about choosing the most suitable target, so it is essential to have a consistent number of possible options, and then select the company that truly proves to be the most suitable, based on subsequent analyses. By carrying out an initial search for companies it is possible to find investment targets.

The research process, selection and identification of potential investment opportunities represents a vitally important step in the development of your business. In fact, it represents the first fundamental prerequisite of the activity itself, as, in the absence of concrete investment opportunities, it cannot be carried out.

The generation of a constant deal flow therefore constitutes an activity in which the private equity operator must regularly invest a significant amount of time and resources.

The identification of profitable investment opportunities is a very challenging and difficult objective to achieve, also because the selection process in the private equity market is typically very severe.

Investors must analyze the market, in search of companies that match the selection criteria and are willing to open their shareholding to institutional investors. Companies willing to let an institutional investor join the company decides based on the characteristics of the new possible shareholder.

In this regard, a very important factor is given by the subjective qualities of the operator-financier such as the image, notoriety and consideration he enjoys in the reference market, as well as the experience gained.

These subjective characteristics derive from the track record attributable to the operator, i.e. from the quantity, quality and type of operations carried out in the past.

The track record constitutes the fundamental element on which the investor builds his credibility in the market. In fact, a private equity operator is unlikely to be considered capable and reliable by the market in the absence of an important wealth of positive experience.

However, other factors such as the size of the intermediary or the number of shares desired by it are less important in the choice.

A good track record, however, is a necessary but not sufficient condition to generate a significant deal flow: in fact, the ability to effectively communicate and explain one's experiences and successes to the market through an adequate marketing process is extremely important.

In the research conducted by *Querci, F. (2009)* an important aspect to maximize origination capacity is the nature of the geographic market in which you intend to operate. If you intend to operate internationally, the characteristics of the management team must be perceived and recognized even outside the home.

The Business Plan is drawn up by the target company.

The Business Plan is in fact a document aimed at representing the entrepreneurial development project from a prospective perspective, with the aim of evaluating its feasibility, in relation both to the corporate structure in which this project is inserted and to the context in which the proposing company operates., and to analyze the possible repercussions on the main company choices and on its economic-financial results.

The Business Plan (or industrial plan) is the document that illustrates the strategic objectives of the entrepreneur and management, the action plans aimed at achieving these objectives and the evolution of the prospective economic and financial results. The industrial plan must also include hypotheses regarding three possible scenarios: an optimistic scenario, an average scenario and a pessimistic scenario.

It represents the first tool for contact with the institutional investor, through which the entrepreneur brings the project to the attention of the investor. For this reason, its drafting requires particular attention.

The due diligence

The second phase means an activity of acquiring the information necessary for the preparation of the documentation required by operational practice and by legislation regarding a financial instrument issuance operation.

Due diligence is a process that characterizes one of the most delicate phases of a capital market access operation (issuance); the term itself underlines the care and confidentiality with which it must be carried out.

Cheffins, B & Armour, J. (2007) illustrates further that the objective of due diligence is to bring together two opposing interests: that of the company, which, in order to acquire new resources, must make the subscription of its securities interesting, and that of institutional and retail investors, who need to evaluate the profile risk-return, but they do not have all the information.

Conducting due diligence is different in a share placement transaction than in a bond placement transaction.

In the first case it is aimed at highlighting the increase in value that can be achieved with the capital raised, and the potential critical issues, while from the bondholder's point of view it tends to underline the stability of the cash flows produced by the issuer and the low volatility of its characteristic activity.

Due diligence is carried out by the lead manager, with the collaboration of the issuer, lawyers, auditors and advisors and requires careful investigations aimed at guaranteeing the market that all relevant information regarding the company is true and complete.

As articulated by *Michelini, C.* (2021) exists a various type of due diligence can be distinguished and in particular:

- Due Diligence Management consists of a series of meetings with the company's management staff to find out the main operational and financial aspects of the business as well as future plan.
- Legal Due Diligence, carried out by the investment bank's lawyers with the coordination of the issuer's lawyers, in which everything of legal relevance is examined.
- Financial Due Diligence, aimed at analyzing, with the issuer's audit firm, the quality and sustainability of the financial data, as well as the adequacy of their representation in the offering documents.
- Fiscal Due Diligence verifies tax liabilities and makes suggestions for the tax structure of the operation.
- Environmental Due Diligence identifies potential liabilities in the environmental area, analyzes compliance with the legislation in force and the internal procedures required by law.

From a procedural point of view with reference to due diligence, two fundamental moments can be distinguished: the drafting of the due diligence check list and the data room procedure.

Due diligence is in all respects a real risk management tool, which generates its positive effects over time. It should be noted that superficial due diligence can lead to ignoring potential risks arising from the deal and the failure of the operation.

Bentivogli, C et al. (2006), in the private equity sector, conclude that due diligence takes even more importance due to the physiological lack of in-depth information publicly available on the target company. For these reasons, although costly in terms of time, in-depth due diligence brings out any critical issues and their sources in detail, ensuring greater flexibility in correcting such problems. In-depth due diligence allows the parties to arrive at the negotiating table with a comprehensive information framework and to be able to carry out a negotiation in a professional manner based on objective and independently verified data and information.

In the research conducted by *Campanella G. & Ricciotti W.* (2019) if the final due diligence report highlights unexpected issues, hidden liabilities, or excessive risks, it could lead to substantial revisions to the company's price or, in extreme cases, the termination of negotiations.

To avoid the onset of disputes after signing the contract, it is advisable to carry out due diligence in advance, even if it is often not possible to have complete access and full disclosure of sensitive data in the per-contractual phase.

The internal rate of return equals the present value of expected cash outflows to the present value of expected cash inflows. It is therefore that rate that makes the net present value (or Net Present Value, NPV) equal to 0.

The calculation of the internal rate of return is used to evaluate the convenience or otherwise of an investment: the internal rate of return is compared with a threshold rate of return, called the acceptance rate or cut-off rate. It is worth making the investment if the internal rate of return is greater than the acceptance rate.

The IRR calculation involves the use of an iterative procedure.

The closing

Closing refers to the final phase of the investment process.

A key phase of the investment process in private equity operations is represented by the evaluation of the target company. The attribution of a specific value to it represents the starting point of the subsequent negotiation between buyer and seller, which ultimately results in the price at which the deal closes.

Once the most suitable company has been selected according to the parameters that have been set out, the next step is the definition of the purchase price: the sale value of the company, as expressed by the actual price, is generally different from the relative value of economic capital due to the negotiation and bargaining power of the parties.

There is, in fact, a notable difference between the value of the economic capital and the transfer value (expressed by the price): the value of the economic capital represents the theoretical value estimated based on the current conditions of the company and the development forecasts relating to the strategy currently pursued ; on the contrary, the transfer value is a certain data since it expresses the actual transaction price as a result of the negotiation.

According to A.Gervasoni and *F.L.Sattin* (2022)The value of the economic capital, although different from the transfer value, represents the basis for determining the latter.

As regards the definition of the transfer value, it also depends on the trading conditions. Therefore, after having estimated the value of the economic capital, the transfer price is defined through negotiation between the parties based on the relative contractual strength and specific interests.

The final selling price is established at the end of the buying and selling process.

It is possible to state that in most cases the final sales price can be placed between the value of the economic capital of the company and the value given by the sum between the value of the economic capital of the company and the value of the benefits for the buyer.

The positioning of the selling price within the range depends on the bargaining power of the seller and the buyer.

The greater the contractual strength of one of the two counterparts, the more the final sales price will be in favor of the latter.

Having said this, it is also important to underline that an intrinsically objective evaluation does not exist, just as there is no single and unambiguous value; a certain degree of subjectivity is in fact physiological in the evaluation, as the various methods proposed by the theory presuppose a series of hypotheses, assumptions, estimates and conjectures, which have at least partly a subjective content.

During the closing phase, the introduction of price-related instruments is negotiated and the shareholder agreements to be introduced in the statute are drawn up. This is a delicate phase that affects the success of the negotiation, the relationships between the entrepreneur partner and the institutional investor and above all the future of the target company.

If a minority shareholding is acquired there are pre-emption agreements, but if the acquired shareholding is a majority shareholding there are:

- governance agreements.
- disinvestment agreements.

Monitoring of the investment

This phase is extremely important since the private equity investor must monitor the investment in order to enhance the value of the stake held.

The level and methods of monitoring private equity investors are different based on the orientation of the investor himself: some investors are limited involved in the management of the invested company, while others present a gradually increasing degree of involvement. Based on these differences, the focus of the contribution shifts from the financial aspect to the more managerial one, through participation in the formulation and evaluation of strategies.

This distinction is also reflected with reference to the type of operation: depending on the life cycle phase that the invested company is going through, a different type of intervention will be necessary.

The advantages of investing in PE

- Investments in Private Equity (PE) have on average outperformed the stock market indices.
- Absolute return: managers aim for absolute return and their form of incentive, over performance, carried interest, is aimed at maximizing the return for investors.
- Portfolio diversification: PE returns and stock index returns have a low correlation.

The disadvantages of investing in PE

- Liquidity risk: the investor does not have the possibility of disinvesting his share before maturity
- High commitment: the minimum investment required can make the investment opportunity unattractive for most private investors.
- Very wide dispersion of returns: in certainty in choosing the fund in which to invest.

Divestment

Divestment consists of the total or partial transfer of the stake held by the investor, who, in some cases, may also decide to retain a minimum share of capital in the company on a more permanent basis.

More and more often, however, investors try to predict, at the time of purchasing the shareholding, any exit channels and realization times, in order to better plan this final phase of the operation as well.

In successful cases, disinvestment is made when the company has reached the expected level of development and the value of the company, and therefore of the shareholding, has consequently increased.

According to *Giorgio DI GIORGIO, Massimo DI EDOARDO*(2008) in the event that the initiative fails, because, for example, the new product or new technology fails to establish itself on the market, disinvestment is made when the conviction matures that it is no longer possible to resolve the crisis situation that has been created.

In both situations, the times and methods of disinvestment are usually defined with the agreement of all shareholders.

There are different methods of disinvestment, depending both on the type of business and operation previously implemented, and on the results achieved.

Methodology

This study is descriptive qualitative research based on secondary sources. Making a comparison between the Albanian financial system and the Italian one whose data were taken from the Italian Association of Private Equity, Venture Capital and Private Debt in recent years there is a tendency for this sector to develop more and more unlike Albania who have not experienced any typical operation of private equity funds, at least in the form known and applied in the United States, or anywhere in the world.

Indeed, there are substantial institutional elements that have been missing and are currently missing and the lack of an established and functioning stock exchange in Albania can be perceived as an obstacle to the creation and operation of such initiatives, within the financial market.

Normally, the presence of PE/VC requires a functioning capital market or stock exchange, as should be the destination of companies financed and supported by PE/VC, and at the same time, the market is the best evaluator of their performance.

Research questions:

1. How has the Albanian financial system evolved over the years and why invest in risk capital?
2. What are the instruments used to invest?

Venture Capital, and Albanian financial system

The "early stage financing" phase refers to:

- the period prior to the creation of the company in which the capital is used to finance an idea or project yet to be tested ("seed financing" or "incubator");
- at the subsequent moment of its birth in which, having already developed the product as a prototype and tested with appropriate market research, its production activity begins in line with the forecasts of a business plan ("start-up financing") ;
- at the very first stage of development in which the commercial validity of the product/service is fully assessed ("first stage financing").

In the innovation process characterizing this stage, the investor's financial, managerial and above all technical-scientific skills contribution is fundamental, contributing significantly to the creation of new products/processes or the improvement of existing ones, sharing the high business risk.

To illustrate further, Dell'Acqua A and Previtero A(2006) , the "expansion financing phase" (also called "growth stage financing" or "development capital"), has as its objective is to promote the development of the company:

- internally, increasing or diversifying its production capacity;
- externally, by acquiring other companies or business branches;
- through vertical or horizontal integration with other companies, characterized by the potential inter-dependencies that can be achieved in terms of products or markets ("cluster ventures").

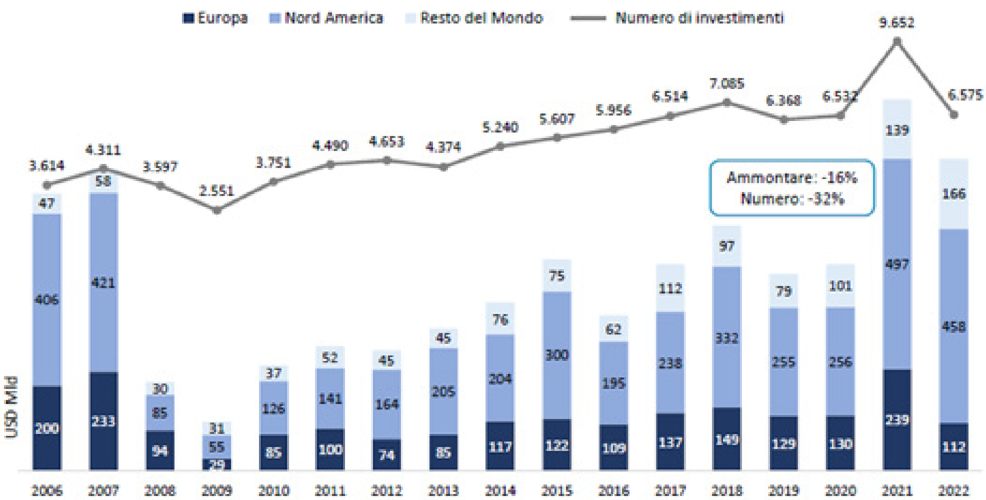
The prerequisite for such interventions according to Giordano L, Modena M(2017) is the validity of the entrepreneur and the sustainability of the company's development plan, which, as a rule, is agreed upon entry. A further requirement for such interventions is represented by the rapid growth prospects of the company or business in question and the presence of an entrepreneur with valid development projects and/or patents that need to be marketed.

The benefits for companies of a venture capital intervention are summarized in the economic effects it produces.

The peculiar characteristics of Venture Capital activity, understood in its narrowest sense (referring only to the start-up and initial development phases), are:

- participation in the equity of a company that has a high development potential thanks to the creation of new goods, services or production processes;
- the achievement of a high capital gain that allows the high risk that the investor has taken on to be remunerated;
- the temporary nature of the investment, even if with a medium-long term perspective;
- the contribution by the investor not only of financial capital, but also of managerial know-how and technical-scientific knowledge that favor the achievement of growth objectives. Furthermore, the company that is financed by an institutional investor can take advantage of a vast network of contacts and collaborations to which it would not normally have had access, as well as gaining credibility in front of all its stakeholders and any possible interlocutor.

FIGURE 2. Evolution of the amount invested (international)



Source : AIFI

As we can see, this latest graph illustrates the situation of international investments in the period between 2006 and 2022 even if in the last year they have decreased in Europe and North America even if they have increased in the rest of the world.

By making a comparison between the Italian and Albanian financial systems it is possible to glimpse that the Italian one is much more developed and articulated and that many investments have been made which have produced a lot of profits even if it is a young phenomenon but one which is reaching great importance. However, in the Albanian financial system these investments are still very rare, in fact only a few banks and some companies such as the ALSE sh.a stock exchange carry them out, this is mainly due to the distrust that exists between people but also to the lack of familiarity in using of these tools.

Albania and its respective financial system have not experienced any typical operation of private equity funds, at least in the form known and applied in the United States, or anywhere in the world.

Indeed, there is a lack of substantial institutional elements that have been and are currently missing and the lack of a consolidated and functioning stock exchange in Albania can be perceived as an obstacle to the creation and functioning of such initiatives, within the financial market.

Normally, the presence of PE/VC requires a functioning capital market or stock exchange, as should be the destination of companies financed and supported by PE/VC, and at the same time, the market is the best evaluator of PE performance /VC.

However, several initiatives have been introduced at an institutional level in the Albanian financial market.

Many studies such as Elvin Meka (2021), show that the Albanian Reconstruction Equity Fund (AREF) was established by the EBRD and the Italian government, with a total capital of $14 million to support the restructuring and expansion of private businesses (OECD 2003).

Additionally, the Albanian American Enterprise Fund (AAEF), funded by the US government through a USAID grant, provides financing to medium and large-sized businesses ($30 million).

Although incorporated as a non-profit organization, the AAEF is managed as a private investment fund to maximize risk-adjusted returns.

During its activity in Albania, the AAEF has invested in a wide range of private businesses.

Additionally, AAEF provides its portfolio investments with training to establish best business practices that incorporate acceptable financial data reporting standards, as well as guidelines for improving management capabilities, recruitment of qualified personnel and strategic planning.

However, the most successful PE initiatives in Albania were those related to the purchase of BKT (known as the National Bank of Commerce), the establishment of the American Bank of Albania (now part of Intesa Sanpaolo Bank – Albania and the American Investment Bank.

Elvis Bregu (2019) it shows that in 2017 the ALSE sh.a Securities Exchange becomes the first Albanian private equity company authorized in our country.

Sustainable And Responsible Investment

By "sustainable and responsible investment" we mean "an investment strategy oriented to the medium-long term which, in the evaluation of companies and institutions, integrates financial analysis with environmental, social and good governance analysis, in order to create value for the investor and for society as a whole.

Sustainable and Responsible Investment strategies

Below we report the six strategies present in the Italian market:

Exclusions

Approach that provides for the explicit exclusion of individual issuers or sectors or countries from the investable universe, based on certain principles and values. Among the most used criteria: weapons, pornography, tobacco, tests on animals.

International conventions

Selection of investments based on compliance with international norms and standards. The most used standards are those defined by the OECD, UN or by

UN agencies (including ILO, UNEP, UNICEF, UNHCR). Examples include: the Global Compact, the OECD Guidelines on multinationals, the International Labor Organization Conventions.

Best in class

Approach that selects or weights the issuers in the portfolio according to environmental, social and governance criteria, favoring the best issuers within a universe, a category or an asset class.

Thematic investments

Approach that selects the issuers in the portfolio according to environmental, social and governance criteria, focusing on one or more themes. Some examples: climate change, energy efficiency, health.

Engagement

Activity that takes the form of dialogue with the company on sustainability issues and the exercise of voting rights connected to participation in the share capital. This is a long-term process, aimed at positively influencing the company's behavior and increasing the degree of transparency.

Impact investing

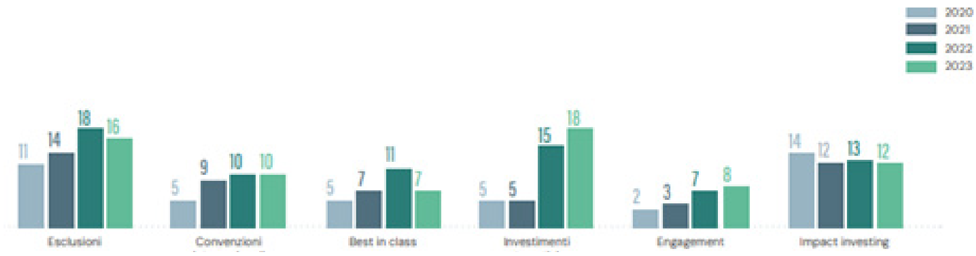
Investments in businesses, organizations or funds with the intention of achieving a positive environmental and/or social impact, together with a financial return. It can be implemented in both emerging and developed countries.

Some examples: investments in microfinance, social housing, renewable energy

When accounting for the SRI strategies adopted, it must first be reiterated that the inclusion of ESG criteria can occur according to multiple strategies: they are not self-excluding and can be applied to the same investment portfolio in the different asset classes. Furthermore, it is noted that, among the 29 Foundations active in the SRI (Socially Responsible Investment) field, one entity is not able to provide detailed information regarding the strategies adopted for the different asset classes and another, despite including ESG criteria in its investments, has not yet defined specific sustainability strategies. Therefore, the two respondents were not included in the analysis relating to this section of the questionnaire.

Thematic investments are the most used strategy by Foundations (cited by 18 institutions), especially in alternative asset classes; Next, the strategy from the exclusions is indicated.

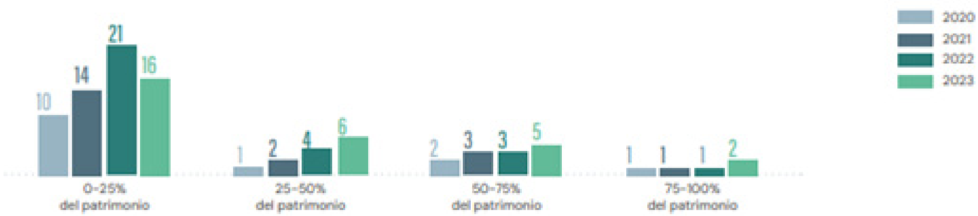
FIGURE 3. SRI strategies adopted



Source:Forum for Sustainable Finance

The majority of Foundations active in the SRI field (55% - 16 out of 29) limit sustainable investments to a minority share of assets under management; however, the figure is decreasing compared at the 2022 edition, in which they stood at 72% (21 out of 29). Conversely, the number of Foundations that adopt SRI strategies on a portion of assets exceeding 25% is increasing. In particular, 6 institutions extend sustainable investments to a share between 25% and 50%, another 5 Foundations hold sustainable investments at 50%-75% of the assets and 2 institutions extend the SRI quota to almost the entire portfolio, with a coverage rate between 75% and 100%

FIGURE 4. Coverage rate of sustainable investments



Source:Forum for Sustainable Finance

Conclusion

In conclusion, investment activities in risk capital, therefore Private Equity and Venture Capital funds, will not be limited to a simple financial contribution but their commitment will go further by acting as a real support to the entrepreneur.

But there are also disadvantages, 1) liquidity risk: the investor does not have the possibility of disinvesting his share before the maturity, 2) the high commitment: the minimum investment required can making the investment opportunity unattractive for most private investors and 3) the dispersion of returns very wide: uncertainty in choosing the fund in which to invest.

By making a comparison between the Italian and Albanian financial systems it is possible to glimpse that the Italian one is much more developed and articulated and that many investments have been made which have produced a lot of profits even if it is a young phenomenon but one which is reaching great importance.

The absolute certainty remains of the decisive influence of these funds in the companies in which they decide to invest and of the multiple possibilities they give these to survive, grow and expand in an economic context like today's.

Usually when we talk about risk we think of something negative and that no one wants to take on but as we have seen there are various advantages that can be obtained from these investments: an absolute return, in fact managers aim for absolute return and their form of incentive, to out performance, carried interest is aimed at maximizing the return for investors, there is a diversification of the portfolio: the returns of Private Equity and the returns of stock indices have a low correlation, it can facilitate the growth of SMEs, favoring the access to financial markets or accompany generational change and contribute to the strengthening of the managerial structure.

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