IPO: AN EXIT ROUTE FOR A SUCCESSFUL INVESTMENT

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Private equity (PE) has a clock on its money, which is to say, it has to turn the capital. Time is the enemy of returns. Most PE investors work on a cycle of between three and seven years between acquisition and sale and aim to achieve a return of at least two or three times their original investment.

PE investors have several options when exiting from their investments: they may sell their stakes to other companies ("trade sale") or to another PE firm or financial institution, float the company on the stock market or write it off if the investment has been unsuccessful.

The statistics show that trade sales have always been the most important exit route for PE divestments and this continues to be the case in the UK, Europe's largest and most mature market for PE investors, and also in Spain.

The sharp rise in secondary buyouts, where a PE house acquires a business from another PE house, continued to be another key trend of European private equity in 2006. If a company has already been in the control of a private equity house for a number of years one would expect that its potential has already been reached, and that the job of the secondary private equity owner therefore becomes one of development and building rather than turnaround, a riskier and less profitable operation.

However, secondary buyouts are seen by many PE houses as a safer and more attractive investment. They can acquire an asset that has already operated within the private equity model by a PE investor who is merely at the end of its investment cycle.

A third emerging alternative in Spain seems to be that the target company goes public through an initial public offering (IPO). Often regarded as the most elegant form of exit, it is however a rather costly alternative and usually only allows for a partial exit in the short run. Additionally, an IPO tends to be suitable only for certain companies, with a straightforward business model and equity story, and operating in a relatively stable state.

Whereas IPOs have long been the preferred method of exit for American venture capital investors, public offerings account for only a small percentage of European venture capital divestments, particularly following the collapse of the Neuer Markt at the end of 2001 (almost as fast as it took off). Outside the UK, the European IPO market seems to remain in the post-dotcom doldrums.

However, the alternatives for divestments may be increasing, at least in Spain. Whilst no IPO was recorded in 2003, only three in 2004 and one in 2005, 2006 saw 10 IPOs (GAM, Hemoderivados Grifols, Renta Corporación, ...) and this exit route may attract more PE firms seeking divestment in 2007.

The proportion of total exit value realised through these differing routes however may vary considerably. If a trend is for the most successful portfolio companies to IPO, then their relative share may be higher.

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In terms of maximizing returns, the general rule is that the earlier the exit, the higher the return for the fund. Subsequently, PE houses need to handle the process in a proactive manner as the following factors can delay an IPO:

- unrealistic timetable
- complexity of preparation of financial track record
- issues discovered during due diligence take time to be resolved
- finalising an effective capital structure
- revisions to business and strategic plans
- changing market conditions
- market congestion
- regulatory reasons

Except for changing market conditions, which are beyond the company's control, most delays to an IPO can be eliminated or reduced with proper planning and preparation.

It is therefore important that, regardless of the exit route finally selected and market trends, the planning of the exit must begin at the earliest stage of the investment, since each target company requires a specific exit strategy customized to its own business characteristics and market conditions.

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