

PRIVATE EQUITY – CHALLENGE OR A CHANCE?

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The purpose of this study is to present the advantages and the opportunities of the private equity funds impact on the Romanian economy, and also identifies the economic disadvantages that can derive from applied strategies. For this reason we can consider private equity as a challenge and a chance at the same time, because beginning with choosing the investment domain, sector, company and the investment strategies the private equity funds can drive to performance for the investee companies, and implicit can have an important impact on the business environment and not in the least to the entire economy.

Keywords: private equity, involvement, economic and social implications, investment cycle, divestment;

JEL classification: G24, G34, E44

1. Introduction

Given that financing of a company in need of capital can't be realised by own sources, bank loans or on behalf of "the 3 F's" (Family, Friends or Fools), new forms of financing have been created such as account funding through venture capital funds and/or private equity.

In the current economic context, the private equity industry has become a solution of solving the lack of liquidity for various companies because this industry plays an active role on the entire market that can have an major impact on rehabilitating the states economies which have been affected by the financial crisis.

This industry is considered an alternative source of financing for companies that are target for investment funds and also represents a good way of investing on long term, during all stages of the business – from start-up strategies to expansion or replacement strategies. Beside this, private equity financing has become more attractive because these funds have and may provide financial resources for companies in need of large amount of money. This funds have the necessary amounts on behalf of the advantageous strategies applied on the exit, that have provided substantial benefits for up to several times the amount originally invested.

This situation has been considered as an alternative in the context that banks (the most used financing sources till nowadays) have increased the costs of borrowed capital and have roughen the borrowing conditions as a derived response to the actual lack of liquidity on the economy.

2. Private equity advantages

In the actual economic context, the industry of private equity is considered to play an active role in the rehabilitation of the economies affected by the financial crisis, by providing important sources of liquidity in the economy that cannot be obtained through in debt. Private equity is to be a long term investment during all stages of business - starting with initiative strategies up to corporate restructuring strategies.

Through time, has been set that the private equity backed companies have obtained several benefits, such as:

- Retrieving cash from selling a stake of the company to an investment fund, cash in need to accelerate the development of the company. Thus, in addition to bank loans, another option is to attract financing for companies in the ownership of a private equity fund.

- Once a company has been absorbed by the fund and becomes a portfolio company, investment funds bring along professionalization, new practices, new people and market experience.

Considering the recent evolution of the private equity industry, this financing form has created a particularly environment around it. It has been said that because of this, economy has been entered into „private equity era” (Stoica V, Corbu I, 2006), situation that has several advantages, such as:

- Industrial structure is renewed rapidly due to technological progress which shortens the life cycle of products and consequently the life cycle of investments;
- Medium and long term loans can not meet new industry requirements which give rise to very high financial risks;
- Frameworks and company employees want to be more empowered and to participate actively in increasing the capital firm.

3. Private equity actions – Case of Sicomed - Zentiva

In representing the efficiency of the involvement of investment funds in the companies targeted, this article will continue with the Sicomed Bucharest company case study and the observation of the financial indicators in relation to the evolution of the employees.

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Turnover	6155164 5	7936937 0	10104600 0	12745544 1	14580000 0	17534766 4	19231316 4	24209661 8	19399664 0	21850584 8
Net Profit	8776403	1859978 0	13264000	13063000	18100000	19486464	15997222	23074860	4258101	23184647
No of employees	na	na	na	2000	1670	1140	918	1012	821	738
<i>Period before SCD taking over from the private equity</i>	<i>SCD private equity take-over period</i>		<i>The period of the Fund involvement and the restructuring of the merged company</i>				<i>Fund Exit and the taken from SCD - Zentiva</i>	<i>The company's reorganization under the Sicomed – Zentiva's merger</i>		

Source: www.zentiva.com, www.mfinante.ro

Considering the involvement of fund investment in the company we can say that: both entities can benefit from - the fund as a result of leaving it at a momentum can multiply their initial investment several times and the company which benefits from the investment fund, receives a major influx of cash on account of the amounts invested, amounts that can ensure the recovery and / or development of the business.

Actually, if we refer to the situation after the fund had exit from Sicomed, followed by the takeover by Zentiva, Czech Republic, another company in the same line of business, Sicomed has received:

- Restructuring – starting with the restructuring and the redevelopment of the technological infrastructure and the working environment up to the management and staff restructuring;
- Replacement of the production lines with some new ones, modern and which fulfill the latest requirements as far as manufacturing conditions are concerned, which are associated with specific production of medicines;

- Development of new production lines, due to changes in the portfolio of products that are designed to be completed by the Romanian company;

- Introduction of new principles of organizational culture;

Besides these positive aspects, undoubtedly negative sides appeared that have resulted on account of the impossibility of full integration of the old society Sicomed in the standards and the Fund's investment strategies and also into the acquiring company. These aspects can be observed in the reduction of the number of staff employed after 2000, the year of the involvement of the fund.

4. Private Equity Involvement during the Investing Process and Exit time

On one hand, it has been observed that the companies have registered a growth of financial wealth, in terms of high turnarounds, high profits and a better financial position on market, the implementation of new technologies, etc, a situation that is comparable with all the benefits that can derive from a positive involvement of a private equity fund.

Analyzing the related data on the economic impact of private equity industry (PE thereafter), namely the data from *PricewaterhouseCoopers (PwC)* report on the Economic and Social Impact of the private equity funds we intend to verify if the conclusions presented on the reviewed report are common with the real situation of Romanian PE backed companies.

The PWC report sustains that private equity industry has a positive influence on the economy, it contributes to revitalization and restructuring of the existing industrial companies and it consists in financial support and growth potential. For this reason, the private equity industry has become an important pillar of the global economy.

At European level, following the involvement of these funds in the economy, there have been significant increases related to the rate of employment in the sectors covered by these funds, as it follows:

Table 2 - The increase of employment in Europe by sector of activity

<i>The number of employees in companies funded by private equity & venture capital investment</i>	<i>% of increases</i>
Biotechnology	+46,9%
Medical services and pharmaceuticals	+46,3%
Electronics and telecommunications	+38%
Industry	+25,2%
Production of goods for consumption	3,9%
The average employment	+30,5%

Source: Processing by PWC Report on the Economic and Social Impact of the private equity funds

The research report, provided by Technical University of Munich in November 2005, has demonstrated the contribution of investment funds such as Private Equity and Venture Capital on the labor market. Thus, from an empirical study examining the number of new jobs created over the period 2000-2004 showed that were created over 1 million funded companies hiring in Europe, including over 430 000 jobs were created in companies financed by buyouts, and about 630 000 jobs were created among companies backed by venture capital infusions.

Furthermore, the employment rate in the analyzed period, 2000-2004, it was increased with an average of 5.4%. Specifically, it was increased 8 times over the average increase of employment in Europe (0.7%)

In these circumstances, it was the found that private equity firms create more jobs than listed companies (a 5.5% annual growth in Europe between 2001-2004, compared with average annual growth of 0.7% for countries EU), or, most often improves the performance of portfolio companies. Beside all this, the profitability of the portfolio is sometimes higher than similar companies listed, which, ultimately, helps millions of people who contribute to pension funds that represent the largest category of institutional investors.

Therefore, since the PWC report presents the positive aspects of the private equity economic impact, we can assume that as well, can be expected negative aspect. Beginning with this assumption, the study attempts to identify the effects of the private equity involvement in the Romania`s economy by observing this aspects on a private equity backed company (i.e. Sicomed - Zentiva).

In the case of Sicomed the turnover`s growing evolution, presented in the figure 1, with an average of 21% per year (in real terms a growth of 3% over the inflation rate) demonstrates the positive involvement of the fund in the investee company, a company that has benefit of restructuring strategies (organizational, managerial, technological, etc).

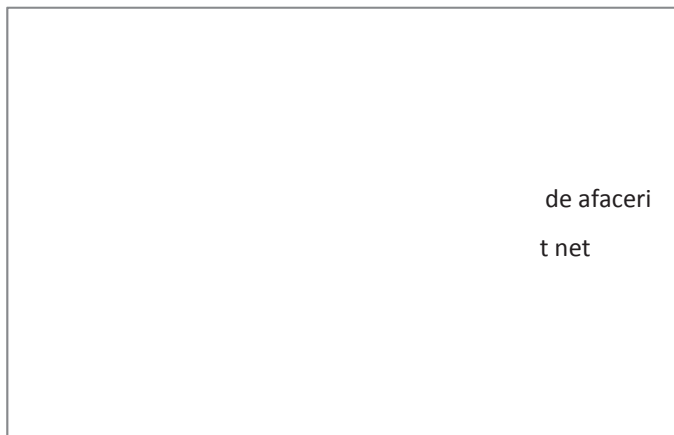


Figure 1. The turnaover`s and profit`s evolution from investment (2000) up to divestment of the fund (2005) – case of Sicomed - Zentiva

On the other hand, from a social point of view, the Romanian companies that have been embedded in a fund portfolio, have registered an unfavorable influence among the number of employees, although private equity funds have developed a number of advantages on business investment and restructuring.

In other words, these funds have acted only in terms of economic efficiency of these companies on short and medium term, instead the human factor became the one that required restructuring. On account of the restructurement of the company following the management change, some production lines are altered and the funds were put into position of reducing the number of employees through layoffs since the funds involvement (through operations like takeover or buyout). In the following figure it can be observed the evolution of the number of employees while the funds involvement (from 2000 to 2005) and after the Sicomed acquisition of Zentiva in 2005.

During the involvement of the investment fund, starting with 2000 were dismissed over 50% of employees to over 2,000 employees reading in 2005 when it reached a total of 918 employees. All these staff reductions were justified by the management by the need for a restructuring plan in the Romanian company Sicomed Bucharest. In compensation, all the layoffs were redeemed by the inclusion in a social project organized by the company and named "Advice and assistance for reintegration" of over 1 million EUR. The employees included in this restructuring program have obtained a financial redemption - they had to choose between the receipt of four compensatory wages or inclusion in this project for six months, while receiving a monthly salary and professional services capabilities assessment, training courses, setting job interviews, offering legal advice and financial consultances for starting new for businesses.

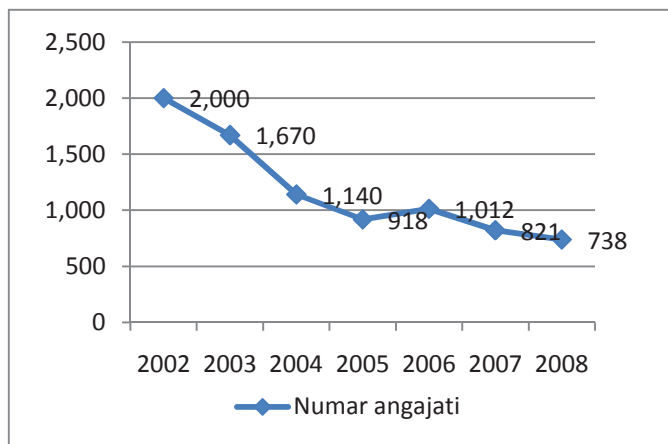


Figure 2 - The employees evolution for Sicomed & Zentiva between 2000-2008

As you can see in figure 2, throughout the involvement of the fund, the number of employees was reduced from year to year, with an average decrease of about 22% per year. The largest number of redundancies being made in 2004, at a rate of decrease in the number of employees with over 31%.

After 2005, with Zentiva's involvement in Sicomed activities, as the beginning of any company, the first year (2006) was marked by the recording of a growth in the number of employees. Employability was at the level of 10.24% higher than in 2005. However, in the coming years, 2007 and 2008 the restructuring continued, with rates of redundancy of 18.87% and 10.11%. Also, in 2007 the reducing of the number of employees took place that is from 1012 (2006) to 821 employees at the end of 2007, change that was realized with proper wage compensation for redundants.

Some personnel changes were made also for reviewing and modifying the market wage level at the standards of group Zentiva - changes that have increased staff costs by over 30% in 2007, which led to the redundancies.

Throughout those 4 years since the formation Sicomed-Zentiva were made redundant 200 people, the current number of employees was only 738 people in the recent report of the company.

With reference to the entire period analyzed, from 2000-2008, during the involvement of the fund and after the divestment of the fund from the company, the number of employees has been reduced from over 2,000 employees to 738, with a medium reduction in staff of 63.1%.

For Sicomed, the investee company, the employees reduction has become a favorable part, because this restructuring process has led to higher turnarounds, results that can be translated in terms of productivity growth and efficiency.

This downsizing cannot be limited solely to the Sicomed-Zentiva business case, it can influence in a certain way all the economic activity. Any redundancy in the number of employed people in the economy could increase the unoccupied population (i.e. the number of unemployed). Reducing the number of employees only in the Sicomed with over 63%, above the European average employability of 30%, generates an average vacancy rate of over 30%, which may show that the reduction in the number of employees in Sicomed has increased by 30% unemployment rate at the industry level, or even in Bucharest, with the assumption that employability rate that it is reached at European level it's also reached in Romania.

5. Macroeconomic implications

Reducing significantly the number of employees due to the influence of these funds, and the corresponding increase in unemployment rate on their behalf, has implications not only on the labor market (through loss of jobs increases the number of unemployed), but also on economy as

a whole. Job cuts will lead to a decreasing of the income, which will result in reducing the demand for goods and services as a result of reduced household consumption in their care to spend and save money. Moreover, at the macroeconomic level, it may record a restriction of activity on account of the inability of covering the supply of goods and services by reducing the demand for them. Subsequently, the lack of activity is to be registered due to degradation of the national production assessed by reducing the level of GDP, with direct consequences for national economic growth. Reducing domestic production will reduce economic growth. That is the recording of negative growth rates, and even economic downturns, that is a stage forerunner of economic crisis.

It should be noted that this study was summarized only to the economic and social implication driven by the involvement of a investment fund of PE in a Romanian company only. The withdraw of these conclusions to a macroeconomic level, has been realized with the purpose of observing the possible incidences on to the macroeconomic indicators, especially if the case of Sicomed Zentiva might be registered by other entities.

Moreover, the negative social implications of company activities must be completed by all the effects observed - that relate to the growth of the business and financial results assessment.

Surprisingly, on account of the number of employees, Sicomed has registered continuously an increasing turnover from year to year. The same situation could be noticed at the profit level, as reviewed in the figure 1. For this reason, we can make positive assessments related to reducing the number of employees – this downsizing, which is due to the re-engineering process and restructuring strategies, has been made in order to have an efficient production, rationalizing the use of resources, to facilitate labor, to reduce medium costs, etc.

Noting all these facts, it has to be said that the restructuring of staff, in this case, was set to be a social cost into/through the innovation and technical progress, cost that is going to lead later to higher competition between companies, and to a continuous improvement of products (diversification and/or quality improvement standard), all into the development of each business. Assessments related to effects of the crisis that influence the reduction of the number of employees can not be done yet, because these personnel changes have been found to have a rationale mean that relate directly to the restructure of the activities and to the replacement of manufacturing technologies, and not on account of restriction of activity.

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