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Realza Capital (A): December 2006 *

It was a cold night in Madrid in December 2006 as Alfredo Zavala and Martin Gonzalez del Valle walked back to the ten square meter office they were subletting from a venture capital firm in Madrid. The founders and General Partners (GPs) of Realza Capital, a fledgling mid-market private equity fund, had just returned from the company's Christmas dinner and things were not going according to plan. Their cornerstone investors, who had verbally committed the initial €40 million for Realza's first fund, had just called Zavala to say they were pulling out of the deal.

Realza's goal had been to raise €150 to €200 million for the fund. The process of raising money was well underway and Zavala and Gonzalez del Valle had already built a small team. They had recruited Catherine Armand as Administrative Assistant and had just convinced Pedro Fernandez-Amatriain to take a risk, forego a steadier career in corporate finance and join them as an Analyst. With the promise of future success, they had convinced Armand to join for free and Amatriain to join for a very moderate sum for the next 6 months. But Armand and Amatriain were not the only ones with everything on the line. Zavala and Gonzalez del Valle had both left lucrative jobs at leading Spanish private equity firms to pursue this entrepreneurial venture, which now appeared to be at risk. Three alternatives presented themselves to the Partners. The first was that a major European private equity group was trying to convince them to join and create a south European private equity fund. The second was that they had an indication of a serious offer to become an asset manager for Spain for a high net worth individual. The last option was that a major European private equity firm had approached the Partners to join as co-heads for a new Spanish office. But while these offers represented viable and immediate alternatives to the founders' original ambitions, Zavala and Gonzalez del Valle needed to carefully weigh all the aspects.

 The case was prepared by Jo Coles, (Executive MBA 2009), Vijay Sachidanand (Executive MBA 2009) and Professor Eli Talmor, Chairman of PEI. We thank Professor Florin Vasvari for his assistance in preparing the case. We have benefited from the useful suggestions and help of Martin Gonzalez del Valle and Alfredo Zavala (founding partners of Realza Capital), Etienne Deshormes (founder of Elm Capital) and Jim Strang (Director of Fund Investments at Dunedin Capital).

* The case has been completed recently and this version is preliminary. Comments are welcome.

Attractiveness of the Spanish Market Landscape

Macroeconomic Environment (2000-2006)

Zavala and Gonzalez del Valle realised that the Spanish economy was performing extremely well in 2006 and that the country's business landscape offered unique opportunities for private equity. Real GDP growth in Spain had averaged 3.7% annually in the period from the first quarter of 2000 until the end of 2006. By comparison, the average GDP growth in the European Union (EU) during the same period had been a little over 2% per year. Spain had almost consistently outperformed its Euro zone neighbours during this time by as much as 3.5%, even during the recessionary period triggered by the 'dot com' crash of 2002 (See **Exhibit 1** for Real GDP Growth in Spain vs. EU 2000 - 2006).

This had not always been the case for Spain. When the country joined the EU in 1986, it was a laggard compared with existing member states and over the next 2 decades, it received billions of Euros in EU development funding to boost growth. Between 1994 and 2005, increased construction investment and private consumption, reduced inflation, high levels of foreign investment, liberalisation of the Spanish labour market and significant immigration fed each other in a virtuous circle of wealth creation for the country.

The Low End of the Mid-market – The Partner's Target Segment

Zavala and Gonzalez del Valle considered their target segment to be the low end of the mid-market, which consisted of businesses with an enterprise value (EV) in the range of €15 to €100 million. Zavala and Gonzalez del Valle recognised that Spain was a land of family-owned, small to medium size enterprises. Many SMEs were facing the challenges of succession planning for the first time in their history. Within this segment, when transactions occurred, they tended to take place without a financial adviser. Financial advisers were only used in 34% of all M&A transactions in the SME segment during 2006, while 90% of the 50 largest transactions used a financial adviser[1]. In addition, acquisition financing in this segment tended to be sourced from local banks at Debt/EBITDA levels which rarely exceeded 3-4x.

The SME segment had many dynamic companies with capacity for growth, but generally these lacked good governance mechanisms as well as financial sophistication and needed to strengthen management teams, business processes and information systems. These types of companies presented attractive opportunities for private equity investors who were prepared to be hands-on and to undertake a buy-and-build strategy.

Private Equity in Spain

The potential for private equity in Spain was clear to Zavala and Gonzalez del Valle. Spain had a long history of risk capital dating back to the 1970's, but it was in the latter part of the 1990's that private equity and venture capital became significant. The Spanish private equity market grew by a factor of almost three between 2002 and 2006. And according to the Spanish Private Equity Association (ASCRI), €1,118 million was raised during the first six months of 2006, up

[1] Source: Thomson Financial research, 2006

107% from the first half of 2005[2]. (See **Exhibit 2** for PE Investment in Spain and **Exhibit 3** for Number of PE Deals in Spain).

Zavala and Gonzalez del Valle also knew that the Spanish government recognised the key role private equity could play in helping to develop the country's economy and improve productivity. In 2005, a private equity regulatory bill was passed through parliament.[3] It sought to simplify regulation of the private equity industry. In particular, the bill stipulated:

- Reduction of the administrative burden on private equity firms and funds.
- Expansion of funds' areas of activity.
- Permission to invest in other private equity firms, funds of funds and public-to-private transactions.
- Creation of special regimes for closed-end entities and qualified investors that do not require "small investor" protection rules.

The Partners – Alfredo Zavala and Martin Gonzalez del Valle

Alfredo Zavala and Martin Gonzalez del Valle were both recruited in 1989 by Mercapital, a merchant bank involved in private equity investments and corporate finance. Though they had only casually known each other before joining Mercapital, they had taken strikingly similar directions in life; both studied economics at Madrid University, and then obtained an MBA from INSEAD before moving on to spend some years working in industry (See **Exhibit 4** for Realza Founding Partners' CVs).

In 1995, Gonzalez del Valle left Mercapital to become Deputy General Manager and Head of Investment Banking at Banque Indosuez. Then in 2000, he was recruited as a Partner by InvestIndustrial to head and build a private equity business in Spain. Zavala, on the other hand, remained at Mercapital for 17 years, where he became one of the founding Partners when Mercapital carried out a management buy-out in 1996 before leaving in 2006.

The combined track record of Zavala and Gonzalez del Valle in private equity and investment banking over the years resulted in total investments of €427 million in 22 companies that generated €568 million in proceeds from 16 exits. Zavala and Gonzalez del Valle led 14 out of the 22 deals and exited ten of these companies. These ten exits generated an average multiple of 2.9x. (See **Exhibit 5** for Track Record of Realised and Unrealised Investments and **Exhibit 6** for Case Studies of Prior Investments).

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[2] ASCRI, founded in 1986, states its purpose as "representing, managing and defending the professional interests of its members, as well as promoting and encouraging the creation of entities whose objective is the taking of temporary stakes in the capital of non-financial enterprises that are not quoted on a stock market".

[3] Law 25/2005 simplifies the regulatory burden, allows acquisition of listed firms in order to de-list them, and permits the creation of private funds of funds aimed at institutional investors.

Launching Realza Capital

Background, Motivation & Vision

One afternoon in November 2005, the Partners met at Gonzalez del Valle's home in Madrid to discuss where their respective private equity careers were heading. As they reflected on the opportunities that might follow, they agreed that the environments at their respective firms were changing. As Zavala put it, "Mercapital was moving into the upper end of the private equity market. Martin and I felt we had exhausted our opportunities to grow at our current firms". Gonzalez del Valle added, "We realised that, at heart, Alfredo and I are entrepreneurs. We wanted to be part of something we could start and build from the beginning." With this in mind, Gonzalez del Valle and Zavala decided to start Realza Capital. "Realza" means "to enhance" in Spanish[4]. Both partners felt the name succinctly captured their vision for the new company.

This vision was to create value for investors by leveraging their own prior experience and making primarily control investments in Spanish SMEs. Initially, they sought to raise €150 million for their first fund, with a target portfolio of 8 to 12 companies. The equity investment was expected to be anywhere from €5 to €25 million per portfolio company. As a key feature, their strategy for creating value was not based primarily on leverage. Within a segment comprised of companies sorely lacking in management expertise, they sought to bring their significant operating experience to bear, moving their portfolio companies into "the next stage of their development"[5].

Strategic Positioning, Organisation & Team

Zavala and Gonzalez del Valle chose to focus on the SME segment described above for a number of reasons:

- Companies in this segment accounted for a significant portion of the economic "value-added" in Spain (See **Exhibit 7** for "Value Added" by SMEs within the Spanish Economy).
- Both founders had spent the majority of their careers building a successful track record in this segment.
- The vast majority of companies in this segment were family-owned, lacking sophisticated operational strategies, processes and structures; therefore, this segment represented an opportunity for the general partners to add value upon acquisition.
- Deal transactions in this segment were most often negotiated (as opposed to auctioned) deals, thus offering the opportunity for more favourable acquisition prices.
- The sheer number of companies in this segment ensured a wealth of "buy and build" investment opportunities and a good quality deal flow. Both partners were familiar with this type of investment, given their prior experience.
- There was virtually no competition in this segment, either from Spanish funds (very few with comparable experience) or international funds.

[4] The word also has 'regal' implications; "Real" means royal in Spanish.

[5] Realza PPM document.

By the time the fund achieved its final closing, the GPs anticipated having a team of six investment professionals (two partners, two investment managers and two analysts) and two administrative staff. As the number of companies in the portfolio grew, the partners planned to strengthen the team accordingly, intending to hire an additional investment manager and analyst within two to three years after Realza's final closing. (See **Exhibit 8** for Realza Organisation Structure).

Another crucial component of Realza's organisation was an informal advisory board, comprised of a network of seven to ten senior managers and sector experts with whom Zavala and Gonzalez del Valle had worked in the past. For each portfolio company, one or more members of this board would be designated to support the team in reviewing the due diligence and executing the business plan. These professionals would be compensated via a combination of "director's fees", stock options and the opportunity to participate in the investments in which they were involved.

Competitive Landscape

In Spain, the private equity market in 2006 was stratified into three levels (See **Exhibit 9** for Illustration of Competitive Landscape). The first "tier" was the large buy-out fund, which targeted investments greater than €300 million in EV and was represented by global organisations with operations in Spain. This highly competitive tier was populated by both top-tier US and pan-European funds.

The mid-level competitors were a more mixed group. Some global organisations such as 3i rubbed shoulders with the larger Spanish firms, Mercapital being a prime example. Deal sizes ranged from €100 million to €300 million in this mid-level. Zavala and Gonzalez del Valle had observed that the size of these organisations' deals had been increasing significantly, and that more of them were being completed through advisers and auction processes.

Finally, the closest competitors to Realza were the small buyout funds, typically targeting €100 million or less in deal size. In this segment, having a strong local team and network was vital for deal origination. As Zavala and Gonzalez del Valle recognised, competition was limited in this space.

Realza's Investment Strategy

During their time in private equity and industry, Zavala and Gonzalez del Valle had developed an extensive network that gave them excellent access to the business community in Spain. As their former firms moved away from the smaller transactions, the newly-formed Realza could capitalize on the opportunities in the market that were left behind. In particular, Zavala and Gonzalez del Valle directly approached the intermediaries they had dealt with before, given their deep expertise in the smaller transactions that no longer interested Mercapital and InvestIndustrial.

Realza's fund strategy was to invest in buyouts in the low end of the mid-market in Spain. 76% of Spanish companies are family-owned and 97% of companies have a headcount greater than ten, but less than 200[6]. Zavala and Gonzalez del Valle felt strongly that this strategy offered some uniquely attractive opportunities. The SME companies are generally less structured, which allows experienced investors to make a significant contribution to value creation by working closely with the existing management teams.

Realza shared the view, which is widely consistent in PE, that creating value by providing not only financial, but also strategic business partnership was the key. Zavala and Gonzalez del Valle had also proven themselves to be adept at this. **Exhibit 10** illustrates how the Realza GPs created value during the 22 investments they were involved in prior to forming Realza. Business plan development and implementation, professionalization and strengthening of management were persistent themes, even more so than the execution of the acquisition and financial restructuring. From the outset, it was agreed that Realza would not invest in start-ups or distressed companies. Family-owned, SME enterprises seemed to be the right fit.

Zavala and Gonzalez del Valle determined that Realza would invest with a target outlook of three to five years, a reasonable period in which to generate value. Disinvestment in companies would principally be through sale to strategic (trade) buyers, and to a lesser degree, through secondary transactions to private equity (financial) investors interested in furthering the business project underway and supporting the management teams.

The return on investment was to be achieved through the following factors, listed here in order of importance to Realza:

- Expansion of operating profit (EBITDA), through organic growth and acquisitions.
- Increase in the EV/EBITDA multiples, compared with the corresponding multiples paid at acquisition. While GPs in general have little control over market multiples, these multiples usually reflect expected growth opportunities for the company and GPs do have control over improving the company's ability to pursue these growth opportunities.
- De-leveraging/Financial restructuring – using the cash flow of the business to pay down a portion of the debt on the company's balance sheet.

Realza's Investment Process and Portfolio Management

Realza's investment process would involve the deal team (one Partner, one Investment Manager and one Analyst) visiting the potential target, deepening their knowledge of the company and writing a "preliminary investment memorandum" on the opportunity. Once the potential deal was agreed internally, a "letter of intent" would be issued between Realza and the target company, giving Realza a period of exclusivity on the deal (around 3 months, but varies from deal to deal). Realza would then conduct the more costly, in-depth due diligence on the company, before completing the deal.

[6] Source: ASCRI / INE.

Realza's intention was to have the same team that did the acquisition remain in place to monitor and manage the investment, and eventually to undertake any buy and build acquisitions. Realza would also work very closely with its Industrial Board in this regard.

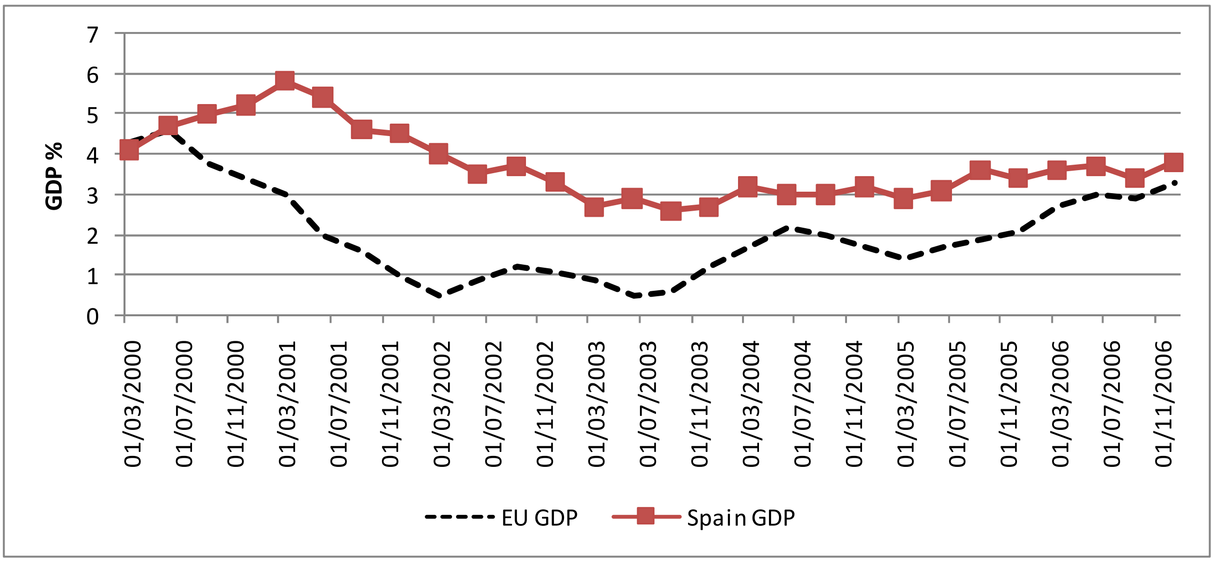
Conclusion

Just after 2am, Zavala and Gonzalez del Valle resigned themselves to returning home to try and get some sleep. The following day they would need to begin re-engaging vigorously with potential investors. How should they promote the fund and reach the right investors? Would they be able to successfully close the fund and achieve the €150 – 200 million target size? Or should they more seriously consider, for the sake of stability for themselves and their team, the three alternatives that currently were available to them?

Madrid was just coming to life with evening revellers braving the cold as Zavala and Gonzalez del Valle walked to their cars. Although the GPs had a clear vision of where they wanted Realza Capital to go, they knew they were still far from being able to celebrate success.

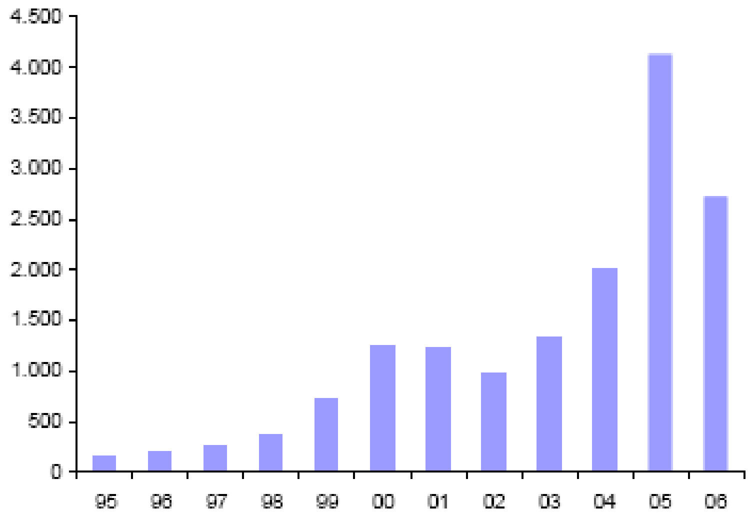
Appendix

Exhibit 1: Real GDP Growth in Spain vs. EU 2000 - 2006



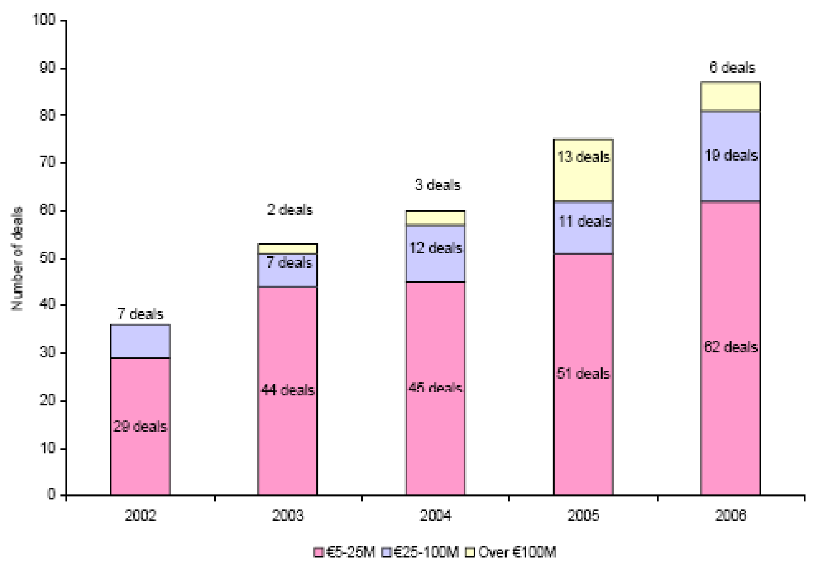
Source: Datastream

Exhibit 2: PE Investment in Spain (€ Millions)



Source: Spanish Private Equity Association, ASCRI

Exhibit 3: Number of PE Deals in Spain



Source: ASCRI

Exhibit 4: Realza Founding Partners' CVs – Alfredo Zavala and Martin Gonzalez del Valle

Martin Gonzalez del Valle

- 2006: Advised Charterhouse on the buyout of Levantina
- 2000-2005: Investindustrial, Madrid, Partner and Managing Director in Spain (4 deals)
- 1995-2000: Credit Agricole Indosuez, Madrid, Deputy GM, Head of Corporate
- Finance and Capital Markets
- 1989-1995: Mercapital, Madrid, Senior Director, Member of Management Committee
- (5 deals + corporate finance)
- 1986-1988: Socelec, Madrid, Sales Director, Member of Management Committee
- 1984-1986: Baxter Travenol, Valencia, Head of Home Care Products
- 1980-1983: Sociedad Metalurgica Duro Felguera, Internal Auditor
- BA in Law (Madrid 1980) and Economics (Madrid 1981), MBA (Insead 1984)

Alfredo Zavala

- 1996-2006: Mercapital, Madrid, Partner (15 deals in total)
- 1989-1996: Mercapital, Madrid, Senior Director
- 1985-1987: Editorial Graficas Espejo, Madrid, Director, Assistant to General
- Manager
- BA in Economics (Madrid 1985), MBA (Insead 1988)

Exhibit 5a: Track Record of Realised and Unrealised Investments

i: Where Zavala and Gonzalez del Valle were primarily responsible for the transaction

Realised Investments[1]

(Performance as of December 31, 2005. Figures in € million)

Company	Partner	Industry	Year of Initial Inv.	Total Inv. Amount	Initial Equity Ownership	Realised Proceeds	Year Realised	Multiple of Inv.	Gross IRR
Mesa	MGV	Electrical Equipment Manufacturer	1989	2.8	61%	6.1	1990	2.2	269%
Mesa Gatica	MGV	Electrical Equipment Manufacturer	1989	2.4	59%	4.9	1990	2.0	212%
Baron de Ley	AZ	Rioja Wine	1991	16.4	65%	61.8	1997	3.8	25%
Intermedica	MGV	Medical Products	1992	6.7	99%	10.7	1997	1.8	13%
Parques Reunidos	AZ	Amusement Parks	1994	12.7	66%	101.7	1999-2000	6.0	51%
Frida	AZ	Frozen Food	1995	8.6	46%	2.0	1997	2.3	63%
Santos	AZ	Logistics Services	1999	20.5	60%	68.0	2005	3.3	22%
Grupo Care[2]	MGV	Nursing Homes	2001	10.6	98%	19.9	2006	1.9	17%
Logic Control	MGV	Computer Software	2002	38.3	100%	72.4	2005	1.9	22%
System[3]	AZ	IT Training & Education	2003	11.1	47%	11.1	2005	1.0	0%
Sub - total realised				**130.0**		**376.5**		**2.9**	

Unrealised Investments

(Performance as of December 31, 2005. Figures in € million)

Company	Partner	Industry	Year of Initial Inv.	Total Inv. Amount	Initial Equity Ownership	Estimates by Inv. Bank (end of 2006) Equity value	Multiple
Yidilo[4]	AZ	Speech Recognition	2000	3.6	24%	9.2	2.6
Recoletos	MGV	Publisher of newspapers & specialist magazines	2005	22.0	5%	45	2.0
Saprogal	AZ	Animal feed	2005	30.2	75%	37	1.2
Inaer	MGV	Helicopter on-shore services	2005	47.4	74%	77	1.6

Sub - total realised	**103.2**
Sub - total realised	**233.2**

(1) When the deal was led by Mercapital Group of investindustrial, the investment figures also include coinvestors. Otherwise data only reflect investments by Mercapital Group or investindustrial (for Yidilo shareholding by financial investors was 68% and for Recoletos the MBO was for 100%)

(2) Investment realized in July 2008

(3) Contract declared null and void. Investment cost recovered

(4) Shareholding reflects position as of December 31, 2005

Source: Realza Capital

Exhibit 5b: Track record of Realised and Unrealised Investments

ii: Where Zavala and Gonzalez del Valle were members of the investment team

Realised Investments

(Performance as of December 31, 2005. Figures in € million)

Company	Partner	Industry	Year of Initial Inv.	Total Inv. Amount	Initial Equity Ownership	Realised Proceeds	Un-realised Proceeds	Total Proceeds	Year Realised	Multiple Inv.	Gross IRR
Midesa	AZ & MGV	Periodical distribution	1988	27.2	43%	51.0	_	51.0	1989-1997	1.9	35%
Avidesa	AZ	Ice Cream Manufacturer	1988	35.6	26%	42.3	_	42.3	1989-1992	1.2	23%
Cantonajes Suñer	AZ & MGV	Packaging	1989	13.8	43%	11.1	_	11.1	1992-1993	0.8	n.a
Comelectric	AZ & MGV	Electrical Equipment Distributor	1989	19.6	50%	0.2	_	0.2	1993	0	n.a
Cope	AZ	Radio broadcasting	1993	3.3	6%	4.6	_	4.5	1997	1.3	12%
Record	AZ	Car rental	1999	37.5	56%	73.0	9.8	82.8	2006-2008	2.2	n.a
Sub - total realised				**137.1**				**191.9**		**1.4**	

Total - realised (primarily responsible and members of the investment team)	**267.1**	**5687.4**	**2.1**

Unrealised Investments

(Performance as of December 31, 2005. Figures in € million)

Company	Partner	Industry	Year of Initial Inv.	Total Inv. Amount	Initial Equity Ownership	Estimates by Inv. Bank (end of 2006) Equity value	Multiple
Jofel	AZ	Hygienic accessories	2001	33.2	54%	82	2.5
Lasem	AZ	Frozen dough & Oleochemicals	2003	23.4	42%	48	2.1

Sub - total unrealised	**56.6**
Total as members of the investment team	**193.7**
Total combined investment performance	**427.0**

Source: Realza Capital

Exhibit 6a: Case Studies of Prior Investments

Grupo Santos – Investment Led by Alfredo Zavala at Mercapital

- **Deal Description :**
  - Integrated provider of logistic services
  - Strong reputation for the service quality. Owned by the Santos family

- **Investment Rationale:**
  - The logistic services sector:
    - experienced strong growth as a consequence of the trend towards subcontracting;
    - was poised to undergo a concentration process at a European level
    - was increasingly demanding in the quality of the services
  - Santos was deemed to be the appropriate platform from which to create a national leader
  - Opportunity to grow through organic growth and acquisitions
  - Opportunity to create value by strengthening the management team and implementing management systems

- **Value Creation**
  - Appointing a CEO, a CFO and other middle managers
  - Carrying out a corporate restructuring, conceiving a new brand and a corporate image
  - Introducing information systems (SAP) and management systems (budgeting financial controls, etc.)
  - Defining for the first time in its history a strategic plan, including acquisitions
  - Leading four acquisitions of competitors
  - Optimizing financial structure through financial leverage

	Sales	EBIT	Multiple	Enterprise Value	Net Debt
Entry	54.0	5.0	7.6	38.2	4.0
Exit	204.3	13.6	9.7	132.5	13.2

Source: Realza Capital

Exhibit 6b: Case Studies of Prior Investments

Logic Control – Investment Led by Martin Gonzalez del Valle at InvestIndustrial

- **Deal Description**
  - Leading software company specialising in accounting and business management software for small and medium sized companies
  - Originated as part of the divestment program of its parent company, Service Point Solutions

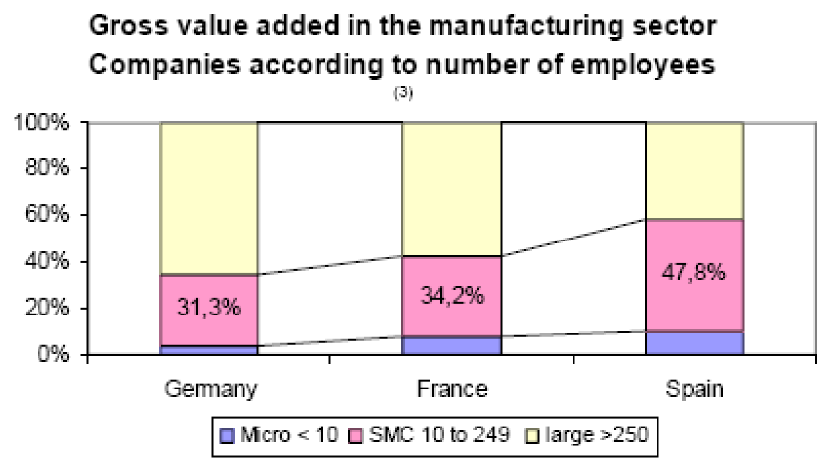
- **Investment Rationale**
  - The industry offered high barriers to entry (due to national and regional tax and accounting policies)
  - Leader in its industry with wide brand awareness and an installed base of 22,000 active customers
  - High cashflow visibility due to maintenance contracts
  - Low acquisition multiple compared to listed companies
  - Clear exit opportunities

- **Value Creation**
  - Stopped hardware business line
  - Reduced workforce and expenses related
  - Strengthened management team, sales network and the distribution network (VARs)
  - Created incentive Plan
  - Migrated the existing customer base to more value added services, while increasing customer loyalty
  - Started vertical expansion to reach related market segments
  - Increased the recurrent revenues stream through the introduction of additional maintenance services
  - De-leveraged through stable cashflow generation

	Sales	EBIT	Multiple	Enterprise Value	Net Debt
Entry	36.6	0.7	85.7	60.0	21.7
Exit	43.6	3.1	22.8	70.8	(1.6)

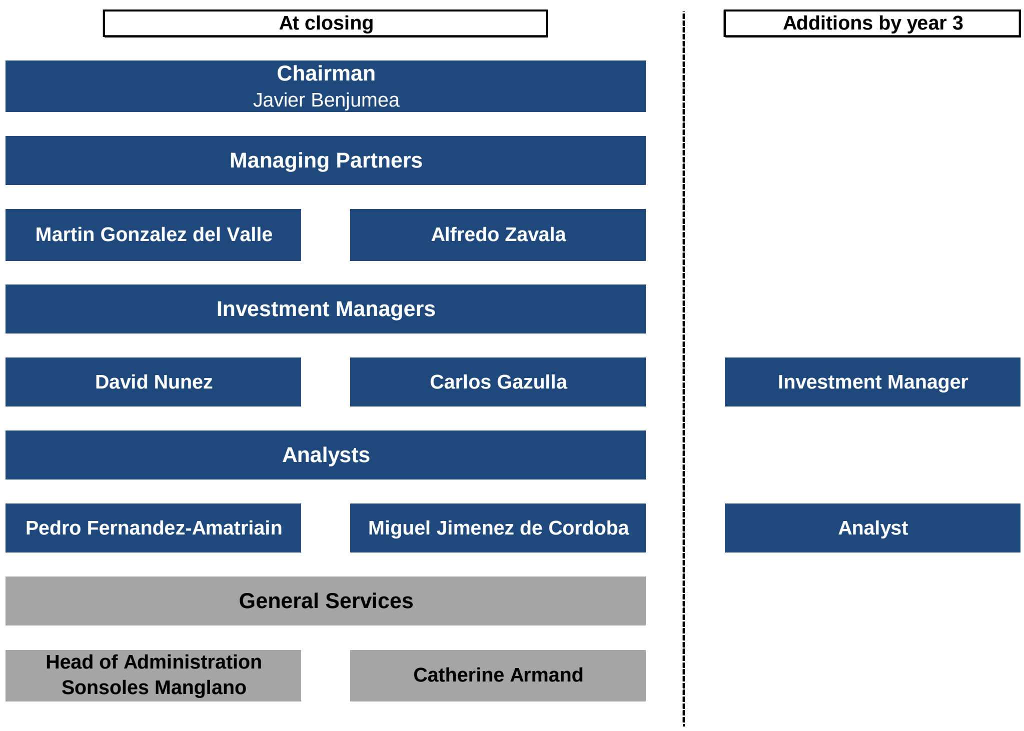
Source: Realza Capital

Exhibit 7: "Value Added" by SMEs within the Spanish Economy



Source: Realza Prospectus

Exhibit 8: Realza Organisation Structure



Source: Realza Capital

Exhibit 9: Illustration of Competitive Landscape

Transaction Value (EV)		
+ €300M	€300M - €100M	€100M - €15M
# of buy-outs in 2006		
6	7	19
PE firms with an office in Spain		
	Mercapital	
CVC	3i	Realza
Apax	Advent	Nazca
P AI	Bridgepoint	Corpfin
Carlyle	Vista	Espiga
Candover	N mas 1	Catalana
Doughty Hanson	Impala (ex Suala)	Proa
	Ibersuizas	
	InvestIndustrial	
	MCH	
	Magnum	

Source: Realza Capital, Capital and Corporate

Exhibit 10: Value Creation by Alfredo Zavala and Martin Gonzalez del Valle in Pre-Realza Investments

Company	Business plan development & implementation	Transformation of family companies into professionally run companies	Strengthening of management	Improving companies structures and processes	Identifying and executing acquisitions	Optimising financial structure	Succession plans and management incentives
Mesa	X	X					
Mesa Gatica	X	X					
Barón de Ley	X		X		X		X
Intermédica	X		X	X			
Parques Reunidos	X		X		X	X	X
Frida	X		X	X			X
Santos	X	X	X	X	X	X	X
Grupo Care	X	X	X	X	X	X	X
Logic Control	X	X	X	X		X	X
System	X		X				X
Ydilo	X		X				X
Recoletos	X					X	X
Saprogal	X				X	X	X
Inaer	X		X		X	X	X
Midesa	X	X	X	X		X	
Avidesa	X	X	X				
Cartonajes Suñer	X	X		X			
Comelectric	X	X	X	X			
Cope	X		X	X		X	
Record	X		X			X	X
Jofel	X	X	X	X			X
Lasem	X	X	X				X

Source: Realza Capital

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Realza Capital (B): January 2009 *

As Martin Gonzalez del Valle and Alfredo Zavala discussed where to hold Realza Capital's Christmas party in December 2008, they reflected on the events of the past two years. They recalled how grim the mood had been at their Christmas dinner in late 2006. Key investors had withdrawn their commitments and a wealthy family had offered the General Partners (GPs) a fallback from their dream of setting up and running their own, independent fund.

How times had changed since then. At the end of 2005, they had made the decision to create Realza Capital. By the end of 2006, the Partners had made a further three decisions; firstly, to reject the alternative offers that had presented themselves. Secondly, despite a difficult beginning they had decided to pursue an international base of limited partners (LPs) rather than just domestic Spanish companies. Thirdly, in order to successfully attract international LPs and raise funds, Zavala and Gonzalez del Valle engaged a placement agent. Just three months ago, Realza had completed its fourth and final closing. Overall, the fund had raised €170 million, well within the range the GPs set out to achieve. The mood within the firm as 2008 came to a close was buoyant.

Yet as they entered 2009, Gonzalez del Valle and Zavala knew there were new challenges on the horizon. The Realza team, so intensely focused on fundraising until now, needed to quickly shift gears into "investing and operating mode" and start realizing value for their LPs. This would have to happen against the backdrop of a deteriorating economic climate in Spain. The country was now truly starting to feel the effects of the global financial crisis.

While the turn of the year was surely a time to celebrate the achievements of the past two years, Zavala and Gonzalez del Valle knew that the real challenges still lay ahead.

 We thank Professor Florin Vasvari for his assistance in preparing the case. We have benefited from the useful suggestions and help of Martin Gonzalez del Valle and Alfredo Zavala (founding partners of Realza Capital), Etienne Deshormes (founder of Elm Capital) and Jim Strang (Director of Fund Investments at Dunedin Capital).

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Placement Agents

Zavala and Gonzalez del Valle knew that private equity funds sometimes use placement agents, or intermediaries, to connect them with investors. The agent is typically compensated based on a percentage of funds raised, and the agent's role includes:

- Working with the GPs of the fund to create investor due diligence materials, including a private placement memorandum (PPM), sales presentation, due diligence questionnaire (DDQ) and references to support the GPs' track record.
- Finding potential investors, primarily through personal contacts.
- Scheduling the investor "roadshow", a process whereby the GPs (usually accompanied by the placement agent) "sell" the fund to potential investors.
- Providing advice and support to the GPs on how to effectively present the investment opportunity during the roadshow.

The larger the fund being raised, the larger the placement agent because typically larger agents work with the bigger investors that large funds are targeting.

Etienne Deshormes and Elm Capital

Etienne Deshormes, 48, was born and raised in Brussels, Belgium (See **Exhibit 1** for Etienne Deshormes' CV). Deshormes studied History and Economics at the Université libre de Bruxelles. After graduating in 1985, Deshormes spent a year working for the International Monetary Fund and then joined Euroclear, the Europe-based global securities clearing house. In 1992 he was recruited by JP Morgan's Corporate Finance division. Deshormes rose to Managing Director by 1998, before leaving to join Zurich Capital.

In 2000, Deshormes left Zurich Capital to create Global CFO, an internet based service for Chief Financial Officers to select financial advisors; the company suffered as a result of the 2001 dotcom slump and was wound up in September 2001 after failing to raise a second round of funding.

After the demise of globalCFO.com, Deshormes had been considering his next career move, when a former colleague approached him to ask for help in raising money for a first-time fund in Italy. The venture was challenging but ultimately successful, with the fund closing within six months of Deshormes becoming involved in the process. He realised that a gap existed in the market for a placement agent with his background and a track record in raising money for first-time funds. As Deshormes put it, "First-time funds have no existing investor base or direct track record to leverage…and this is a difficult story to tell to relatively risk-averse investors. In addition, raising a country-specific fund is tough, as there are fewer investors with an allocation in their portfolio for country-focused investments." With this in mind, Deshormes established Elm Capital in 2002 and went on to place a further six funds, before being introduced to Zavala and Gonzalez del Valle by a mutual acquaintance.

Realza Engages Elm Capital

In November 2006, Deshormes flew to Madrid to meet with the GPs of Realza Capital. Deshormes recalls, "As I sat in their sublet office, I noticed that the main meeting room was also the only route for everyone in the office to get to the bathroom…I hoped that they had an alternative meeting room for visiting investors! Nevertheless, the meeting was great and I felt confident that I could work with Martin and Alfredo."

As he boarded the flight back to London, Deshormes reflected further on the appeal of working with Zavala and Gonzalez del Valle. He recalls "Both Alfredo and Martin had significant experience in the Spanish market, and a strong track record and reputation in the mid-market in particular. In the context of the Spanish economic environment at the time, I felt that the best deals [in terms of potential to create value] were the smaller ones. Also, given that larger private equity funds in Spain had recently shown pretty erratic performance, I felt that investors were looking for a fund with this type of focus."

Meanwhile, Zavala and Gonzalez del Valle also considered their options. In the European marketplace, they assessed the merits of working with placement agents across the 3 broad tiers:

- Large-market (large funds, typically more than €1 billion in funds raised) – examples were Credit Suisse, Merrill Lynch and UBS.
- Mid-market (mid-size funds, typically €500 million to €1 billion in funds raised) – examples included MVision, Campbell Lutyens, Helix, JP Morgan Cazenove and Lazard.
- Small-market (small funds, typically less than €500 million in funds raised) – examples included Capstone, Accantus Advisers, Triago and Elm Capital.

Although Zavala and Gonzalez del Valle felt they would get more attention and focus from a smaller agent, they realised that one possible downside of working with a smaller agent could be lack of resources to dedicate to producing due diligence materials for potential LPs. However, in the case of Realza, this was less of a concern, as the Partners had already generated most of the required information.

Zavala and Gonzalez del Valle decided to partner with Elm Capital as a placement agent and quickly settled on terms. As per the typical placement agent model, they agreed that Elm would get compensated via a fee based on a percentage of funds raised. As it turned out, Deshormes and Elm would spend the ensuing 18 months working exclusively with Realza.

Overview of the Fundraising Process

Deshormes outlined the fundraising process to the Realza team, taking them through the following 3 broad phases:

- Preparation of due diligence materials.
- Conducting the roadshow.
- Conducting follow-up meetings and finalizing terms with the LPs.

Preparation of Due Diligence Materials

Deshormes explained to Realza that there are certain documents investors typically like to see, to enable them to make a decision on whether to invest in the fund. These include a presentation for the roadshow meetings, the PPM, the DDQ and references for the GPs of the fund. The GPs and the placement agent might work together in preparing these materials and, where possible, customizing them to address particular investor "hot-buttons".

The roadshow presentation is typically a slide presentation outlining the macroeconomic and competitive landscape, the GPs' motivations for setting up the fund, the fund's investment strategy and structure, and the backgrounds of the key investment professionals working for the fund. Deshormes knew from experience that a crucial piece of the background of the founding partners is their track record. A significant portion of the presentation is usually devoted to describing the track record, both at an overall performance level (e.g., 3x realised investments over the past 20 years) and at an individual portfolio company level (e.g., 30% gross IRR). The goal of the presentation is to excite potential investors in the relatively short period of time available in the introductory roadshow meeting. Typically, the PPM is a more detailed, "leave behind" booklet version of the presentation, while the DDQ aims to answer all further questions a potential LP might have. **Exhibit 2** contains an outline of the key topics covered in Realza's PPM and DDQ.

Zavala and Gonzalez del Valle were aware that potential investors also want to see references supporting the founding GPs. In Realza's case, they obtained references from several CEOs of the portfolio companies with whom they had worked in the past, two of which are shown for illustration in **Exhibit 3**.

Conducting the Roadshow

Deshormes played a key role in contacting target investors and arranging the roadshow for Realza. Through his network, Deshormes approached close to 300 potential LPs. Deshormes, Zavala and Gonzalez del Valle were soon on the road; they embarked upon an intensive 3-week European trip, meeting more than 40 potential investors in 16 countries. Typically, Zavala and Gonzalez del Valle were the main presenters on the day, with Deshormes playing a crucial role before (preparation, packaging, tailoring the messages and delivery) and after the meetings (providing feedback).

After the roadshow, Zavala and Gonzalez del Valle sent investors who had expressed an interest a copy of the DDQ and, facilitated by Deshormes, followed up with the investors regarding specific queries. Once their interest became serious, the investors were invited to visit Realza's office in Madrid and spend the day with Zavala, Gonzalez del Valle and their team.

Deshormes recalls some of the concerns prospective investors had at the time. "They were concerned about attribution. How much of the value that Alfredo and Martin had created had been due to them as opposed to market conditions, leverage or other factors? And how much of it was accurate? We had to show them numerous references from the CEOs with whom the GPs had worked. And even if the track record was to be believed, there was some concern around the fact that the GPs had been in the private equity market for about 20 years and had only completed 22 deals. Finally, there were some reservations expressed about the ability of Zavala and Gonzalez del Valle to work together to re-produce their track record. The two had of course worked together before, but that had been quite a long time ago."

Deshormes and Realza knew that after the office visit, potential investors who wanted to proceed usually had to present the opportunity to their own investment committees, often multiple times. During this process, Deshormes, Zavala and Gonzalez del Valle did everything they could to answer any questions and support these internal presentations. Once the prospective investors gained approval from their internal committees, the lawyers representing Realza and the potential LPs would meet to hammer out the term sheets and legal agreements (**Exhibit 4** provides a Summary of Principal Terms for Realza).

First Investment and Fund Closing

By the spring of 2007, Zavala and Gonzalez del Valle knew it was going to be important to demonstrate to potential investors that Realza had the right network of contacts in the SME segment to enable the fund to successfully complete investments in portfolio companies. Zavala put the issue succinctly: "Without the money you can't do the deal, but without the deal you may not be able to attract the investors and close". Clinica Perio, Spain's largest chain of high-end dental clinics, offered just such a chance for Realza.

Realza signed the stock purchase agreement (SPA) with Clinica Perio (subject to due diligence) on 10th July 2007. Realza negotiated to acquire 62% of the equity from its three founders, who reinvested to take the remaining stake[1]. Zavala and Gonzalez del Valle recognised that the dental market in Spain was highly fragmented and returning excellent (double digit) growth consistently for the past two decades. The investment was also a good fit with Realza's strategy, as it demonstrated that Realza could originate transactions directly in fragmented sectors and be a majority investor alongside existing management.

Unusually, Realza actually signed the SPA prior to the first close (hence before being able to make the actual capital call). However, this was not as risky at it might appear, as the only step remaining to complete the first close was final approval of fund's incorporation from the Comisión Nacional del Mercado de Valores (CNMV – the Spanish financial services regulator). Most of the soon-to-be LPs had already signed letters of commitment and the SPA for Clinica Perio contained a clause making the deal contingent upon a successful first close.

The first close (at €43 million) took place in August 2007 but Zavala, Gonzalez del Valle and Deshormes made the decision not to advertise in the trade press. Now, with an investment under their belts, the Realza Capital story became a more tangible proposition to potential investors. This first close was followed by a second close at €87 million in January 2008 and a third close at €142 million in May of the same year. Meanwhile, the overall economic picture in Spain had continued to worsen. Real GDP growth in Spain had been vigorous since 2003 but by 2008 forecasters were expecting to see the first contraction since 1993. The housing sector was showing significant signs of decline and the levels of corporate debt across the Spanish economy were at almost 115% of total GDP. Despite these concerning signs, demand from investors for Realza's fund meant they were able to exceed their target and reach €170 million by the final close in September 2008.

Conclusion

Gonzalez del Valle and Zavala knew the Realza team had accomplished a tremendous amount over the past two years. The GPs had begun with an ambition to start their own fund and stay independent, and had stuck to their guns in the face of investor withdrawals and fallback options they really did not want to entertain. They successfully raised €170 million, well within their original target range.

But meanwhile, Spain was not immune to the global financial crisis. Zavala and Gonzalez del Valle were acutely aware that Spain was beginning to show the tell-tale signs of an overheating economy. The country was entering a new phase of its downturn, and it was in

[1] No debt on the company's balance sheet or to finance the investment

this context that Realza needed to shift from “fundraising mode” to “investing and operating mode” to start delivering value to its LPs; and they needed to do this quickly.

Would Realza have the right balance of skills on their team to source and invest in portfolio companies in the current environment? Would the managers on their Industrial Board have the right skills to create value within the portfolio companies during a time of considerable economic distress? And how might the evolving (largely worsening) macroeconomic conditions impact the exit strategy for their portfolio companies?

Zavala and Gonzalez del Valle had much to think about as the winding road of 2009 stretched out ahead of them.

Appendix

Exhibit 1: Etienne Deshormes' CV

ETIENNE DESHORMES

Career

Nov 2001 – Current	**Elm Capital Associates Ltd, London - Founder and Chief Executive Officer**

- Advisory to Private Equity Funds assisting in the fundraising process and in negotiating acquisitions or divestitures of companies and funds.
- Raised over €700 million for Private Equity Funds in Italy, France, Spain, Germany, UK and the US

May 2000 – Sep 2001	**Global CFO Limited, London – Founder and Chief Executive Officer**
1998 – 2000	**Zurich Capital Markets, London – Managing Director**
1996 - 1998	**JP Morgan, London - Managing Director**
	Head of Equity Capital Markets for France and Belgium
1992 - 1996	**JP Morgan, Brussels – Vice President**
	Head of Corporate Finance
1987 - 1992	**Euroclear, Brussels - Account Officer**
1986	**Cabinet of the Minister for Small and Medium Industry, Belgium**
1985	**International Monetary Fund and World Bank, Washington DC**

Academic background

1979 - 1984	Degree in Economics with Grande Distinction, Université libre de Bruxelles, Belgium
1978 - 1983	Degree in Contemporary History with Grande Distinction, Université libre de Bruxelles, Belgium
1966-1978	European School, Brussels, Belgium

Exhibit 2: Outline of the Contents of the Private Placement Memorandum and Due Diligence Questionnaire

Private Placement Memorandum Contents

- Executive Summary
- The Market Opportunity
- Investment Strategy
- Organisation
- Partners' Track Record
- Case Studies
- Summary of Principle Terms
- Risk Factors
- Tax Considerations
- Certain US Tax, Employee Retirement Income Security Act (ERISA), and Securities Law Matters
- Selling Restrictions

Due Diligence Questionnaire

- Investment Strategy
- Deal Flow / Deal Origination
- Investment Process
- Investment Performance / Track Record
- Personnel
- Litigation Check
- Investor Reporting & Relations
- Legal Status, Structure and Organisation
- Appendix:
    - Internal Due Diligence Checklist
    - Partners' CVs
    - Sample Report to Investors

Source: Realza Capital

Exhibit 3: Examples of References for Realza GPs

Attribution letter: Logic Control

To whom it may concern: Barcelona September, 2006

As CEO and Managing Director of Logic Control until July 2005, I've had the opportunity to develop a very close professional relationship with Martín González del Valle from 2001, at which time InvestIndustrial led the acquisition of Logic Control in a leverage buyout operation, until June 2005, when the company was sold to the British Sage Group.

Martín was InvestIndustrial's CEO in Spain and we both designed the strategic plan with him as well as the company's goals for the following five years. Also, together we established new remuneration packages for the management team and other key personnel, establishing a stock option plan, bonus policies, etc.

Once the investment group's entry had been finalised, Martin regularly attended the monthly meetings of the Board of Directors, in which he participated actively in overseeing the different areas of the company. Additionally and when necessary, I had personal meetings with Martín to review specific matters regarding the performance of the company in distinct areas. In fact, all of the relevant decision I took in Logic Control during this period were formerly negotiated and agreed with Martin.

In the final state, along with his team and the investment bank that organised the competitive tender, he led and was responsible for this process until the sale was completed with the entry of Sage Group.

During these years, Martín has been for me a highly professional collaborator and his opinions and good judgement have had a positive effect on the company's results.

Carlos Grau Serra

Reference letter: Grupo Recoletos

Joaquin Güell Ampuero
Managing Director

Madrid, 31 August, 2006

To whom it may concern:

The Leverage buy out – LBO – staged by the management team of Recoletos in the first months of 2005 attracted a lot of interest (we received 8 firm offers from interested parties) among the leading national and international players in the world of private equity.

As CFO of Grupo Recoletos, I played a particularly intense role throughout the whole process. Given the interest the operation aroused, our goal was to choose the best partner; one who would contribute to the project's creation of value and maximise the investment's value. To do so, we designed a highly competitive selection process, making special emphasis on qualitative factors such as experience, professionalism, team prestige, sector knowledge and differentiating factors.

As the CEO of InvestIndustrial in Spain, Martín showed great interest in the operation from the very beginning of the process and played an active role in all of the entry negotiations, convincing us in the management team and our advisers of the differentiating and enriching factors for the project that his team could provide. Additionally, we personally knew his worth, and professional reputation, which were very relevant factors we took into consideration when we made the final decision to bring InvestIndustrial into the Recoletos project. Later on, he was involved in the investment for a few months until October 2005. During this period, his contribution to defining the company's strategy and monitoring the management was very valuable.

Sincerely,

Source: Realza Prospectus

Exhibit 4: Summary of Principal Terms for Realza

LEGAL STRUCTURE	The Fund will be formed as a Spanish regulated simplified scheme private equity fund (the "FCR") established under the Private Equity Act and registered with the CNMV, and any parallel investment vehicles as required, subject to substantially the same terms and conditions (the "Parallel Funds"). Each vehicle will participate proportionately in all investments on substantially the same terms and conditions
MANAGEMENT COMPANY	Realza Capital SGECR, SA, a Spanish regulated private equity management company (*Sociedad Gestora de Entidades de Capital Riesgo*) duly incorporated under the Private Equity Act and registered with the CNMV, will be the management company of the FCR and any other Parallel Funds established in Spain. The Management Company will be responsible for identifying, making and realising suitable investments for the FCR and the Parallel Funds and for the administration of the FCR and any other Parallel Funds established in Spain
PROMOTERS	Alfredo Zavala and Martin González del Valle or their successors from time to time
SIZE OF THE FUND	Total Commitments of the FCR and the Parallel Funds are targeted to be €150 million with a maximum of €200 million
INVESTMENT PERIOD	Commitments will cease to be available for draw-down 5 years after the final closing of the Fund (the "Investment Period"), provided that Commitments may be drawn down thereafter to the necessary extent: (a) to make investments where a letter of intent or agreements have been entered into before the end of the Investment Period; (b) to pay the Management Fee, expenses and liabilities of the Fund; and (c) to make investments other than New Investments (provided however that in this latter case, such investments shall not exceed the lower of: (i) 15% of Total Commitments; or (ii) total undrawn Commitments)
COMMITMENT	The minimum investors' Commitment to the Fund, subject to the Management Company's discretion, will be € 3 million
PROMOTERS' COMMITMENT	The Promoter's will commit to the Fund an amount equivalent to 2% of aggregate total commitments which shall be allocated as follows: (i) 1.5% shall be co-invested, *pari passu*, with the Fund in all portfolio company investments; and (ii) 0.5% shall be directly invested in the Fund through the subscription of the corresponding Commitment

Term

The Fund will terminate ten years from the date of the final closing, but, subject to prior approval of the Supervisory Committee, it may be extended for up to two additional one year periods, at the discretion of the Management Company to provide for the orderly realisation of investments

Drawdowns

Commitments will be drawn down in euro on an "as needed" basis on no less than 10 business days' notice

Management Fee

As of the First Closing and until the end of the Investment Period the Management Company will receive an annual management fee (the "Management Fee") equal to 2.0% of Total Commitments

After the end of the Investment Period and until the liquidation of the Fund, the Management Fee will reduce to 2.0% of the following:

(i) Total Commitments drawn down;

(ii) plus undrawn amounts corresponding to the reserve for investments other than New Investments which the Supervisory Committee has authorised the Management Company to take into account for the purposes of calculating the Management Fee;

(iii) less the acquisition cost of investments realised or written off

The Management Fee, or drawings on account thereof, will be payable semi-annually in advance

Investment Related Fees

The fees received by the Management Company as transaction fees, break-up fees and other investment-related fees from the making of Fund's investments, for an amount equivalent to the abort costs incurred by the Fund not previously recovered, will be offset against the Management Fee for the relevant accounting period

80% of the remainder investment-related fees received by the Management Company will be for the benefit of the Fund (by credit against the Management Fee)

Establishment Costs

All preliminary expenses (including but not limited to travel, legal, accountancy, printing and other costs) incurred in relation to or in connection with the establishment of the FCR and the Parallel Funds (the "Establishment Costs") will be borne by the FCR and the Parallel Funds up to 1% of Total Commitments (plus any VAT)

The Management Company will bear any Establishment Costs in excess of this amount. No placement fees will be borne by the Fund

Operating Expenses

The Fund will bear its own operating expenses (inter alia legal, tax, audit and insurance fees) and costs arising from uncompleted transactions (abort costs)

Carried Interest

The Promoters will be entitled to a carried interest equal to 20% of the aggregate Fund's profits, subject to investors first receiving repayment of drawn down Commitments and the Preferred Return

Preferred Return

An amount equivalent to interest at an annual rate of 8% (compounded annually) on Commitments drawn down and not repaid (the "Preferred Return")

Distributions

All income and realisation proceeds will, after satisfying any expenses and liabilities of the Fund and subject to payment of the Management Fee and the re-investment rights described below, be distributed as follows:

(a) first, to the investors in repayment of their Commitments drawn down;

(b) second, to the investors in payment of an amount equal to the Preferred Return;

(c) third, to the Promoters until they have received 20% of all amounts distributed after repayment of the Commitments) and

Carried Interest Escrow

Prior to the date:

(a) when the investors have received distributions of the drawn down and undrawn Commitments and the Preferred Return; or (if earlier)

(b) the termination of the Fund;

the Management Company shall retain within the Fund the following percentage amount of the carried interest distributions which would have been made to the Promoters:

(i) 30% during the first two years as from the final closing;

(ii) thereafter, 20% during the third and fourth years as from the final closing; and

(iii) thereafter, 10% during the fifth year as from the final closing

Clawback

The Promoters will be subject to clawback provisions with respect to any excess of carried interest received

Re-investment

The Management Company shall not be obliged to distribute Fund's proceeds where the Fund is entitled to re-invest these amounts

The Management Company shall be entitled to reinvest the following amounts:

(a) those amounts received by the Fund from divestments of bridging investments or underwriting transactions (up to the amount of their acquisition cost in each case) where such commitments or investments are sold down within 12 months of the making the commitment, bridging investment or underwriting transaction;

(b) those amounts received by the Fund on the realisation of any investment arising within 12 months of the making of the investment (up to the amount of its acquisition cost); and

(c) proceeds from deposits or short-term negotiable instruments made or acquired for management of cash-flows and other liquid assets of the Fund

Co-investment Opportunities

The Management Company, at its sole discretion and in the best interests of the Fund, may offer co-investment opportunities to investors in the Fund or to third party investors (including strategic investors), if the Management Company considers it to be in the best interests of the Fund

In case they are offered to investors in the Fund, they shall be offered in accordance with the following order of preference:

(a) In the first place, to those investors whose commitment is greater than or equal to €15 million, pro rata to their respective commitments;

(b) if in accordance with section (a), above, any one of the investors does not accept the co-investment opportunity offered thereto in its entirety, the other investors whose commitment is greater than or equal to €15 million may accept the offer of the remaining co-investment opportunity, pro rata to their commitments;

(c) in the event that, in accordance with the provisions of section (a) and (b), above, there should be a remainder of the co-investment opportunity, this may be offered, at the discretion of the Management Company, to any other investors and/or third party investors

The co-investment opportunities shall, in any case, be offered and made in the same terms and conditions as the investment made by the Fund, procuring that the expenses related to said

Key Executives	Alfredo Zavala and Martín González del Valle will be the key executives (the "Key Executives"), primarily responsible for the Fund In the event that during the Investment Period, any of the Key Executives cease for whatever reason to devote substantially all of their business time to the Fund, the Investment Period will be automatically suspended and Commitments may only be drawn down thereafter in order to settle prior liabilities and ordinary expenses of the Fund The Management Company shall give notice of this event to investors which may resolve by means of an Investors' Special Consent that: (a) the suspension of the Investment Period shall be resumed; (b) the Investment Period shall be terminated; or (c) the Fund shall be liquidated
	investments, as well as the remainder of obligations, shall be shared by the Fund and the co-investors, pro rata to the amount invested by each one of them The Management Company shall make reasonable efforts to ensure that co-investors do not dispose of any investment in a portfolio company before the Fund disposes of its investment in such portfolio company Any disposal of an investment in portfolio company shall be made at substantially the same time as the Fund unless the co-investors desire to hold the investment until a later date and the Management Company considers that it would not be contrary to the best interests of the Fund

Source: Realza Prospectus