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EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

EPFSF Briefing: Private Equity

The growth of the private equity industry and its increasing role in the economy have led to an intense political debate, extensive press coverage and an increasing interest from the public in the private equity asset class. A broad debate has been opened regarding the nature and activities developed by private equity firms.

A. Introduction to Private Equity

Private equity provides equity capital to enterprises not quoted on the stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the **buyout and buyin** of a business by experienced managers may be achieved using private equity funding.

Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business.

The **typical characteristics** of the private equity industry are:

- Investment by a dedicated professional team, predominantly in unquoted companies
- Drawing capital from a defined pool of limited partners/investors
- Negotiated contractual relationship of fund managers with qualified/professional investors
- Profit-sharing schemes which align fund managers' interest with investors'
- Strong self regulation with defined reporting, corporate governance and valuation requirements
- Involving stand-alone management of each individual company
- Involving active ownership supporting the investee company's managers and driving value creation
- Investing on the basis of a medium to long-term strategy and holding period
- With a focus on financial gain through exit by sale or flotation.

The European private equity industry has seen **5 consecutive years of investment growth**. Between 2002 and 2006, €212 billion were invested across Europe in over 37,500 companies. In 2006 alone, €71 billion were invested in over 7,500 companies. 90% of those companies receiving private equity backing, employed less than 500 people.

Private equity firms in Europe raised a record €112 billion in 2006. Of the total, €84 billion was allocated to buyouts and €17 billion to venture capital, an enormous rise of 60% on the €11 billion raised in 2005 and the second highest amount raised for venture since the €22 billion all-time record of 2000.

In 2006 **pension funds** were once again the largest institutional investors, next to insurance companies and banks, boosting their contribution to 27.1% of the total funds raised by private equity funds, benefiting from high returns to be distributed to million of pensioners. However, to put this in perspective, it is estimated that pension funds globally have only invested about 2% of their assets in the private equity sector.

B. Overview on different positions

- Following a Green Paper on investment funds launched in July 2005, the European Commission appointed a group of experts with the aim to analyse ways in which the European environment for the sector could be improved. The report released in July 2006 "Developing European Private Equity" highlighted and identified useful EU-level improvements that could facilitate cross-border investments and capital raising by private equity funds.
- This report has been followed by other European Commission initiatives. In March 2007, a report on "Removing cross-border investments for private equity and venture capital funds" was released, and an expert group on "Removing tax obstacles to cross-border venture capital investments" has recently been launched.
- On 29 March 2007, an expert report on "Hedge Funds and Private Equity, A critical analysis" was published by the European Parliament Socialist group. The report was commissioned by Poul Nyrup

Rasmussen, former Danish Prime Minister, and Ieke van den Burg, Dutch MEP and Spokeswoman on economic and monetary affairs. The report argues for stronger regulation of hedge funds and private equity.
• The European Commission, IOSCO and OECD are among the international organisations that have recently reviewed private equity. OECD members agreed on 7 June 2007 that the corporate governance practices of private equity firms (and hedge funds) are best addressed within the framework of the existing OECD principles of corporate governance, rejecting the idea of a separate code for alternative investment managers.

Within the general discussion of the private equity sector as a driver of healthy corporate change, there has been a discussion in the UK and US about the relatively favourable tax treatment of carried interest as capital gains in the hands of private equity executives. This tax treatment is generally available to other classes of investors, and so the issue is not specific to the private equity sector.

C. The current challenges of the European private equity industry

1. Transparency and prudential rules

The private equity industry has developed on the basis of privately negotiated agreements between private equity fund managers and their "professional" investors. The industry adheres to self-imposed standards which have been developed in conjunction with investors/clients. In addition to the control agreed between managers and investors, the industry has adopted self-imposed codes of conduct, encompassing all aspects of its activities: from valuation and reporting to investors to corporate governance principles for the management of the fund and of the portfolio companies. Adherence to these standards represents an essential element in establishing and maintaining confidence and trust between market professional and investors. Most recently, the BVCA has announced a high level working group to assess the adequacy of current disclosure arrangements for investors in equity portfolio companies, the clarity and consistency of practice with regard to valuation methodology, and the disclosure to investors of returns and fees, with a view to establishing a voluntary code of compliance with appropriate standards. Although the BVCA is a UK organisation, the work group's findings will likely have resonance internationally.

2. Appropriate regulatory action

There are different layers of regulation. There is no EU-level regime governing the regulatory approach to the private equity sector per se, but a number of EU financial services directives apply to the activities of private equity, and most Member States regulate part or all of the private equity value chain. As a result, the fiscal, legal and operating environment in which a private equity fund may develop is determined largely at national level.

The **main areas of regulation** cover:

- Management of pooled investment vehicles and funds
- Placement to eligible investors
- Tax incentives and restrictions
- Accreditation and/or supervision of the funds and/or management companies

2.1 National regulation

Regulation varies across the European Union Member States. Investors and investment managers are faced with various layers of tax and legal barriers. Private equity funds, therefore, are often liable for separate registration or establishment in each Member State and are due to invest through complex parallel vehicles established in non-home countries when operating across borders.

The UK FSA has published feedback after a consultation on several potential risk factors (including excessive leverage, market abuse, and conflicts of interest) in the private equity sector. The FSA concluded that there is no present need for a specific set of regulations for the sector, but it confirmed its intention to include the sector within the purview of its Alternative Investments Centre which will monitor developments. The FSA has also indicated that it will survey leveraged lending activity in the UK semi-annually.

2.2 EU regulation

Private equity funds fall outside the direct scope of EU legislation. However, there are a number of EU Directives which affect the activities of the private equity sector, even though none are specifically aimed at the private equity industry (e.g. Market Abuse Directive, Prospectus Directive, MIFID, Takeover Directive and Transparency Obligations Directive).

3. Economic and Social Contribution to European Competitiveness

To achieve the Lisbon Agenda and a level of competitiveness sufficient for Europe to stand tall against other economies, companies are required with strong management and with the ability and knowledge to adapt to market and financial cycles. This is where venture capital, private equity and buyout models are able to contribute, bringing efficient ways of corporate development to all kinds of companies - albeit in different ways - and across all segments of companies.

Private equity firms provide more than just financial support. In addition to monitoring financial and operating performance, private equity is about adding long-term value through the implementation of a strategic vision and about acting as a sounding board for management ideas. Private equity firms are a key source of contacts and networking opportunities, and assist with the recruitment and development of management.

Moreover, private equity encourages European employment: between 2000 and 2004 European buyout and venture capital financed companies contributed to the creation of one million new and qualified jobs and thus to the concept of a "Europe of Excellence”.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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