

## **EPFSF Lunch Discussion**

10 November 2009, European Parliament, Brussels

### **“Alternative Investment Fund Managers Directive (AIFMD)”**

**Speech from Anne Holm Rannaleet**

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Chairman of IK’s Industrial Advisory Board**

Ladies and Gentlemen,

It is a pleasure for me to be here today and to have this opportunity to engage in dialogue with you all. Sometimes when I follow the debate around the private equity industry I do not recognise myself nor the activities, threats and risks as described and that worries me.

#### **More than 20 years of PE experience**

I have been active within the PE industry since more than 20 years. I was part of the team that raised the first ever buy-out fund active in the Nordic region in 1989 and IK has done five more fundraisings since then, with continued support and encouragement of our investors. We have invested in more than 60 European businesses in a number of different sectors and have exited some 40 of these, mainly through sales to industrial buyers.

#### **Best of two worlds**

For me, with a background of 10 years in the automobile and manufacturing industry and then another few years in investment banking, PE combines the best of two worlds. First of all, private equity is more about ownership than asset management. We invest in the real economy. We as an industry are owners of companies in all stages of development – from very early stage spin-offs coming from universities, small technology and biotechnology start-ups, companies needing support in growth and expansion stages, to giving mature companies a second chance, acting as catalysts for change in companies where growth and development have come to an halt or which have not been allowed to develop to the full of their potential.

#### **The Corporate Governance model is key**

To me – the key characteristic of private equity is the corporate governance model. This is also what unites all the different stages of private equity investing.

In a world where private ownership of companies generally is on a decline, where many family owned companies do not make it through the succession stage and more and more public companies are in the hands of institutional owners who focus on quarterly earnings development, there is a need for a complementary ownership model that also provides longer term capital. Private Equity provides companies with focused and dedicated ownership which supports necessary change, development, and growth over a longer cycle based on a development plan which is often laid out over 3 -7 years.

## **Driver of performance is ability to transform businesses**

While credit may have been a driver of additional activity in the boom years of 2004-2007, the real driver of performance for PE investors and their end-investors, like the pensioners, has historically been and will always remain - the ability to transform businesses.

Working closely together with management teams in refining strategies and processes as well as identifying new opportunities for growth enables us to build best in class companies. Whatever the economic conditions the corporate governance structure allows us and our portfolio companies to act early and decisively in addressing both threats and opportunities. It is very easy to call the board together when needed to take quick action.

Whereas in a public company owners may have different agendas and time horizons for their investment meaning that much time in board meetings is spent on aligning these and seeking compromise solutions, private equity has the benefit of working through majority ownership (either alone or together with like-minded parties) with a well developed business plan and a “sense of urgency” to put it into play.

## **Alfa Laval example**

When we bought Alfa Laval back in 2000 from privately held Tetra Laval it was a reasonably large company with global sales of more than 1,5 bn EUR. However, within the much larger Tetra Laval group it was somewhat of a corporate orphan as it was not part of the core business. Sigge Haraldsson, the CEO of Alfa Laval at the time, has said that while part of the Tetra Laval group he would at best get some 40-50 minutes at the end of a quarterly Tetra board meeting to address specific Alfa Laval issues whereas when he came under IK ownership he would receive 4-5 hours of undivided attention at 5-6 board meetings per year with full focus on Alfa Laval development and matters. This focus and quick decision making process allowed us to change the sales foot print of Alfa to match that of its customers. Organised in a traditional way, Alfa Laval was still working with country based sales offices while its customers increasingly used centralised purchasing. It thus made far better sense to instead organise the sales offices regionally by customer segment, i.e. catering for the oil industry from one location, the food and beverages industry from another. When we exited the company through listing it on the Stockholm stock exchange it was a better focussed, much more efficient company with stronger margins and which has since continued to show strong growth in sales and earnings and is often among the analysts' buy recommendations.

I strongly believe that PE has a very important role to play as a transitional owner for companies during certain stages of their development.

## **Private equity's contributes to the real economy**

The global PE and VC industries have over the recent years invested an average of almost €80 billion per year in Europe, this is equivalent to 2/3 of the EU budget.

The industry has raised over 370 billion collectively in Europe over the last 5 years – much of this from pension funds which represent 25% of all capital raised, and insurance companies that account for 10 % of the funds raised. PE and VC offer important investment opportunities – both from a return and diversification perspective – for European pension funds and insurance companies.

PE and VC investment and fund raising brings in €30 to €50 billion a year in outside investment to finance the EU economy. Conversely, €30 to €50 billion a year raised in EU provides EU investors an important avenue to invest outside the EU.

**Private equity is different from most other alternative investment fund managers who predominantly invest in financial instruments and markets.**

Private Equity does not invest in or trade in securities or other types of financial instruments. Our investments are in companies and we hold these investments over longer periods. Each fund will have no more than perhaps 12-15 portfolio companies.

Given the long investment period (usually 4-7 years), **private equity funds are also closed-ended** – meaning investors **do not have redemption rights** (that is the right to withdraw funds) over the life of the fund (generally 10 years with 2-3 one year extensions possible). Investors know when they invest in a PE fund that they will only get their money back as and when the underlying portfolio companies are sold/exited. Funds are in addition not paid in on day one but called as and when investments are made. In addition **PE funds are not leveraged.**

This means that unlike most other types of ‘funds’, a private equity fund does not hold investors’ money but it has a right to draw down a pre-agreed sum (what we call the investor’s commitment) as and when needed to make investments and to pay Fund expenses (generally giving the investors 10 business days prior written notice). Private equity funds are further not ready made off-the-shelf products marketed to investors but **heavily negotiated agreements** with a limited number (20-40) of institutional investors that spend up to 6 months on due diligence of the fund, the manager and its investment professionals. These investors further expect the investment professionals to invest along side with them in the fund, **sharing the risk.**

As many of these **investors (the pension funds) are tax exempt** in their home countries it is very important to them that **the fund is structured in a tax transparent** way so as to avoid any double taxation. Hence the frequent use of Channel Island structures by many European PE firms that raise funds for cross-border investments internationally.

**Private equity’s main concerns with the proposed Directive**

As an industry we are not opposed to regulation as such. We are already regulated in several parts of Europe. Nor do we oppose sharing information with regulators and our investors. Investors in PE already have access to more information about their PE investments than their public ones. But as currently worded there are a number of provisions in the Directive which when applied to Private Equity bring **no additional benefits but only create an un-level playing field and act contrary to investor’s interests and can be directly harmful to the competitiveness of portfolio companies in sensitive stages of their development.**

## **So which are our main concerns?**

**Improvement of the Scope:** There needs to be an adequate threshold so that smaller managers and their portfolio companies (that in no way are systemically important) are not unnecessarily caught. In addition the Directive should provide PE and VC with a level playing field vis-à-vis other private investors. This is currently not the case.

## **Valuator, Depositor and Capital Requirements – way out of proportion**

The proposals on liquidity and capital requirements need to be tailored to the specific business model of the industry. As mentioned earlier, PE funds do not hold cash in their accounts, funds are not leveraged nor are there early redemptions. Investors know that their investments are long-term and illiquid and that cash is only returned as and when investments are exited.

Furthermore, the requirements for an independent valuator and the appointment of a depositary are of no added benefit to PE and its investors. Segregation of assets – and here we talk about share holdings in a limited number of unlisted companies – already takes place in PE as the fund is entered as owner in the share register of the portfolio companies. PE funds do undertake regular valuations of their investments as agreed with their investors, often in accordance with the industry valuation guidelines. These valuations serve no real practical purpose and merely serve as a guiding star to investors as to what return the fund will eventually generate. As PE funds are closed-ended there are no redemptions by investors for which valuations would be needed. Nor are PE managers paid fees on the basis of valuations. Fees are paid based on commitments and the profit sharing resulting from the co-investment and joint risk taking only takes place when the portfolio companies are sold and money is on the table. Imposing these requirements as currently worded will be an additional burden on the fund without providing tangible investor or market benefits.

## **Revision of Disclosure Requirements:**

Private equity owned companies are bound by the same national laws on disclosure and information to employees as other companies of same size. These obligations lie with the company and its board of directors and are not related to ownership. To now impose additional disclosure at the portfolio company level for PE/VC owned companies would be in direct conflict with company law and would discriminate PE/VC vis-à-vis other private investors. It also introduces an un-level playing field for these portfolio companies vis-à-vis their competitors.

## **Improvement & Clarification of a fair Third-Country Regime:**

As currently worded EU investors would be prohibited from investing with non-EU based managers. This has a direct negative impact on their ability to carry out risk diversification strategies and achieve returns which will have a direct negative impact on their returns and the returns for pensioners or insurance takers. What we in daily life consider as European funds technically under this Directive become third country funds as the managers, for investor tax transparency reasons, are based in e.g. the Channel Islands. The proposed Directive also raises concerns about whether we will see a reduction of investment and capital flows into the EU as a result of the proposed measures. This reduction of the free movement of capital cannot be in our common interest in times when the European economy is already under heavy strain with huge budget deficits, aging populations and facing competition from more expansive regions like Asia and the US. We need to be able to invest in growth and new industries and attract capital to Europe and European businesses, not put obstacles in places where no additional benefits can be seen.

**Introduction of Grandfathering Clause:**

The proposal has the potential to create huge amounts of legal uncertainty around existing funds which as previously noted are based on negotiated agreements with investors. Given that private equity funds have an average lifespan of 10 years and are directly invested in illiquid portfolios (ie companies), this could create significant problems for the funds and investors if additional costs are to be allocated or funds are forced to wind-down pre-maturely leading to fire-sales of portfolio companies.

The above are just a few examples of where we believe the Directive could be improved in order to ensure that it is appropriate, proportionate and fair in relation to private equity.

Thank you for taking the time to come here and listen and I will be happy to take any questions that you may have.