Private Equity as a catalyst for growth in the EU

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Private equity and firms managing PE investments have a key role to play in defusing the "retirement time bomb" and might be strong catalysts for meaningful growth within the European Union (EU).

Private equity (PE) as an asset class for pension funds has the potential to create a virtuous circle; it could boost local grass-roots economies, offer returns to consistently outperform those of more conventional investments, and, by providing the most efficient means for injecting capital into the real economy, create new jobs and local tax revenues.

However, to realize this potential, the sector and its actors face, at best, an unfavorable and, at worst, a hostile regulatory and political environment.

Mainly due to the ageing population and a significant increase in the number of pensioners, pension financing will become a major issue in Europe. For that reason, the pension reform system is part of the European Union's (EU) 2020 strategy.

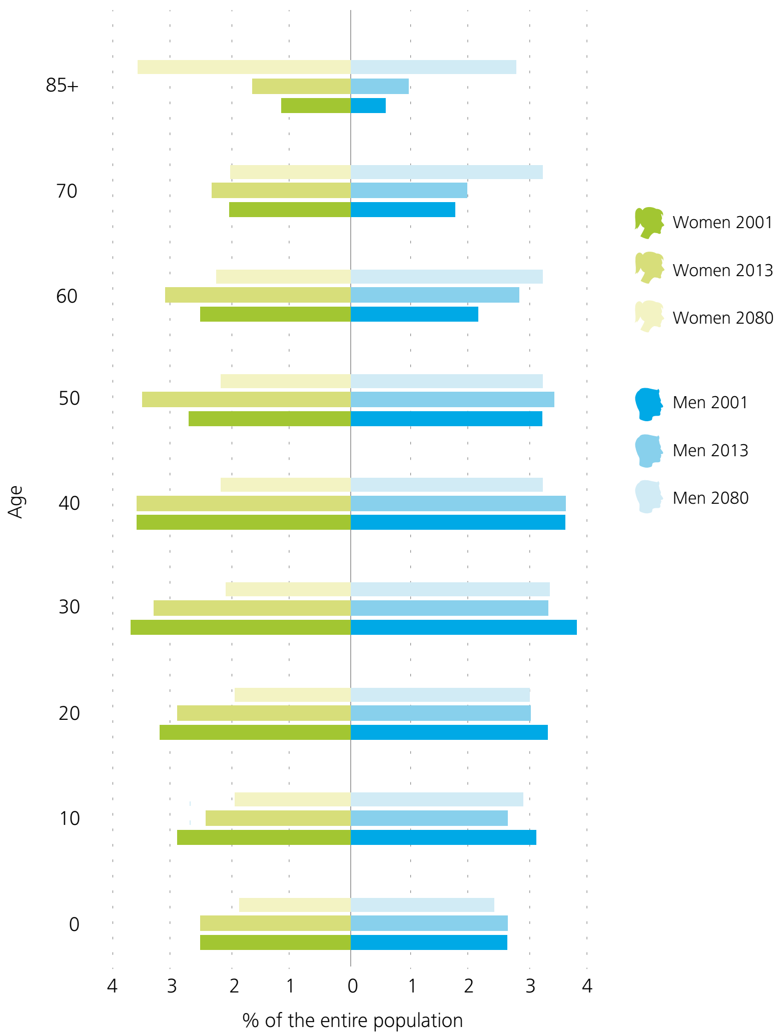
According to the OECD predictions, the pyramid of ages will be changing over the next 50 years with a significant increase in the elderly population as shown in Figure 1.

In 2080, people aged 65 and over will become a much larger share (rising from 17 percent to 30 percent of the population), and those aged 80 and over (rising from 5 percent to 12 percent) will almost become as numerous as the young population (0 to 54 years).

As a result, the demographic old-age dependency ratio (people aged 65 or above relative to those aged 15-64) is projected to increase from 26 percent to 52.5 percent in the EU as a whole over the projection period.
In other words, the EU will move from having four working-age people for every person aged over 65 years to two working-age persons.

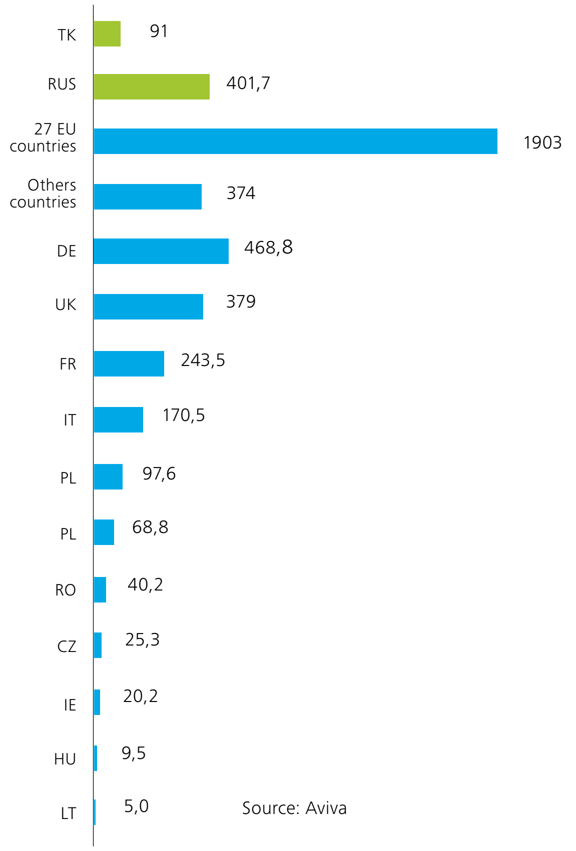
It will therefore become increasingly difficult for working people to contribute to the pension system for the entire retired population as shown in the below figure. This was also stated during the 2011 Horizon conference.

Figure 1: European population pyramid in 2001, 2013, and 2080



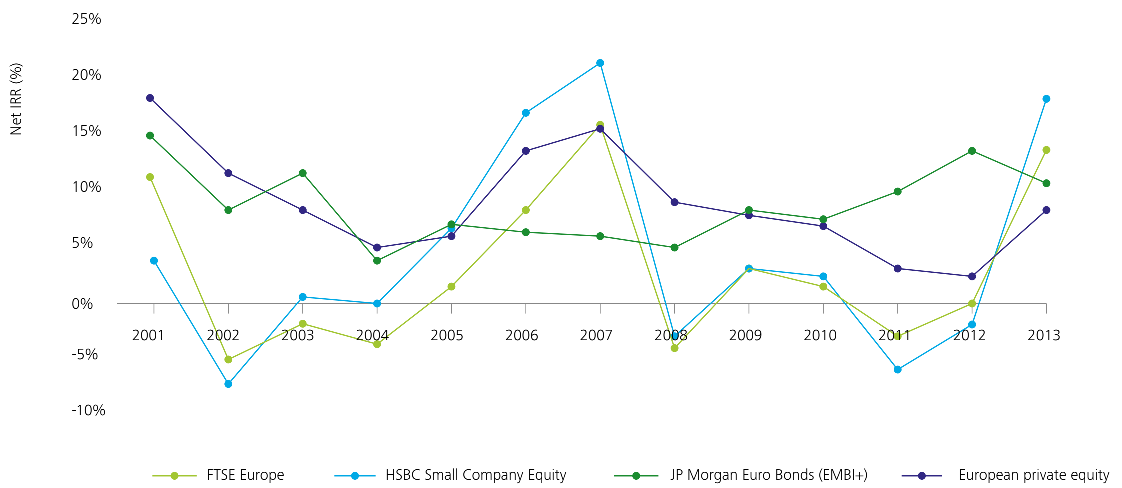
Source: eurostat

Figure 2: Total annual deficit of retirement savings in the European Union for persons retiring between 2011 and 2051 (EUR billion per year)



Source: Aviva

Figure 3: European private equity performance compared with other European indicators



Source: 2013 pan-European private equity benchmark study EvCA - Thomson Reuters

That's why it is critical for the pension funds to invest in products offering higher returns than traditional financial products (equities, bonds, etc.). In that respect, private equity investments present a number of advantages:

1. **Their investment returns are generally higher than the ones of other traditional investments, especially on the long run.**
   According to the EvCA 2013 Pan-European Private Equity Performance Benchmarks Study, private equity funds outperform the performance of public markets. Figure 3 demonstrates that over the last 10 years, private equity indexes have globally outperformed the other indexes.

2. **Private equity funds might also foster economic growth, creating therefore a virtuous circle.**
   By offering their investors the possibility to invest in long-term products, private equity funds provide small and medium-sized companies (SMEs) with capital at different stages of their growth: when they are a start-up, needing capital to expand or access new markets, when they are close to bankruptcy, in financial distress, when they are family-owned companies requiring succession planning, etc.

   Besides, most private equity general partners also provide managerial expertise and specialized industry know-how to their portfolio companies.

As a consequence, a number of studies performed across Europe demonstrate that private equity has a positive impact on the portfolio companies' survival rate, which might address the concerns raised from public authorities and investors fearing that high leverage could have a negative impact on the portfolio company survival rate as the greater the use of leverage, the greater the risk of default.

Figure 4 shows that each year 80 to 400 companies domiciled in Europe avoid failure thanks to private equity financing.

Figure 4: Private equity-backed firms' failure rate

	BIS (2008)	Kaplan and Stromberg (2009)	Thomas (2010)
Number of private equity portfolio companies	21,000	21,000	7,000
Average company failure rate	7.5%(1,575 companies)	7.5%(1,575 companies)	7.5% (525 companies)
Private equity impact on company failure	5% lower	25% lower	50% lower
Estimated number of annual company failures avoided due to private equity participation	80	400	260

Source: Portfolio company data from EVCA, company failure rate data from Eurostat, impacts from BIS (2008), Kaplan and Stromberg (2009), Thomas (2010). Note that estimates by Thomas apply to buy-out investments only.

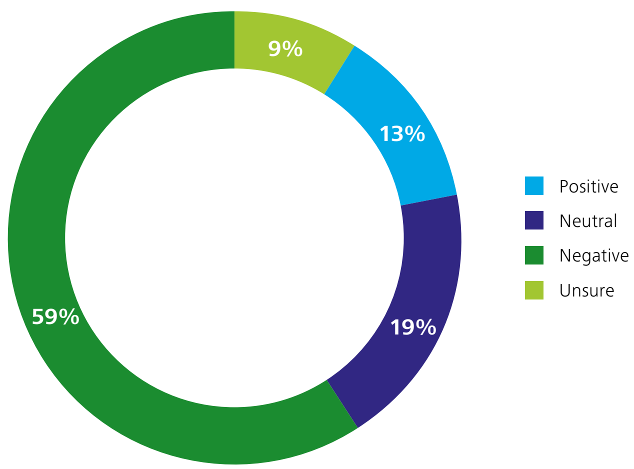
Similarly, a number of research studies conclude that private equity financing participation leads to more sustainable employment. The European Commission funded VICO project had indeed found out that private equity investments are negatively correlated with the unemployment rate.

However, pension funds have been facing a number of constraints regarding investments in private equity funds:

Constraint 1: Bad reputation

Private equity funds suffer from a bad reputation as they are often seen as the funds who will rationalize the companies rather than helping them grow. According to the study performed by (Preqin, 2014), almost 60 percent of the public have a negative perception of private equity funds and only 13 percent have positive feedback. Still, according to Preqin, media have been playing a major role in this negative perception.

Figure 5: Investors' views on public attitude towards private equity



Source: Preqin Investor Outlook: Alternative Assets, H1 2014

This negative perception has also been shared by the European authorities (Rasmussen, 2009) who raised two major concerns:

- PE firms consider privately held companies as a "class of assets" rather than companies
- PE firms are a very specific type of shareholder. They hold companies with a view to resell them, with a strong control on management, but they have in reality a low commitment to the company's prospects and long-term survival

Constraint 2: Regulation on pension funds

Legal constraints preventing pension funds from investing into private equity funds could also become tighter should IORP II's requirements align to Solvency II ones.

While we address here public and private pension schemes (and not individual savings schemes in scope of Solvency II), we would like to highlight the potential impacts of Solvency II on private equity investments as some clauses of IORP II (applicable to private pension schemes) could be aligned to Solvency II ones.

The most significant Solvency II constraint for private equity investments might be the application of the Solvency Capital Requirement (SCR), which is higher for private equity stocks, potentially limiting the interest of pension funds and insurance companies in private equity underlyings.

Constraint 3: Regulation on private equity funds (AIF), namely AIFMD

AIFMD presents some constraints for private equity funds that might be unsuitable given the type of business, and notably along the following aspects:

1. **Risk management and portfolio valuation**
   AIFMD requires that the risk management and portfolio valuation functions be independent from the portfolio management's one. Contrary to hedge funds and funds of hedge funds, a private equity fund's portfolio manager will select a target company and follow-up on a day-to-day basis the performance of this company. In doing so, the portfolio manager will perform a valuation of the company and also assess the risks related to the company at the investment stage as well as throughout the investment period until the divestment stage. In other words, risk management and portfolio valuation are part of the duties of a private equity fund's portfolio manager. Having independent risk management and portfolio valuation functions would generate extra costs with very limited added value.

2. **Liquidity management process**
   AIFMD specifies requirements for funds that hold investments with "limited liquidity." Private equity falls into this category. AIFMD notably requires a process that must be put in place regarding how these assets should be managed and documented by the PE manager. We believe that such requirements represent a substantial task with a limited added value as private equity investments are long-term and therefore illiquid.

3. **Asset stripping**
   Asset stripping may happen in various contexts. It may be done, for instance, when the target company is performing well and the private equity fund wishes a quick reimbursement of its acquisition debt; or, on the contrary, it may be implemented when the target company is overloaded with the acquisition debt and its survival requires a quick sale of assets.

   AIFMD introduced limitations on asset stripping. Private equity funds would not be allowed for two years to perform any distribution, capital reduction, share redemption, or acquisition of own shares by such companies. Also, the private equity fund wouldn't be authorized to vote in favor of such events and will be making its best efforts to prevent such events from occurring. These restrictions mainly affect private equity with LBO and distressed / turnaround strategies; therefore, in these cases, private equity funds would have to take these restrictions into consideration when planning to make an acquisition as they may impact the timing of their expected returns.

We have two concerns about the asset stripping constraint:

- If the private equity is not allowed to perform asset stripping, it does not have the flexibility to rationalize when the target company is in financial distress; therefore, in the end, the target company goes bankrupt, which is a lose-lose situation
- Also, this constraint only applies to private equity funds domiciled in Europe. Private equity funds domiciled outside Europe can perform asset stripping on European-based target companies, which does not solve at all the problem

The sector and its actors face, at best, an unfavorable and, at worst, a hostile regulatory and political environment

4. Transparency

AIFMD requires full transparency to regulators and investors before they invest. The main noteworthy requirement is disclosure of remuneration details, which is a major change for private equity funds who used to keep remuneration information confidential. Also, the fund will have to provide full information to the investors on the portfolio activity (target companies selected, leverage used, etc.). While these new requirements bring useful data to the funds investors, they generate significant extra costs to the fund to collect, compile, and disseminate those data and documents.

While it is important to provide sufficient information to the fund's investors, we believe the requirements of the Directive go too far as they are as restrictive as the ones applied to UCITS, which are sold to retail investors whereas only institutional investors can buy AIF. This constraint also generates extra costs with limited added value.

5. Leverage

AIFMD stipulates new ways to calculate leverage (Gross & Commitment methods) and adds new reporting requirements. We believe that these requirements are not really applicable to Private Equity funds as Leverage happens at the level of the Portfolio companies rather than at the level of the Fund.

European authorities are setting up ELTIF to foster Long term investments

European authorities are becoming however more and more aware that long term investments are correlated to and foster economic growth. They are currently working on a new type of fund - the ELTIF or European Long Term Investment Fund[1] which would still be under the AIFMD but would be designed for long term investments (notably in infrastructure). The specificities of the ELTIF will be that:

- This fund type would be open to Retail Investors (currently funds which can invest in Private Equity funds are only opened to Institutions) subject to certain minimum criteria in terms of net worth and total portfolio exposure to the asset class.
- The fund would be closed: Regulated European funds offered to Retail Investors are open, meaning that a Retail Investor can redeem his fund shares when he wishes. In this case, the Retail Investor would only be able to redeem his investment after a period stated in the prospectus of the fund (5 to 10 years generally).

While ELTIF will incentivize investments in Private Equity and similar funds as well as the very specific sector of infrastructure, although some barriers remain:

- AIFMD compliance will still be required
- As these funds will also be offered to Retail investors, the full set of documentation aimed at Retail investors will be required and probably investor education above and beyond the intended PRIIPS KID[2], notably to avoid retail investors forming misconceptions as to the nature of the product. The public sponsorship of the formula by the European Commission could lead investors to the erroneous conclusion that the product benefits from some form of European guarantee.

As such, ELTIF might not yet be the “ideal” response to the constraints raised above.

1 ELTIF will become applicable in member states from 9 December 2015

2 “Packaged Retail Investment and Insurance-based Products Key Information Document.”

That’s why it is critical for the pension funds to invest in products offering higher returns than traditional financial products (equities, bonds, etc.). In that respect, private equity investments present a number of advantages

Key considerations going forward

As a conclusion, we would recommend to contemplate the following points should we decide to push towards further investments in private equity products.

1. **Educate investors, pension funds, government about the benefits of private equity investments**
   As for the regulatory framework, this one should be adapted to private equity investments while ensuring pensioners’ protection as well as favoring sustainable economic growth in Europe (through private equity investments in European SMEs). In doing so, we could introduce the following points:

2. **Ensure that pension funds wishing to perform investments in private equity companies “use” experts to make private equity investment decisions**
   To better protect the investors, it is critical that the asset managers of the pension funds have a good knowledge of private equity investments. Europe could benefit from the experience acquired in Australia, the United States, and Canada where large pension funds have recruited private equity experts to perform investments in those types of assets.

3. **Ensure that the IORP 2 standard formula for capital requirements does not overstate the capital required to cover the private equity risk**
   For instance, we could for instance:

   - Soften conditions so as private equity vehicles can be categorized type 1 standard calibration (instead of type 2)
   - Ease the internal model validation process for pension funds

4. **Adapt AIFMD to private equity funds**
   We believe that the below AIFMD requirements should be amended or even removed in the case of private equity funds:

   - Having independent “risk management” and “fund valuation” functions
   - Applying the liquidity & leverage management constraints
   - As for the asset stripping requirement, adapt it so as to ensure that a private equity firm has the flexibility to enhance the performance of the company while ensuring that the actions undertaken do not put at risk the portfolio companies’ sustainable growth and employment

5. **Propose an attractive taxation model for pension funds investing in private equity funds investing in European companies (and generating sustainable return)**
   One of the attractive features that was first proposed for ELTIFs was that they should benefit from the most favorable treatment in the hands of the investor afforded in each Member State. It was hoped that by adopting this approach the proposition would not be seen to encroach upon the fiscal prerogatives of Member States but, at the same time, offer a definite incentive for acquiring the product. Alas, the European Council did not see things in the same light and the proposal was struck down.

The paradox – the need for return but the inherent negative treatment of private equity and related investments for pension purposes – Solvency II, proposed similar capital requirements under IORPs rules – is recognised by the industry. It is an area in which the industry in its broader sense is out of step with the European co-legislators[3].

The latest European Commission initiative, however, holds out some hope, as yet perhaps slender, that this may change. Earlier this year the Commission published a Green Paper to consult on Capital Markets Union—a project to stimulate economic growth via greater flexibility and access to capital markets across the European Union and to diversify the sources of funding available to small- and medium-sized companies, inter alia. Specifically, the Commission itself raised the question of Solvency II and CRD IV inviting comment as to their appropriateness for certain asset classes, including infrastructure. The same consultation asks also about improvements that could be made to ensure greater use of ELTIFs or other funds in the private equity space.

Over 700 replies were received to the Green Paper from all spectrums. It would be premature to speak of consensus, but many commentators raised the issues of the punitive reserve requirements on private equity, referenced the initial tax treatment proposed for ELTIFs and, in some cases, even went as far as advocating a pan-European defined contribution pension scheme.

It is a long way to go from this consultation to seeing private equity as a regular and recognized component of all pension plans. However, viewed dispassionately, the case is unanswerable—private equity is at the heart of securing regular growth of the level required to fund retirement aspirations and as a by-product, its inclusion in the eligible universe of pension and insurance investing would stimulate long-term sustainable growth. All that remains is to convince the European co-legislators of the wisdom of this paradigm.

To the point

- An ageing population and a significant increase in the number of pensioners is forcing EU regulators to reform the current pension system. Private equity could potentially assist with the escalating issue of pension financing since it provides pension funds with the possibility to invest in products offering higher returns than traditional financial products
- Furthermore, private equity funds can foster economic growth by reducing the number of companies that go bankrupt. They provide small- and medium-sized companies (SMEs) with capital as well as managerial expertise and specialized industry know-how. Some studies have even shown that private equity financing participation leads to more sustainable employment
- Nonetheless, constraints to private equity funding exist. This alternative investment fund type has a bad reputation of profiting from suffering companies instead of helping them to grow. Therefore, EU legislations, such as such as Solvency II, IORP II and AIFMD, have been put in place to impose a stricter regulatory environment on funds. These regulations and the setting up of a European long- term investment fund (ELTIF) are constituents of an overall strategy to foster long-term investment and promote sustainable economic development within the EU

3 *"Given the legislative process as it exists post Lisbon, legislation has become the joint preserve of the European Parliament, Commission and Council frequently referred to as "co-legislators."*