EUROPEAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

On behalf of the Public Affairs Executive (PAE) of the
EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

5 March 2010, Brussels

Private Equity: Leverage and investment policy at portfolio company level

The Private Equity and Venture Capital (PE/VC) Industry is faced with a series of amendments which may damage considerably the contribution of PE to the financing of the real economy, in particular:

- supporting companies to develop high-risk technological innovation platforms
- helping companies in need for restructuring to rebuild their capital structure and refocus their operations
- helping companies to achieve competitive scale by building a consolidation platform in their sector
- supporting large SMEs to address their succession issue and bringing the company on a path to public listing
- helping subsidiaries of large corporates to build an independent growth path
- providing capital to SMEs notably for innovation and growth initiatives.

As far as we understand, these amendments intend to micro-regulate the operational level of the portfolio companies, via 3 principal means:

- fixing a maximum debt ratio to PE owned companies
- fixing a leverage cap at fund level, whereby the debt of diverse companies controlled by the fund is consolidated at fund level
- fixing a lock-in period (2 to 5 years) for any equity investment by the fund.

The PE/VC Industry cannot accept these amendments as they will be highly damaging to the capacity of PE/VC to bring real solutions to companies.

The PE/VC Industry is ready to work on regulatory proposals which address concerns, both from a public policy and from an investor perspective while respecting the level playing field for investors and companies.

1/ Regulation should respect a level playing field at the company level.

- **Companies competing with each other in the market**, would be placed in a different competitive position, simply because of their ownership structure.

- **The proposed amendments have a direct impact on the availability and the cost of capital for the operating companies,** especially for innovative companies and SMEs who often face difficulty in direct access to loans and a principle lack of capital.

- **Decreasing availability of capital and increasing cost of capital have a direct impact on all strategic aspects of the operations of the company**: its ability to do mergers & acquisitions, ability to focus on the development of innovation and core activities where it is most competitive and ability to attract institutional shareholders through its dividend policy.

Bastion Tower, Place du Champ de Mars 5, B-1050 Brussels, Belgium - Tel +32 2 715 00 20 - Fax +32 2 725 07 04 info@evca.eu - www.evca.eu

- **The lock-in provision would be value destructive** in the cases when cash flow generation is strong and debt levels have been reduced. The cash would still be blocked in the company and would not be returned to the shareholders to be recycled into new investments. **Turnover of capital would be reduced and thereby the capital available to finance new SMEs**, new innovative projects, and new companies faced with restructuring issues.

- **The lock-in provision would be particularly value destructive in the case of VC-backed companies**. They are financed by numerous rounds of equity from different VCs. The latest rounds for the most successful companies often come from new venture capitalists that stay invested only for a short period: 3 to 12 months. The purpose is to ensure those innovative companies have the resources to consolidate market share and balance sheet before exiting via an IPO (initial public offer). This would be impossible with the proposed minimum holding period. As a consequence, the companies would no longer have the choice of investors for the different phases of development. The companies' interests are not being fully considered.

- **The lock-in provision might result in contradiction with competition rules.** Competition authorities very often impose divestments as a condition to authorise mergers and acquisitions. The same holds true when a company faced with restructuring difficulties requires public support according to restructuring state aid rules. Interference of any lock-in provision with such rules should at least be carefully assessed.

- **The leverage cap at fund level would make the ability of a portfolio company to raise capital dependent on the debt ratio of other portfolio companies**, with whom it has no connection, besides sharing the same controlling owner.

- **It does not make economic sense to set generic debt/equity levels.**

  The risk assessment of debt does not only relate to the level of debt, but more so to its structure (senior, junior, subordinated), cost (the yield) and the agreed maturity (repayment schedules).

  The risk assessment must also primarily relate to the specific situation of the company. Companies operating in growth sectors with strong cash flow capabilities or network industries with stable investment perspectives and long term cash flows can support higher levels of debt than industries operating in highly cyclical sectors or companies faced with a declining market or reduced profitability.

  High seasonality in sales, production or purchasing patterns impact debt tolerance levels over the year. And consumer goods companies relying on consumer credit have very different financing and cash-flow patterns than heavy engineering companies where use of advance payments and guarantees result in a completely different balance sheet.

  A company specific risk assessment is exactly the approach expected from financial institutions and Credit Rating Agencies in their due diligence of potential credits and is also applied by the Commission when assessing the market investor behaviour in the case of potential State Aid.

- **Portfolio companies are, like their sector peers, already subject to sector specific rules regarding capital requirements and prudential equity ratio.**

  This is the case for financial institutions, insurance companies, payment services institutions, many of which have benefited from investment by PE. Capital requirements have been reinforced and will be reviewed again in the Banking sector (Capital Requirement Directive) as well as for Insurance companies (Solvency II).

  A lot of companies in these sectors currently need to attract investors, also due to the Commission's decision to impose divestment as counterpart to massive State aid. Why should PE owned banks or financial institutions be subject to specific rules compared to their

Bastion Tower, Place du Champ de Mars 5, B-1050 Brussels, Belgium - Tel +32 2 715 00 20 - Fax +32 2 725 07 04 info@evca.eu - www.evca.eu

competitors? Why would one want to limit the access of banking subsidiaries to new investors like PE?

2/ Regulation should respect a level playing field at investor level.

- **Investors would be placed in a different competitive position**, whereby European investors, investing through a pool of capital, are discriminated against in comparison to sovereign wealth funds, holding companies, family offices or any other owner like a publicly listed company, even though the latter finance their acquisition purely through debt.

- **This will gravely affect the auction process** which is an essential route to market for corporate and government owned assets, the latter as part of state privatization or budget deficit reduction programs.

- **In situations of intended public listing**, it would discourage PE investors from holding a controlling stake in the period after listing, although this practice demonstrates to new public shareholders that long term sustainable value has been created with significant remaining growth potential and capital investments to fund future growth.

- **The investment strategy of Private Equity funds, which are not leveraged at fund level**, which have no redemption rights and hold the portfolio company for several years, which take the responsibility to bring corporate governance and operational support to the company, would be more restricted than active hedge funds who buy minority stakes using highly leveraged funds and exploit market dislocations or market volatility to extract value from the rapid purchase and sale of company assets.

3/ If debt levels are considered to be a concern for the XXIst century economy, this should be treated through appropriate, non market disturbing regulatory rules.

- **The availability of capital in the form of debt is to be controlled by appropriate regulation at the supply side level**, through capital requirements and strict due diligence at the level of the provider of the capital.

  This is the only way to address the issue of leveraged corporate credits building up in the bank or trading books of financial institutions.

- **Any regulatory intervention on debt at demand side should be done through horizontal legislation,** including corporate law, dealing with all companies which are in a similar situation.

  Such preventive rules should be built upon the existing rules at EU and national level.

  Asset divestment and subsequent profit distribution are regulated in EU member states implementing the capital maintenance rules foreseen by the Second Company Law Directive (77/91/EEC). This preventive regulation is reinforced by other general rules such as shareholders'/board members' liability if they act to the detriment of the company.

  Safeguards exist in national law against undue financial assistance and other forms of upstream loans or securities imposed by shareholders to Portfolio Company (including via efficient tax legislations). These strict restrictions on financial assistance are due to the transposition by the Member States of Article 23 of the Second Company Law Directive (77/91/EEC). Any financial assistance shall respect the company's minimal reserves. In most of the jurisdictions, additional limitations have been added (provisions governing by-passing structures and transactions with the same effect as the transactions listed by Article 23 or restricting financial assistance of private limited liability companies).

Bastion Tower, Place du Champ de Mars 5, B-1050 Brussels, Belgium - Tel +32 2 715 00 20 - Fax +32 2 725 07 04 info@evca.eu - www.evca.eu

Article 23 of the Second Company Law Directive has been recently deregulated by Directive 2008/68 adopted by the European Parliament and the Council with the intention to ease change in the ownership. Member States are now permitted to authorise public limited liability companies to grant financial assistance up to the limit of the company's distributable reserves (under certain conditions). One should assume that a thorough impact assessment has been made before deciding in 2008 to soften the most protecting rule in that respect.

In many member states there is tax legislation in place which limits leverage levels for companies by focusing on the deductibility of interests for third party or shareholder loans **or influences the distribution policy to investors** at fund level by focusing on specific holding conditions attached to the capital gain tax regime.

4- PE/VC owned SMEs are already disadvantaged by the prudential standards imposed on financial institutions when they invest in the non listed market. The non listed market should not be punished twice while it is in the best interest of the EU to improve this situation.

- **This problem has been raised by several independent studies** (see notably "Private equity and French capitalism", by the French Council of Economic Analysis, July 2008[1] requesting to "*amend prudential standards overly discouraging of investment in the unlisted market*"…such as "*Basel and Solvency II*").

- **The difficulty for PE/VC to attract existing financial reserves to the financing of SMEs and innovation will be dramatically increased** by the implementation of the last Solvency II update, currently under discussion.

- **It cannot be the intention of the EU legislators to further reduce the capital at the disposal of SMEs** both by discouraging financial institutions to invest in unlisted companies and by penalising PE/VC funds to act as investors, at a moment when access to credit is so difficult for SMEs.

Conclusion

- **The PE/VC Industry calls for a horizontal approach if debt regulation at company level is needed.**

  If further regulation of debt ratio and leverage is considered as needed, the PE/VC Industry calls the European Commission and the European Parliament for a review of Article 23 of the Second Company Law Directive and its current transposition process. This could be required in a recital of the AIFM Directive.

- **The PE/VC Industry calls for an impact assessment as required by EU better regulation principles**.

  The PE/VC Industry does not believe that the aim or unintended consequence of regulation is to make access to capital more difficult and more expensive for companies and especially SMEs. The impact of the envisaged measures has not been carefully assessed.

  Before any decision on these issues, the Parliament should notably look at all the objectives to be conciliated: SME financing, funding of innovation, capital turnover, ease of change in ownership, level playing field and competition rules.

1 Report by Jérôme Galchant, Jean Hervé Lorenzi, Philippe Trainar : see notably executive summary part III, page 315, and introduction by Christian de Boissieu, Executive Chairman of the CAE. www.cae.gouv.fr

Bastion Tower, Place du Champ de Mars 5, B-1050 Brussels, Belgium - Tel +32 2 715 00 20 - Fax +32 2 725 07 04 info@evca.eu - www.evca.eu

- **The PE/VC Industry supports adequate disclosure**.

  The industry would support a provision to be introduced in the directive (art.19) by which, in its annual report, the AIFM would have to report on the way relevant horizontal legislation to be considered of particular relevance for investments sponsored by private equity funds (Second Company Law Directive, Acquired Rights Directive, Takeover Directive, Information and Consultation of Employees Directive and Transparency Directive) has been implemented and complied with.

Notes to the Editor

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About EVCA

The European Private Equity and Venture Capital Association is the voice of European private equity and venture capital, representing more than 1,300 members. In addition to promoting the industry among key stakeholders, such as institutional investors, entrepreneurs and employee representatives, EVCA develops professional standards, research reports and holds professional training and networking events.

Bastion Tower, Place du Champ de Mars 5, B-1050 Brussels, Belgium - Tel +32 2 715 00 20 - Fax +32 2 725 07 04 info@evca.eu - www.evca.eu