EVCA Public Policy Priorities

Private Equity and Venture Capital
An Engine for Economic Growth, Competitiveness and Sustainability

European Private Equity &
Venture Capital
Association

EVCA Public Policy Priorities

Over the next few years, fast changing markets and an increasingly complex regulatory environment will lead to further evolution of the private equity and venture capital industry as well as structural changes among and within private equity and venture capital firms. EVCA will continue to play a fundamental role in representing, promoting and protecting the long-term interests of the European private equity and venture capital industry.

In the following paper, EVCA presents nine action-oriented priorities and measures to policymakers, to help acheive the EU's Lisbon objectives of growth, competitiveness and innovation.

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Introduction

Since its inception, the European Private Equity and Venture Capital Association (EVCA) has encouraged an ongoing dialogue and consultation between policymakers and private equity and venture capital industry representatives to enhance government and business efficiency as well as national and European policy and regulatory frameworks. These exchanges currently aim to promote better regulation for the private equity and venture capital industry and continued assessment of the impact of policies affecting the success of the European Union's (EU) 'Lisbon agenda' [1].

Europe is deeply in need of a homogeneous market free from obstacles where dynamic, world-class companies can thrive. As has been widely recognised by EU policymakers, the European private equity and venture capital industry is at the core of achieving the Lisbon objectives of growth, competitiveness and innovation: energising the European economy by actively investing and supporting businesses with high-potential in existing industry sectors, as well as creating new innovative enterprises, sustaining growth, job creation and innovation.

The development of this industry has been underpinned by the creation and further evolution of a full set of standards and guidelines, developed in consultation with policymakers and other stakeholders.

The European private equity and venture capital industry is well poised and ready to continue delivering long-term results, which will further benefit the European economy. To do so, however, national governments and European policymakers, working in partnership with EVCA, must address remaining regulatory and administrative barriers for the private equity and venture capital industry, entrepreneurs and high-potential companies as part of a dynamic, integrated European marketplace.

The objective of EVCA's Public Policy Priorities is to recommend nine essential measures that policymakers can take at European, national and regional levels to provide a full "entrepreneurial and technological eco-system" through private equity and venture capital to help achieve the goals outlined in the EU's Lisbon agenda.

[1] *The commitment by EU leaders at the Lisbon Spring EU Council in 2000 to make Europe the most competitive knowledge-based economy by 2010.*

Summary of Recommendations:

Foster Europe's entrepreneurial environment, culture and education:

I - Entrepreneurship through an adequate regulatory framework.

II - Entrepreneurship through education and support programmes.

Boost innovation and research and development (R&D):

III - Innovation through a favourable environment for world class research in Europe.

IV - Innovation through a specific European status for Young Innovative Companies.

V - Innovation through an integrated, clear and efficient system for intellectual property rights.

Ease the raising and deployment of private equity and venture capital funds to drive a high-growth entrepreneurial economy:

VI - Enhance finance by enabling investors with an appropriate profile to invest in private equity and venture capital without undue restrictions.

VII - Enhance finance by deploying public efforts to facilitate the economic environment in specific sectors, stages or geographies.

VIII - Enhance finance through the creation of a specific pan-European fund structure for private equity and venture capital investment funds to facilitate cross-border investment decisions.

IX - Enhance finance through the emergence (preferably by mergers) of efficient integrated pan-European trading platform(s) and quoted market(s) for high-potential companies.

The European Private Equity and Venture Capital Industry: An Active Partner for Sustainable Economic Growth and the Competitiveness of European Companies

The private equity and venture capital industry consists primarily of venture capital funds, which invest directly in seed and start-up businesses and buyout and buyin funds, which acquire existing companies and focus on re-energising or revitalising them:

- Venture capital firms not only fund but also proactively support the development of high-potential companies in the early stages of their development and growth, often creating highly skilled employment in new and innovative areas where other sources of finance are hard to access.
- Buyout/in firms facilitate the transfer of ownership of existing companies; this includes facilitating the generational change of family owned businesses, helping to grow smaller companies into larger ones, or investing in viable businesses which are 'spun-out' of existing companies, including units which are no longer considered core or strategic businesses by its parent. Buyouts/ins work by initiating corporate revitalisation programmes to better align companies with changing market needs, helping to protect and develop existing employment [(2)]. The role of buyouts/ins in the European economy is often misinterpreted whereas its long-term impact is very positive.

Both venture capital and buyout/in firms provide long-term value through the implementation of a more clearly defined strategic vision, with sharper and more focussed operational and financial controls. In practice this relationship lasts for a period of 4-8 years, enabling private equity and venture capital backed companies to reach their next level of development and growth. Private equity and venture capital firms are also important economic change agents, providing a strong framework for corporate governance, standards and professionalism in private companies [(3)].

Economic Growth and Job Creation

The European private equity and venture capital industry has a proven track record of contributing to economic growth and job creation by providing a vital source of stable investment capital to companies with high-potential, across industry sectors and at all stages of development. It creates mobility in the capital flows and allows for optimal allocation of financial resources among growth companies.

Since the start of the Lisbon process in 2000 up until the end of 2004, over €140 billion of equity capital was invested by the private equity and venture capital industry in over 40,000 companies throughout Europe. These investments represent jobs for over 6.5 million people, many of which are critically needed highly skilled jobs. Even during the economic downturn of the early 2000s, private equity and venture capital backed firms outperformed other private sector firms and contributed significantly to Europe's growth [(4)].

Private equity and venture capital firms have an inherent strategy built into their business model, which focuses on investing in high-potential companies, either in sectors which are in fields of new technologies and thus rapidly developing, or those where market or operational inefficiencies can be improved thereby enhancing the competitive situation of existing businesses.

Policies, incentives and programmes for economic growth and job creation should therefore be tailored to market conditions to enable high-potential companies to take advantage of the Europe wide marketplace.

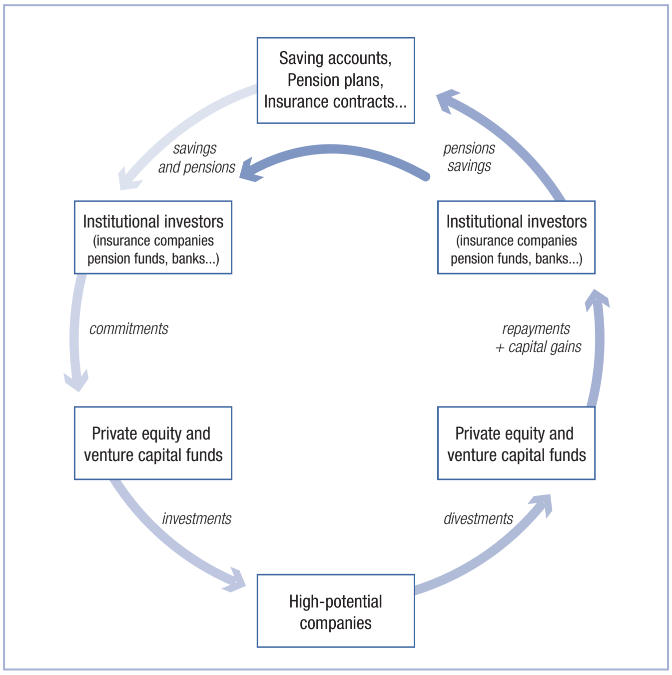
[(2)] *A study on the contribution of private equity to the succession of family businesses in Europe, undertaken on behalf of EVCA by CMBOR, January 2005.*
"Survey of the Economic and Social Impact of Management Buyouts and Buyins in Europe", published by EVCA, January 2001.
[(3)] *EVCA Guidelines 2003: http://www.evca.com/pdf/Guidelines2003.pdf*
[(4)] *As an example, please see "The Economic Impact of Private Equity in the UK 2004", BVCA, 2004.*

Sustainability

The private equity and venture capital industry provides a "virtuous" financing cycle within the European economy (see graph). Institutional investors, primarily pension funds, banks and insurance companies provide the bulk of the funds to private equity and venture capital firms, which in turn invest to start up, grow, support or revitalise high-potential companies. When these private equity and venture capital backed companies succeed, they become important engines of growth in the economy. Financial returns for the investee firms and their investors are often realised through the flotation of the companies on a stock exchange or through a merger with or acquisition by another firm. The returns, on average above those offered by standard equity investments [5], provide the incentive and capital to redistribute the money, ensuring healthy pension and insurance funds whilst also funding future cycles of investment.

For the private equity and venture capital industry to contribute to sustained European economic growth, policymakers must ensure coherent, inclusive policies, which will enable the industry to continue to provide a continuous financing cycle for start ups, spin-offs, and company transition and buyout investments.

The Virtuous Financing Cycle of Private Equity and Venture Capital Investment



Competitiveness

The further development of fiscal, legal and regulatory frameworks that are more conducive to entrepreneurship, innovation and investment will be central to Europe's future economic health and competitiveness, as capital is increasingly allocated on an international basis to the most competitive economies. In addition, a dynamic and highly skilled and productive workforce, either re-energising existing companies or working in fields of new technologies, is essential to supporting these investments.

For Europe to remain competitive, policymakers should support regulations that encourage investments that will bring productivity growth and innovation, which are key to encouraging and retaining employment.

[5] *See "Performance Measurement and Asset Allocation for European Private Equity Funds", CDC Ixis Capital Markets, 2004.*

The European private equity and venture capital industry is well poised and ready to continue delivering long-term results, which will further benefit the European economy. To do so, however, national governments and European policymakers, working in partnership with the private equity and venture capital industry, must address remaining regulatory and administrative barriers for the industry, entrepreneurs and high-potential companies as part of a dynamic, integrated European marketplace.

In the following section, EVCA presents nine policy priorities and measures to policymakers, to help acheive the EU's Lisbon agenda.

Foster Europe's Entrepreneurial Environment, Culture and Education

At present, there are simply too few fast-growing knowledge-based enterprises in Europe. Without this vibrant sector of the economy, GDP and productivity growth will continue to suffer compared to competing economies in North America and the Far East. Although Europe has made progress in encouraging a more favourable culture and environment for entrepreneurship, much remains to be done to make this a reality both on the regulatory and the educational side. Long-term changes in cultural attitudes will also be a key driver in improving the entrepreneurial environment.

I - EVCA Public Policy Recommendation:
Entrepreneurship through an adequate regulatory framework.

Implement an effective single pan-European corporate structure for companies to take full advantage of the European marketplace; simplify the requirements for company formation, lighten the burden of regulatory and administrative compliance costs, improve access to finance at all levels and adjust insolvency and bankruptcy rules to allow for an orderly end or restructuring of a failed business.

This begins first with the continuous need to simplify the complicated and costly administrative requirements involved in the creation of a business across Europe. This should go as far as the efficient implementation by all Member States of a single pan-European corporate structure for companies to enable them to take full advantage of the European marketplace, enhancing their competitivity before entering global markets. European companies have to struggle greatly to develop their market share outside of their national boundaries, whereas US companies do not have to face internal administrative conflicts and costs to access a market of the same size.

Although unfamiliarity with the entrepreneurial process and the associated risks are certainly to blame in part for the stigma of failure with which European society views entrepreneurs of failed businesses, on a more practical level, current insolvency and bankruptcy rules should be adjusted to allow for an orderly closure or company restructuring.

II - EVCA Public Policy Recommendation:
Entrepreneurship through education and support programmes.

Integrate entrepreneurship and the key elements central to establishing and running a business into education at all levels; promote mentoring and support to potential entrepreneurs; sustain and enhance awareness of the positive relationship between entrepreneurs and private equity and venture capital firms.

Education and training are needed to encourage potential entrepreneurs to start their own company. Topics related to establishing and growing a company should not be limited to economics or business courses, but integrated across the curriculum, at all levels – in schools, universities, business schools and within established companies to increase the number of new businesses in Europe (6).

Mentoring potential entrepreneurs and exposing them to real business rigours through links with experienced managers as well as with large mature firms will also contribute to the flow and growth of entrepreneurial spirit. It is particularly important to ensure that Europe has a future base of entrepreneurs aware of the key elements central to establishing and running a business. These elements include finance, company strategy, and attracting and retaining a pool of skilled, talented employees. The private equity and venture capital industry and its business model are one source able to provide such elements to entrepreneurs because they are widely recognised as their strategic and mentoring partners, providing business rigour to companies (7). Therefore further efforts must be made to sustain and enhance awareness of entrepreneurs of the private equity and venture capital business model through education and business support organisations.

Boost Innovation and Research and Development (R&D)

Innovation and R&D spur economic growth, competitiveness and highly-skilled employment, notably in high-tech and high-value creating areas of the economy. The wider impact of supporting and facilitating innovation and R&D and converting this into successful businesses will help meet the EU's own 3% funding target for R&D (two thirds of which should come from the private sector), and greatly enhance the health and wealth of the European economy (8).

This will only be achieved by building a full "entrepreneurial and technological eco-system" to enhance Europe's global competitive potential, through a critical mass of research, companies and finance combined with favourable regulations and taxation. This will provide a catalyst for innovation and research by facilitating the sharing of knowledge, encouraging the development of entrepreneurial and international mindsets, and providing easier access to technology and services.

Such an eco-system will revolve around attracting and retaining the most talented researchers, encouraging links between universities and the private sector, enlarging the flow of technology transfers supported by efficient and effective intellectual property rights, and the creation of a European status to specifically support young innovative companies at the cutting edge of development.

(6) *"Entrepreneurship Education Toolkit on Private Equity and Venture Capital" published by EVCA.*
(7) *"Awareness & Perceptions of the Venture Capital / Private Equity Industry", survey conducted by EOS Gallup Europe on behalf of EVCA, April 2004.*
(8) *Please see: http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0226en02.pdf*

III - EVCA Public Policy Recommendation:
Innovation through a favourable environment for world class research in Europe.

Attract and retain the most talented researchers; encourage links between universities and the private sector and enlarge the flow of technology transfer.

Nurturing centres of R&D excellence in Europe is crucial. Clusters provide favourable environment for innovation by encouraging collaborations that often stimulate the creation of new firms. This requires attracting and retaining the most talented PhDs from around the world. The EU produces more science and technology graduates than American universities but does not leverage these potential resources[(9)]. Many of the best and brightest move to the United States and subsequently remain there as research budgets are larger and researchers are likely to get substantially higher remuneration.

Although European universities provide some of the finest engineering and technology training in the world, the commercialisation of R&D is still in its infancy in Europe. While a number of European institutions have been proactive in this area, more needs to be done to encourage links between universities and the private sector as well as the sharing of best technology transfer practices across Europe. To foster technology transfer, scientific and technical universities should include modules on finance and entrepreneurship to enhance awareness within the research community about the opportunities and modalities that exist to commercialise innovative R&D.

IV - EVCA Public Policy Recommendation:
Innovation through a specific European status for Young Innovative Companies.

Create a specific European status for young innovative companies to reward the eagerness to take risks with incentives and benefits from the early stages of a company's development. Address size limits or restrictions and overly bureaucratic processes that could reduce the effectiveness or positive impact of such initiatives.

Given the difficulty, risks and long-term nature of starting and building a business, potential entrepreneurs must be incentivised and encouraged to start companies or organise spin-offs from larger firms. Creating a specific European status for young innovative companies is essential to support businesses that invest in R&D intensively, and can grow rapidly. This could be achieved by lowering the cost of starting the business and providing fiscal incentives. It could, for instance, entitle companies to significantly lower social charges, revenue taxes and provide incentives to invest in R&D as well as to incentivise investors in such firms. In addition, certain rules such as the current 'de minimis' rule for state aid to SMEs may impede some countries from supporting such companies and should be revisited.

[(9)] *"The Old World Becomes a Little Newer", Business Week, 11 October 2004.*

V - EVCA Public Policy Recommendation:

Innovation through an integrated, clear and efficient system for intellectual property rights.

Provide European businesses with an integrated, clear and efficient system for intellectual property rights and further reduce the high costs and the time involved in obtaining a patent. Such a system must be coherent with patent intellectual property rights systems elsewhere in the world.

Further to the previous remarks on competitiveness, the European economy needs to stop competing against itself and work towards making itself a much more attractive environment for researchers and entrepreneurs, as well as investors. Intellectual property rights are another area where the inability to provide European businesses with an integrated, clear and efficient system should be solved rapidly in order to cut back on the current lengthy and costly processes to obtain and enforce these rights.

At present, the number of patents that European companies file at home and abroad is still very low, although this is fundamental to help strengthen the transfer of technology into commercial applications, particularly from universities. This is of particular concern for venture capital funds whose investees, which are high-growth and innovation-oriented companies, have a high propensity for patenting. This patenting activity is conducive to the creation of global competitive advantage through intellectual property rights. Those rights are key to supporting and financing European innovation, as no-one would allocate resources in new technologies without the perspective of securing return on investment.

Ease the Raising and Deployment of Private Equity and Venture Capital Funds to Drive a High-Growth Entrepreneurial Economy

An effective integrated market for financial services is necessary to provide more and cheaper capital for investment, including equity sources such as private equity and venture capital, which are increasingly cross-border activities. Key to this process is the need to promote institutional investors choice, reduce administrative costs and expand investment funds available. For private equity and venture capital to further increase its role as an active player in financing European high-potential companies, such a market should provide not only adequate sources of funding for equity investors, but also an efficient pan-European legal investment structure and efficient stock markets to recycle and redeploy financial wealth.

The Risk Capital Action Plan (RCAP)[(10)] contributed to raising awareness of the need for an appropriate regulatory framework for private equity and venture capital. However, the lack of progress by Member States in policy coordination produced isolated and often non-coherent measures, and the delays in implementing many of the recommendations are an indication of the work that remains to be done to avoid further European fragmentation, as noted by the recent review of the Financial Services Action Plan (FSAP)[(11)]. Such work should be focused by undertaking a dialogue between the private equity and venture capital industry and policymakers at all stages of the process, instigating relevant actions via the most appropriate method (regulatory or non-regulatory) and on the basis of a detailed impact assessment.

To identify the remaining barriers to the development of Europe's entrepreneurial and equity investment environment, EVCA has embarked on a long-term benchmarking initiative[(12)] highlighting tax and legal measures, which could be improved to develop a truly favourable environment for private equity and venture capital investment in Europe's promising high-potential companies.

[(10)] *More information: http://europa.eu.int/comm/internal_market/en/finances/mobil/risk-capital_en.htm*
[(11)] *More information: http://europa.eu.int/comm/internal_market/en/finances/actionplan/stocktaking.htm*
[(12)] *More information: http://www.evca.com/html/public_affairs/issues_detail.asp?id=105*

VI - EVCA Public Policy Recommendation:

Enhance finance by enabling investors with an appropriate profile to invest in private equity and venture capital without undue restrictions.

Implement the EU Pension Fund Directive effectively; ensure capital adequacy or solvency requirements do not unduly impede investment decisions; and ensure compulsory impact assessments for any new proposed regulation.

If businesses cannot function without adequate sources of, and access to, finance, the same is also true for the private equity and venture capital industry, which is now established as a strategic asset for institutional investors such as pension funds, banks, and insurance companies. Institutional investors with a profile appropriate to the long-term approach of the private equity and venture capital industry such as those noted above should be able to invest without undue restrictions.

Pension funds are the main providers of long-term finance to the private equity and venture capital industry and are of critical importance to European society as a whole. The provision of pensions for an ageing population is currently one of the highest priorities on European political agendas. While funded pension systems exist in some national markets, the majority of European countries still depend on unfunded systems. This deficiency must be addressed through full implementation of the EU Pension Fund Directive. Even in those markets in which pension funds do exist, concerns remain as to whether returns will be sufficient to meet future liabilities. Pension funds therefore need to increase the allocation to higher-yielding assets within their investment portfolios [13], which the long-term perspective of the private equity and venture capital industry is able to help fulfil.

For other institutional investors such as banks and insurance companies, policymakers should ensure that their capital adequacy or solvency requirements reflect the real risks and rewards involved in private equity and venture capital funding [14]. Before any decision, there should be a full impact assessment of the proposed legislation in order to avoid the situation that has emerged with several recent high profile issues such as Basel II, and IFRS [15] which have been inappropriately defined, potentially having a severe negative effect on the private equity and venture capital industry.

Furthermore, there is great inconsistency across Europe about the regulation of investment by sophisticated wealthy investors in private equity and venture capital. Such investors are a vital component of particularly early stage financing and should be encouraged rather than excluded from investing in this sector.

VII - EVCA Public Policy Recommendation:

Enhance finance by deploying public efforts to facilitate the economic environment in specific sectors, stages or geographies.

Public funds should only be invested where a tangible or imminent market gap in the private sector is evident. Channel public funds through existing market-based systems, namely private funds; limit the public sector contribution to less than 50% of the total funding, publishing a yearly report on public policy efficiency.

The role of public efforts in promoting entrepreneurship should be geared to enhancing and thus facilitating the economic environment in specific sectors, stages or geographies.

When public funds are deployed, they should be channelled through existing market-based systems, namely private funds, and shaped with a clear market approach to yield the intended results. In addition, the public contribution should be limited to less than 50% of the total funding. Public funds should only be deployed where a tangible or imminent market gap in the private sector is evident. Furthermore, in order to assess their accuracy and efficacy, a yearly report on public policy should be published.

(13) *See "Performance Measurement and Asset Allocation for European Private Equity Funds", Cdc Ixis Capital Markets, 2004.*
(14) *More information: "The Risk profiles of Private Equity"; Weidig/Mathonet, February 2004.*
(15) *For EVCA's work on International Financial Reporting Standards (IFRS), see: http://www.evca.com/html/public_affairs/issues_detail.asp?id=95;*
For EVCA's work on Basel II/Capital Adequacy, see : http://www.evca.com/html/public_affairs/issues_detail.asp?id=98

VIII - EVCA Public Policy Recommendation:

Enhance finance through the creation of a specific pan-European fund structure for private equity and venture capital investment funds to facilitate cross-border investment decisions.

Introduce better coordination between, and mutual recognition of, national structures impacting on private equity and venture capital.

Although becoming increasingly more pan-European, private equity and venture capital funds have to structure themselves around 25 national tax regulatory and legal systems, leading to double taxation, additional levels of intermediary structures, complexities, uncertainties and increased costs for private equity and venture capital investors and fund managers. In short, there is no suitable tax or legal structure for private equity and venture capital funds that is effective in all situations across Europe and the principle of tax transparency is not recognised by all European countries [16]. This reduces the attractiveness of private equity and venture capital for institutional investors and can be contrasted with the situation in the United States where one “vehicle” or one “structure” can be used throughout the country [17].

As a first step, better coordination between, and mutual recognition of national structures would simplify the current complex requirements for private equity and venture capital funds, enabling fund managers to focus more effectively on their investments.

Furthermore, a specific pan-European common fund structure for private equity and venture capital investments, which could operate alongside existing national structures to facilitate investment decisions on a cross-border basis, should be realised. Several key elements are required for an effective common fund structure including access for professional investors (either institutional or sophisticated private investors, but which by definition excludes retail distribution), tax transparency and clear management rules in accordance with professional standards.

IX - EVCA Public Policy Recommendation:

Enhance finance through the emergence (preferably by mergers) of efficient integrated pan-European trading platform(s) and quoted market(s) for high-potential companies.

Such (a) market(s) must attract sponsors and market makers of a depth and quality to ensure long-term financial liquidity is available to the companies quoted on it.

Efficient and well functioning integrated stock markets for high-potential companies are paramount to realising the benefits that the private equity and venture capital industry provides [18]. They are part of the "entrepreneurial and technological eco-system" as they fulfil the needs of high-potential companies for larger rounds of financing, enabling them to become world-class companies. They also provide exit routes and returns on investment for the companies' initial investors. Once a divestment is realised, the private equity and venture capital industry will then be in a position to return the proceeds to investors and ultimate beneficiaries such as pensioners, thereby encouraging recycling of capital into new opportunities for the mutual benefit of the wider economy (see graph, page 5).

The vital role of this process is clearly regarded as the fundamental base of American economic success. However, specific conditions are required to ensure successful outcomes which the different regulators should address: a good pool of liquidity, good equity research to support flotation and on-going trading, investor groups committed to a long term presence in the market, and an efficient stock market clearing and settlement system working on a ‘real-time’ basis.

[16] *See “Private Equity Fund Structures in Europe”, EVCA, December 2001.*
[17] *For example, a Delaware limited partnership: http://www.delcode.state.de.us/title6/c017/*
[18] *See “NVCA Venture Impact 2004”, and the “Economic impact of Venture Capital in the UK”, BVCA 2003.*

Conclusion

Although European policy makers have demonstrated significant awareness of the combined benefits of entrepreneurship, innovation and equity investment in growth businesses on the EU economy, much more practical work remains to be done [19]. Full coordination and regular impact assessments, undertaken on the basis of a partnership involving national governments, European administrations and the private sector, which will identify and address the remaining factors impeding the creation of a thriving entrepreneurial and innovative economy in Europe are essential.

When such policies are fully realised, the private equity and venture capital industry will be able to fulfil its full potential within the wider European economy, and its vital role in achieving the EU's Lisbon objectives.

Summary of Recommendations:

Foster Europe's entrepreneurial environment, culture and education:

I - Entrepreneurship through an adequate regulatory framework.

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Boost innovation and research and development (R&D):

III - Innovation through a favourable environment for world class research in Europe.

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Ease the raising and deployment of private equity and venture capital firms to drive a high-growth entrepreneurial economy:

VI - Enhance finance by enabling investors with an appropriate profile to invest in private equity and venture capital without undue restrictions.

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[19] *See "Facing the Challenge" Kok Report, November 2004: http://europa.eu.int/comm/lisbon_strategy/pdf/2004-1866-EN-complet.pdf*

The Role of EVCA

The European Private Equity and Venture Capital Association (EVCA) was established in 1983 and is based in Brussels. EVCA represents the European private equity sector and promotes the asset class both within Europe and throughout the world.

With over 950 members in Europe, EVCA's role includes: representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins. For more information on EVCA and its activities, please visit **www.evca.com**.

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