white paper

Priorities for Private Equity

Realising Europe's Entrepreneurial Potential

European Venture Capital Association

white paper

PRIORITIES FOR PRIVATE EQUITY

REALISING EUROPE'S ENTREPRENEURIAL POTENTIAL

European Venture Capital Association

VENTURE CAPITAL AND PRIVATE EQUITY

Private equity provides equity capital to enterprises not quoted on a 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 buy-out or buy-in 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. Among different countries, there are variations in what is meant by venture capital and private equity. In Europe, these terms are generally used interchangeably and venture capital thus includes management buy-outs and buy-ins (MBO/MBIs). This is in contrast to the US, where MBO/MBIs are not classified as venture capital. This paper adopts the European usage which views venture capital and private equity as the same.

The European Venture Capital Association (EVCA) was formed in 1983. It has over 380 members, including the leading private equity players throughout Europe who actively participate in the association's board of directors, committees, advisory groups and task forces.

EVCA's mission is to globally promote and facilitate the development of the European private equity industry. EVCA seeks to inform and advise its membership and the public through publications and specialist industry events that provide networking opportunities and occasions to exchange views and ideas. EVCA aims to serve the needs of the entire private equity industry, from fundraising to exits, from seed capital investments to LBOs.

Over the past two decades, the venture capital industry in Europe has grown dramatically. It has raised more than ECU 60 billion of long-term capital over this period and currently holds investments in an estimated 20,000 privately-owned European growth companies.

For further information, please contact:

EVCA
Minervastraat 6/box 6, B-1930 Zaventem (Belgium)
Tel: + 32 2 715 00 20 Fax: + 32 2 725 07 04
e-mail: evca@evca.com website: www.evca.com

PRIORITIES FOR PRIVATE EQUITY

Europe faces two sizeable challenges. Firstly, it needs more new companies that can compete globally and contribute to Europe's economic revival. Secondly, it must solve the problem of significant levels of unemployment. Venture capital/private equity offers considerable economic and employment benefits that address both of these challenges.

Private equity draws on and seeks to maximise entrepreneurial potential. By unleashing entrepreneurial power, it helps grow companies, thereby increasing a region's worldwide competitiveness and at the same time creating jobs. In this regard, Europe has yet to realise its full potential. The volume of private equity in Europe would be at least three or four times its current level were private equity as a percentage of the region's GDP to match the equivalent ratio in leading countries.

The underdeveloped state of Europe's private equity industry is in large part due to institutional, legal and fiscal impediments, all of which act to the region's economic detriment. Actions must be taken to rectify this situation. The European Venture Capital Association (EVCA) has identified five priorities that governments and pan-European authorities should address so that the region can fully reap the rewards of venture capital. These priorities deal with creating more attractive investment opportunities or with improving the sources of funding for private equity. The priorities can also be classified according to the domain within which they principally take place: legal, economic, cultural or fiscal.

The five priorities for enabling venture capital and their principal domain of activity are:

Those that increase investment opportunities:

- *Create an entrepreneurial environment (Cultural)*
- *Encourage tax-efficient share incentives (Fiscal)*

Those that improve funding:

- *Develop long-term capital sources (Legal)*
- *Facilitate fund formation (Fiscal)*
- *Give public support only when partnered with private equity (Economic)*

EVCA invites policy-makers and opinion-leaders across Europe to address these issues in order that private equity can bring Europe growth, innovation and employment.

PRIORITY

Create an Entrepreneurial Environment

Entrepreneurship Education

Entrepreneurial success stories serve as an inspiration to others, inciting them to create and work for young companies. While some entrepreneurial traits are innate, many can be taught. But entrepreneurial studies have received scant attention in Europe's schools and universities. This shortcoming should be redressed.

European universities should develop courses and departments in entrepreneurship. In these, managers, entrepreneurs, and private equity professionals would learn effective ways to pursue opportunities and manage resources. By examining and celebrating the examples of successful entrepreneurs, schools can release the entrepreneurial spirit in a broad number of people. Schools should teach that this spirit and its accompanying skills can be applied to both start-ups and MBOs. It is important for training to extend also to entrepreneurs' advisors - the lawyers, accountants and management consultants who specialise in SME development.

EVCA believes that the creation of university chairs for teaching entrepreneurship should be promoted throughout Europe. Curricula should include assessment of business ideas, marketing, and how to access technical information.

Increase Awareness of MBO/MBIs

As part of entrepreneurial awareness, there is a need to heighten the business community's recognition of the potential of management buy-outs and buy-ins. A widespread knowledge of this financing method will mean that in planning corporate restructurings, companies and managers can assess the full range of possibilities and be able to choose the option that maximises the economic and social outcome. By offering managers the possibility to take over a company, buy-outs enable a business to have a lifespan that exceeds the original management's involvement.

Clarify intellectual property and licensing ownership

The treatment of an entrepreneur's intellectual property is of utmost importance. For many young companies, intellectual property represents almost the entirety of their assets. Countries must ensure that innovative companies have a fair chance of being rewarded. It is important to process patents and licenses efficiently and to have an effective enforcement system.

Regulatory systems that police the development of new drug or biotech products must be able, without undue delays, to judge them. Without a timely regulatory review, an inventor will be burdened with a costly waiting period, during which entrepreneurs elsewhere may gain a lead.

Help Commercialise Research

Europe cannot yet boast of academic systems that have spun off numerous successful companies. Yet it is a truism that Europe's academia harbours a wealth of ideas. It is time to access this rich pool of talent.

Much of the work done by Europe's universities and research institutes could be put to commercial use, but this practice is not widespread. Institutions should be encouraged to commercialise ideas and to strengthen links to SMEs. They need to realise that they can have commercial links without compromising principles. Furthermore, by sharing in profits realised from commercialisation, their ability to pay for increasingly expensive equipment and facilities will be enhanced.

Promote a Flexible Work Environment

The existence of a mobile labour pool helps promising young firms attract talented workers. Europe is handicapped in this respect. To create a less rigid job environment, countries should promote such measures as flexible labour laws and portable pension funds. Heavy social welfare taxes and stiff rules regarding hiring and layoffs create huge expenses for small companies that should be eased.

In the case of the restructurings that bankruptcies represent, European laws and attitudes also need to shift. In Europe, bankruptcy is stigmatised and the head of a failed company has dismal career prospects. This is in sharp contrast to America's more tolerant view of failure - in the US, managing a company that goes bust may actually be viewed as a useful experience. While it is important that a country have adequate creditor protection, a troubled company should go through its failure as efficiently as possible.

Similarly, the process of establishing a company should be straightforward and simple. In many countries, the initial efforts of an entrepreneur get bogged down in unnecessarily elaborate, long or incomprehensible procedures. Once started, companies may find themselves mired in complex regulatory filings. The procedures for companies to be created and stay in business need to be streamlined. While bureaucratic processes can slow any enterprise, they can prove lethal to small firms which are disproportionately burdened by regulatory and compliance costs. A welcoming environment, one that helps companies germinate, will benefit all.

ENGENDER AN ENTREPRENEURIAL ENVIRONMENT IN EMERGING MARKETS

Private equity is emerging in Central and Eastern Europe and in the Newly Independent States (NIS) of the former Soviet Union. After decades of centrally planned economies during which the private sector was marginalised, private equity funds are now being established and are making investments. These countries offer numerous investment opportunities as the old systems' inefficiencies are addressed, privatisations take place, and entrepreneurs address the new opportunities available — particularly in the service industries. There is an excellent human capital base available to staff these opportunities. But, at same time there is potential, there are considerable challenges. These challenges are of a far greater magnitude than elsewhere in Europe.

It is in the interest of all of Europe that private equity develop successfully in this region. Increasingly, private equity is an international affair and these countries' economies are closely linked to those of Western Europe. EVCA has recognised the importance of nurturing private equity in Central and Eastern Europe and has taken an active role in initiatives such as the European Union's PHARE and TACIS programmes that address this region.

Significant progress in developing private equity has already made been made in some of the countries of this region. Many new SMEs have been created. But they are not yet supported to the same extent by the infrastructures available for SMEs in Western Europe. These infrastructures need to be developed. In particular, advisory services for SMEs should be strengthened.

Positive framework conditions for business creation and growth are important everywhere. In these countries, the conditions for private equity are still evolving and are urgently needed. Frameworks must address:

- Proper regulatory functioning within a sound legal structure, especially with regards to ownership and security rights;
- Development of efficient capital markets, in particular, liquid and transparent public stock markets;
- Adoption of high standards for financial reporting.

Simply transferring property rights to the private sector and establishing frameworks is not sufficient to assure a vibrant market economy. To create and manage growth companies, entrepreneurs, managers, and private equity professionals are essential. But in emerging market countries, knowledge of business management and entrepreneurial skills is in short supply. There is a pressing need to create entrepreneurial education and training programmes in these countries. A cohesive approach should be taken, making sure that responsibility for these programmes is not splintered among diverse authorities and ministries that may have conflicting aims and approaches.

PRIORITY

Encourage Tax-efficient Share Incentives

Create Incentives for Entrepreneurs and Managers

Entrepreneurs and skilled managers bear the highest risk in launching growth companies. Managers who move from a large to a small firm usually accept lower initial income and invariably lose fringe benefits; they almost always accept a lesser degree of job security. In addition, entrepreneurs, managers and directors of a new company often supply its initial equity capital. This investment may well be lost, as the failure rate for start-ups is high. Although the public increasingly recognises the role of entrepreneurs, that recognition is seldom echoed by economic reward in the form of favourable tax treatment.

A low capital gains tax rate, tax deduction of losses, and up-front investment relief are ways to offer reward and motivatation for the significant personal risks inherent in launching or joining a new business. Entrepreneurs and managers of new businesses should not be discouraged by adverse tax treatment. Rather, the possibility for founders and managers to acquire, on attractive terms, stock of the companies they serve should be widened.

Gains realised by employees and investors on their incentive shares in growth companies should be subject to a low capital gains tax and to no other forms of taxation.

Stock Options

For entrepreneurs, managers and employees of growth companies, stock options can represent a particularly effective financial incentive. Options can offer the attainable dream of wealth and financial independence. Smaller firms cannot afford to pay managers large firm salaries or offer large firm benefits or security. But managers may be prepared to work in a smaller company at a lower salary if there is the prospect of potentially valuable stock options. An effective option plan can be an indispensable tool for recruiting skilled managers.

Securities rules governing the issuance of stock options, and fiscal rules determining the level and form of taxation and when that taxation occurs, influence whether it will be sufficiently attractive to risk working for a start-up company.

Unfortunately, in many European countries gains realised from the exercise of options are taxed at the same rate as if they were income. To create a truly effective incentive, there should be no tax on the issue or exercise of options to buy shares, provided that their exercise price is not less than the market price was on the date the option was granted. Any tax should be at a low capital gains rate incurred upon sale of shares received from exercise of the option.

PRIORITY

Develop Long-term Capital Sources

Encourage Funded Pension Systems throughout Europe

Private equity is essential to fund the start-up and development of firms. Private equity investments are generally long-term and thus their sources of funding should be those of a similarly long-term nature, such as capitalised pension funds or insurance company portfolios.

Pensions systems vary across Europe. Some countries, such as the UK and the Netherlands, have funded pension schemes in which an identifiable pool of assets provides retirement benefits. Most European countries, however, rely on pay-as-you-go social security pension systems. But demographics indicate that shortfalls loom for this unfunded type of system. The diminishing percentage of the population in the workforce will be unable to support the growing retired population. To assure retirement income, countries will have to adopt funded pension systems. Governments should be strongly encouraged and supported in this trend.

Funded plans bring benefits beyond their ability to plug the funding gaps of a pay-as-you-go approach. With regular inflows of money paired to long-term liabilities, funded plans are able to concentrate their portfolios in long-term assets producing superior returns. Furthermore, investments in capital markets help stimulate economic growth and job creation, and improve a country's competitiveness.

Ease Asset Allocation Restrictions

Of course, in order for funded plans to fully realise the returns offered by private equity, a country's regulatory framework must first permit them to invest in this asset class. This is not universally the case. Throughout much of Europe, pension fund allocation is handicapped by unfavourable regulations, taxation, and investment restrictions.

This is in contrast to the US and the UK, countries acknowledged to have superior pension fund performance. Rather than imposing tight quantitative guidelines, these two countries govern pension funds with "prudent man rules" that call for managers to carry out sensible portfolio diversification.

In the US, prudent man guidelines first permitted pension funds to make venture capital investments in the late 1970s. Another US pension guideline, ERISA's "Safe Harbour" regulation went further. It is interpreted as actively encouraging pension fund investment in venture capital and private equity situations. Even though only a small percentage of US pension fund assets has since been invested in private equity, this has nevertheless represented an enormous source of financing for this asset class which in return has contributed superior performance to pension fund portfolios.

The allocation to private equity is not an altruistic undertaking. As an asset class, private equity has demonstrated its ability to produce superior returns and the companies it backs bring social benefits to their home countries. The time has now come to ensure its inclusion in the portfolios of all countries' pension systems.

Lift Geographic Restrictions

Another restriction contrary to best economic interests is that some countries prohibit or limit pension funds from cross-border investing. Such rules are unacceptable. In fact, they are in breach of EU laws. Pension funds should not be subject to regulations requiring that a proportion of assets be invested in a country's own capital markets; rather, performance within prudential guidelines should determine allocation. European economies will benefit from free movement of capital.

Make Investing in Small Capitalisation Stocks Efficient

It is widely recognised that efficient exit mechanisms, particularly a vibrant stock market for growth companies, are essential to a healthy venture capital industry. It is also the case that for markets specialising in growth companies to flourish, there must be buyers for the stocks listed on them. Sadly, this has not been the norm in much of Europe where institutional investors have been relatively insignificant buyers of small-company stocks. Again, the comparison with the US and the UK is sobering but instructive. In these countries, institutional investors have been significant buyers of small-company stocks. This reflects their regulatory freedom to make such investments and also the existence of the necessary support systems.

European authorities must first of all permit pension funds to invest in small capitalisation stocks. Furthermore, investment in these stocks must be made feasible for institutional investors. High standards for financial disclosure and strict standards of corporate governance must be required. Intermediaries for small-cap stocks need to be encouraged. These must include ethical, high quality investment bankers for these companies and research analysts providing stock coverage.

PRIORITY

Facilitate Fund Formation

Transparent Private Equity Fund Structures throughout Europe

Some European countries have private equity fund structures that accommodate national and international investors, but many countries lack a suitable structure, while others impose overly restrictive structures. The basic problem is that if a fund is simply structured as a local company, taxation is payable at the level of the fund in addition to being payable at the level of investor (i.e. there is double taxation). In order to avoid double taxation, investors from countries without an efficient structure often have recourse to structures based in low tax areas or tax havens. This is less than ideal. Not only is the process often cumbersome for investors, the home country loses much of the positive effect these investments can have on employment and economic growth.

In addition, venture capital is increasingly an international business with funding, management and investment not constrained by national borders. A fund may have several locally-based management teams and may make investments in more than one European country. Although such funds are in keeping with the European Union's objective of a single European market, their structuring, marketing and operation at present create fiscal and regulatory nightmares. Different tax treatments for venture capital and bilateral double taxation treaties open the door to extensive treaty shopping which can lead to complex and expensive structures.

There is a major need for the development of a new European structure or for the adoption of a common European approach with a standard taxation treatment based on the principle of transparency.

The measure of an efficient venture capital fund structure is simple. Fund investors should be no worse off than if they had made an investment directly, without the fund as an intermediary. This is what is meant by tax transparency - tax liability should pass directly to fund investors without the fund first paying taxes on either capital gain or income. Investors should also get any tax credits tied to dividends and interest, withholding tax should be minimised through the application of the double tax treaties of the investors, capital gains tax should only be paid at one level - that of the investor, and fund management charges should be exempt from value-added taxes.

Ultimate Goal: A Pan-European Transparent Fund Structure

The ultimate goal is to have a pan-European transparent fund structure. The availability of an efficient pan-European structure would increase the amount of capital available within Europe for private companies and increase the incidence of trans-national investments.

PRIORITY

Give Public Support Only When Partnered with Private Equity

Create Appropriate Frameworks

Governments and pan-European institutions are eager to reap the economic and social rewards tied to venture capital activity. To that end, they are examining what facilitating role they can and should play. The most important way they can aid venture capital is by establishing sound financial, fiscal and legal regulations.

Private Equity as a Partner

Most countries go further, creating programmes that supply equity or soft loans to unlisted companies, or that offer incentives to particular types of investments or industries. These incentives are well-intentioned, but for them to be truly effective, it is vital that they be applied with caution and only in partnership with private investors.

Misdirected or excessive public spending can displace or retard the development of the private sector. Governments may cause distortions by creating unfair competition or by sustaining unprofitable projects. These types of programmes are certainly to be avoided.

Government measures should stimulate the development of private equity markets based on the competitive functioning of professional fund managers. Support measures should allow all funds to operate on a level playing field.

The public sector should reduce the risk and cost of private equity investments only to the extent that the development of the private sector venture capital industry is complemented and encouraged.

The allocation of funding from government programmes should be made using the skills of private equity professionals. The most effective programmes first elicit private sector participation in the design stage and then look to the private sector to play a professional role in the programme's functioning.

Additionality

The best public incentives stimulate private sector funding that would otherwise not have occurred. In such programmes, government funding is leveraged by private capital.

In order to attract investors, government programmes should have attractive returns to private investors as a key programme objective. This calls for programmes that channel capital to financially promising companies, generate investor profits and develop a self-sustaining investment activity.

The most desirable government programmes are those that strengthen the private venture capital sector and then, as private markets mature, are phased out. The economic and social benefits of such programmes continue long after the government's direct role has ended.

ENCOURAGE COMPETITIVE STOCK MARKETS FOR SMALLER AND GROWTH COMPANIES

AN ACCOMPLISHMENT AND AN ONGOING TASK

For many years, development of liquid stock markets for the securities of European growth companies has been acknowledged as an element needed to foster private equity. Historically, Europe lacked sizeable public markets on which promising venture-backed firms could raise equity capital at attractive conditions. The past few years have seen significant progress to correct this shortcoming. The fall 1996 opening of EASDAQ, in which EVCA played a significant role, was a milestone. Other recently launched European secondary markets, such as the UK's AIM, France's Nouveau Marché, and Germany's Neuer Markt and the Euro.NM system linking several secondary markets, are also positive developments in that they all provide capital for Europe's growth companies.

Despite achievements, much remains to be done. These markets are still in their infancy and support for them must not falter. If or when overall capital market conditions weaken, these markets must do better than the European secondary stock markets of the 1980's that had insufficient mass to weather the downturn for growth markets at the end of that decade.

A main goal should be to increase the liquidity of these young markets. In part, this will happen as European funded pension plans are developed and invest in capital markets. But this will occur slowly. Additional aids to liquidity are needed.

Increased involvement of financial intermediaries in these markets must be encouraged. Intermediaries contribute to market liquidity through investment banking activities (introducing stocks on a market), through market making (ensuring an active, efficient after-market), and through research coverage of stocks (providing the information essential to investors). European authorities can stimulate the interest and activities of financial intermediaries by making reliable information widely available, by promoting high standards for financial disclosure, and by teaching companies the best practices for dealing with bankers, analysts and investors. An important part of the drive for liquidity should be encouraging companies to be listed on these secondary markets.

European Venture Capital Association
Minervastraat 6, Box 6, B-1930 Zaventem, Belgium
Tel: +32 2 715 00 20 Fax: +32 2 725 07 04
e-mail: evca@evca.com web: www.evca.com