SPEECH/06

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# The way forward for European private equity



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Honourable Members, Ladies and Gentlemen,

First let me say how pleased I am to be here in London…and to say that I think now is a very good time to be discussing Venture Capital markets, or more broadly Private Equity which includes the large buyout markets.

## Observations

Financial actors in London are probably the best informed as far as European Private Equity markets are concerned. The City hosts the skills and talent, the infrastructure, and the ambition to provide world class financial services to investors, including in the Private Equity sector.

Let me briefly highlight a few observations on current developments in the European market as a whole, before explaining what I think are some of the challenges we are facing in Europe. I'll end by briefly touching on some of the things that I am doing in Brussels that may be of interest.

### High levels of growth

In Europe, growth in the Private Equity market has been quite staggering over the last 4 years. Only the hedge fund industry can boast such high levels of growth. 2005 saw the biggest fundraising year since the collapse of the dotcom bubble in March 2000. This is a positive development.

### Governance concerns?

With increased capital at their disposal and the possibility to join forces with other players, few deals are off limits to ambitious buyout groups. These developments have given rise to heated debate on Corporate Governance – ie about the actions, interests, and motivations of these types of investors and the influence they have on investee companies. In the Private Equity world this has surfaced most prominently in Germany and Denmark. But with M&A activity picking up in Europe we have seen debates over foreign ownership arising in other countries, across a range of sectors, relating also to hedge funds and to foreign trade buyers. My own take on the matter is the following: A recent tide of protectionism has been gathering strength across Europe - a sure recipe for economic stagnation and decline. Where competition is shut out companies do not become stronger, they become more complacent and then they become weaker. There is, therefore, no case from my perspective to conclude that an increase in Private Equity activity in the public markets should be seen as negative. On the contrary, private equity houses are a formidable watchdog on management teams that are underperforming as public companies and failing to deliver the shareholder value that their inherent strengths should make possible.

## European challenges

I highlight this, because today Private Equity is not as private as it once was. It has matured. Low interest rates, an increased appetite for better performing investments, increased asset allocation from public and occupational pension funds to Private Equity - these are all contributing to the sectors' rapid growth. In this context, two issues strike me as fundamentally important.

First the impressive overall growth in European private equity is not happening across all member states and is not evident in all stages of Private Equity investment. In most Member States the Private Equity industry is still extremely immature. Traditionally equity financing has always been of greater significance in the Anglo-American environment than in continental Europe.

In 2004 Private Equity investment in the UK represented[1] almost 0.9% of GDP; this was more than twice that of second and third place Sweden and Finland, but still lower than the US (1.1%). One of the key elements in the UK's success is the number of IPOs on the LSE – an important source of exit opportunity to generate the kinds of returns expected of many Private Equity portfolios. Secondary sales have picked up dramatically over the last 2 years.

Secondly, over 70% of the EU market is represented by the buyout deals, that is, the financing of later stage companies; those which already have an established track record. This later-stage investment is what is driving the growth in the Private Equity markets today – not Venture Capital. The flip side of this is that the Venture Capital market in Europe is weak. Particularly in respect of "seed" and early stage investment – i.e., the most risky. From an economic point of view this is the most important investment – investment in small but expanding businesses, creating potential growth, jobs and prosperity. Which leads me to my second concern.

## Profitability

While I hesitate to put my finger on the main reason for lower levels of growth in the Venture Capital market, high up on the list must surely be the relatively poor returns historically. Benchmarks are hard to come by in the Private Equity world. But by most measures, the European Venture Capital sector performs badly especially at the seed capital stage. This should be a serious concern to all Member States. The next question is therefore – i) what can be done about this? and ii) what incentive is there for investors to invest in European Venture Capital?

I don't have the answers; but we can all speculate: Maybe the tax take is too high. Maybe the framework for innovation is too fragmented. Maybe the entrepreneurial culture is too weak. Maybe our R&D focus is insufficient or mis-directed. Maybe our public markets are too fragmented.

European Venture Capital investment in Technology grew by about 20% in 2005 – the right direction, but still a long way to go before reaching US levels. Within the overall Venture Capital data there is a group, the top 25% of funds, which are performing very well. The key question for us all is how to increase the 25% or how to get a larger number of people into that growth group. We also know that US Venture Capital managers invest more capital, in fewer projects, primarily in the technology sector.

Despite the fact that an integrated risk capital market has been a strategic objective of the Commission, we are not there yet. There are still major differences between the tax and legal systems; structuring funds and offering funds on a cross border basis is notoriously difficult. Mutual recognition of legal structures for cross-border investments would clearly help and reduce the complexity of managing funds in many countries.

## Policy responses

My comments on the challenges in the Private Equity markets do not imply that new European legislation is warranted for this sector. However, there are important things that the Commission can contribute.

[1] European Venture Capital Association, 2004

Setting the right framework for financial markets is a critical piece of the puzzle. In the capital markets area Europe is gaining a reputation as an open and reliable market-place that has got the balance between economic freedom and investor protection right. We do not have policies that dissuade outside investors from investing in our capital markets. And we are not about to start developing such policies in the Private Equity market.

To understand Private Equity issues in depth I have recently established a group of industry experts to provide us with advice on what is happening in the European Private Equity markets – an industry view – of the developments that are taking place, the ambitions of the industry and some of the obstacles that participants - both managers and investors - think might prevent this continued growth. The group will help to explore some of these issues from a cross-border perspective and publish their report in June. It will provide us with a strong starting point on which to build reflections, on how, if at all, the current framework could be improved.

Intellectual property is at the heart of ongoing discussions amongst policymakers in Europe. An effective affordable IPR protection is essential, as is recognised in the EU's strategy for growth and employment.

Intellectual property rights stimulate and reward innovation, lead to the successful development of new products and processes and thus generate growth and new jobs. But intellectual property of a company is not only a legal asset, it is also a financial instrument and increasingly so as technology develops and innovation race takes up speed.

There is growing awareness that intellectual property (IP) assets can be monetized in a variety of ways. IP can be sold, licensed, used as collateral or security for debt finance, or it can provide an additional or alternative basis for seeking equity from friends, family, private investors (the so-called "business angles"), specialized and sometimes regular banks and of course venture capitalists.

The potential investor will assess whether the new or innovative product or service offered by the SME is protected by a patent, a utility model, a trademark and so on. Such protection is often a good indicator of the potential of the SME for doing well in the marketplace. Ownership of IP rights guarantees a certain degree of exclusivity and thereby higher market shares if the protected product proves successful among consumers. IP ownership is important to demonstrate market opportunities open to the enterprise for the commercialization of the product or service in question. On occasions, a single powerful patent may open doors to a number of financing opportunities.

However, before an SME may include its IP assets in its business plan and exploit their commercial value, it must be able to constitute an IPR portfolio. This means that the IPR system must be based on clear substantive rules at a pan-European level, accessible and inexpensive procedures for obtaining IP rights whereby high quality of delivered titles is maintained and finally reliable, predictable and inexpensive remedies when disputes arise.

Currently, Europe does not fully meet the challenge of providing such an affordable and accessible patent system, the current one being too costly and burdensome.

In order to remedy this shortcoming, we have recently launched a consultation on the future patent policy in Europe. The consultation focuses on the structure of the European patent model without yet touching upon issues of substantive patent law.

Our main intention in this exercise is to gain new momentum on patent matters which have been stalled during the past few years. The adoption of Community Patent remains the top priority. However, pending the outcome of the last effort on the Community Patent, we are also seeking views on what measures could be taken in the near future to improve the patent system in Europe. The consultation is intended to ensure that any new proposals in the area of EU patents policy reflect stakeholders' needs.

Finally, the question of facilitating the use of IPRs as a financial instrument, especially by innovative SME's, is a recurring one and it will be addressed in a more specific manner in the wake of the ongoing consultation.

I think we all agree that we need a truly European and effective Private Equity market to provide adequate funding for technology and high-growth companies. Any public sector programme should not exist without clear market failure rationale and should work in partnership with the private sector. Different legal requirements across the Member States may inhibit cross-border fundraising and investments. Financial markets are clearly important, but Europe's challenges run far deeper. An industry-friendly and streamlined system of Intellectual Property Rights protection is essential for actors competing on the increasingly global markets. Its importance will continue to grow as developed economies switch to high value-added production and services where innovation is the key.

My overall conclusion therefore is that while a fully integrated EU Private Equity market is some way off, strong signs of growth hold out the promise of a confident and prosperous future. I think in many respects momentum is building in the right direction.

At the very least we know that Private Equity boosts economic growth, underpins innovation and creates jobs. My hope is that we can fuel an honest debate about how, in particular, in the Venture Capital market, the culture, infrastructure and incentives can be improved for Europe's many innovative businesses and its investors.