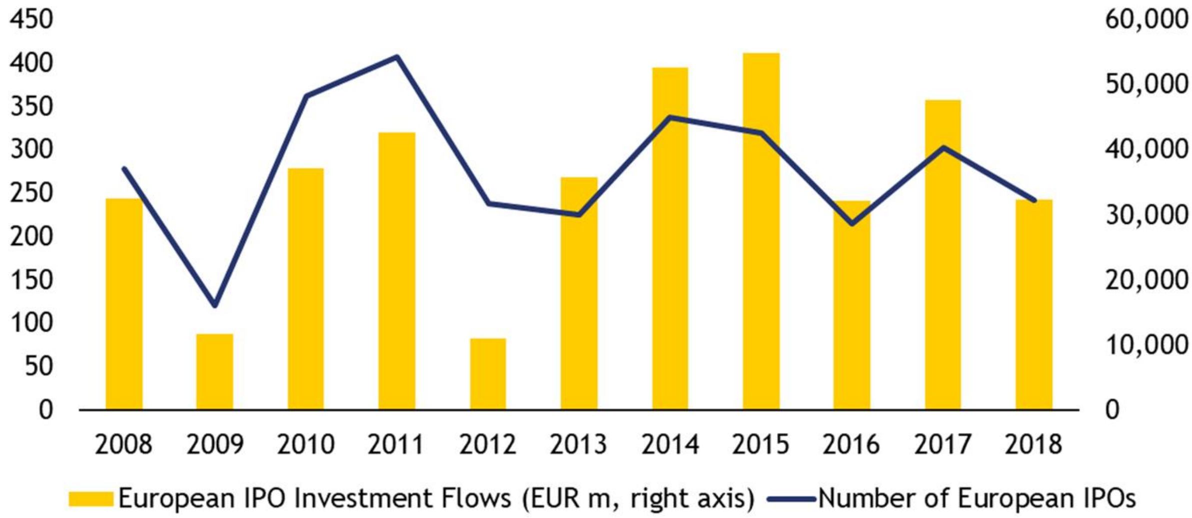
FESE position on private equity

Brussels, 27th February 2020

1. The decline of IPO markets

Initial public offerings (IPOs) have been facing a structural decline over the past 20 years, notably for SMEs.[1] In Europe, the number of IPOs fell from 380 per year (between 1997 and 2007) to 220 per year (between 2008 and 2018)[2] and smaller IPOs (raising less than 100 million) represented 13% of all funds raised in 2015 compared with 19% in the period 1994-2000.[3]

The below graph illustrates the decline in the total number of European IPOs between 2008 and 2018 from around 400 to 200.



Source: FESE and WFE

Concerns have been raised in relation to the decline of the IPO ecosystem which, beyond the global trends, result from structural developments at European Union level that impact SMEs' access to public equity capital markets. Smaller and younger companies are currently facing difficulties to benefit from public market funding which promotes organic growth, provides liquidity to historical shareholders, facilitates international development, whilst enhancing both their profile and reputation towards clients, providers and employees.

[1] OECD, 2016, 'OECD Business and Finance Outlook', available here.
[2] Jean-François Gajewski & Carole Gresse, 15th February 2012, 'A Survey of the European IPO Market', ECMI Paper, available here.
[3] OECD, 2016, 'OECD Business and Finance Outlook', available here.

In line with its Capital Markets Union (CMU) initiatives, the Commission should seek to address the current structural and global trends affecting the decline of the IPO ecosystem in the EU's capital markets. Well-functioning IPO markets support company financing, promote employment, provide citizens with efficient investment opportunities for their pension needs and ensure resources are allocated to their most productive use, including towards the transition to a sustainable economy.

We believe that appropriate steps to level the playing field between private and public equity markets would be to: address the disclosure gap between public and private companies, support EU IPOs via the use of cross-over funds and address the debt/equity bias to encourage companies' listings.

2. The rise of private markets

In parallel to the decline of IPO markets, private equity markets (e.g. venture capital, growth, buy-out) have grown substantially over the past decade, in terms of assets under management, dry powder (i.e. amount of cash that may be injected by private equity funds into companies), investments and money raised. Globally, private equity dry powder hit a record in December 2018; with USD 2 trillion across all fund types.[4]

Traditionally, companies go to venture capital funds as a financing step prior to going public on the stock market which provides an opportunity for the companies' investors to sell their equity and achieve profit from their investments. However, in recent years, the funding escalator has changed and private markets' substantial growth in scale, and accessibility, have now positioned venture capital and private equity funds to compete with public markets for late-stage investment opportunities.

The emergence of new technologies and new standardisation of fundraising / investment terms have enabled a more efficient private market. Whilst, more institutional investors are now open to direct investments in growth and ventures, many companies have chosen to continue with private financing for a longer period of time, increasing private valuations and creating a substantial valuation gap between public and private equity markets.

At the same time, as fewer companies go public through the listing process, publicly listed companies are also increasingly leaving stock exchanges as they are privatised and de-listed. The below graph shows the growth of public-to-private deals over the past decade.

[4] Bain & Company, 'Global Private Equity Report 2019', available here.

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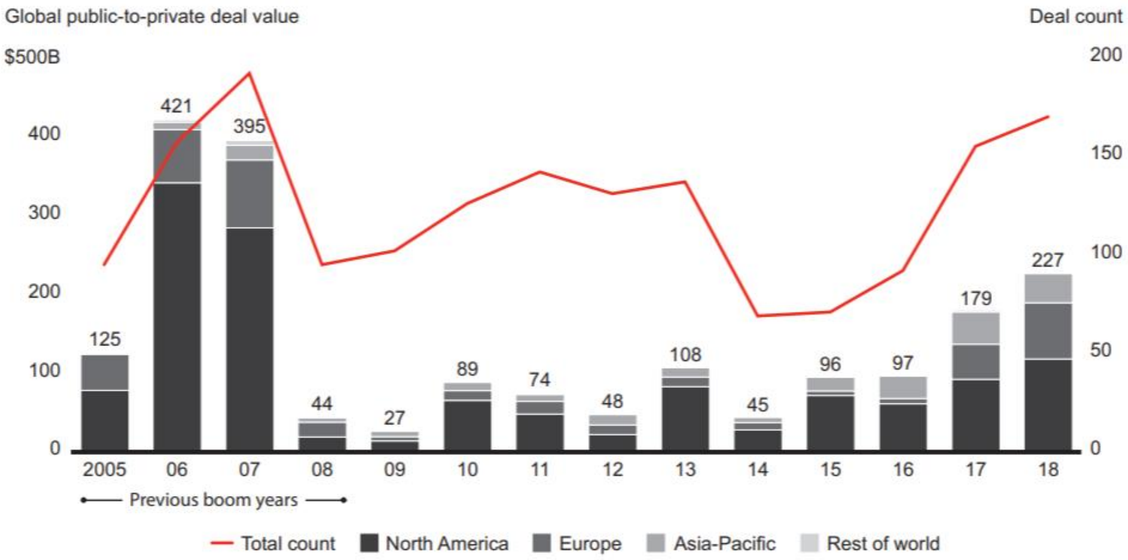
Figure 1.5: Public-to-private deals reached their highest level since the previous boom years, in terms of both value and count



Notes: Includes add-ons; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location
Source: Bain global public-to-private deal database

Source: Bain & Company, 'Global Private Equity Report 2019', available here.

3. Why should we be concerned?

3.1 Private equity investment opportunities are restricted to a selected few

While public equity markets allow private individuals to participate in the investment and growth of companies, private markets are only open to a small number of participants which are mainly institutional. Notably retail investors normally do not have direct access to companies' pre-IPO investments. Concerns have therefore been raised as there is a risk that inequalities are aggravated as only a few investors can take part in the growth of emerging companies if the trend continues.[5]

3.2 Publicly listed companies create more jobs domestically

IPOs allow companies to finance expansion thus supporting job creation. Evidence from the US shows that, publicly traded companies employ around one third of the population and represent 40% of GDP.[6] IPOs allow companies to finance expansion thus supporting job creation. Data from the US market (IHS Global Insight) show that 92 % of job growth occurs after a company's IPO.[7] Similarly, statistics from listings on Nasdaq First North Growth Market during 2006-2012 show that such companies increased their number of employees by

[5] While, it should be noted that private individuals can benefit from exposure to private companies through e.g. their pension fund, it is normally not possible to directly invest in a company before it goes public. This access to finance has effects on wealth distribution.
[6] B. González, 28th September 2019, 'Macroeconomics, Firm Dynamics and IPOs', working paper, available here.
[7] IPO Task Force, 2011, ' Rebuilding the IPO On-Ramp - Putting Emerging Companies and the Job Market Back on the Road to Growth' available here.

an annual average of 36.5 % following their IPO, compared with 1.5 % for private companies on the Swedish market.[8]

3.3 Stock-market based financial systems are tightly associated with better environmental quality

The European Central Bank published a Working Paper to understand how financial market activity contributes to climate change through its impact on the real economy.[9] The results of this study show that carbon emissions per capita are significantly lower in economies where equity financing is more important to bank lending and confirm that:

a. Stock markets tend to reallocate investment towards more carbon-efficient sectors
b. Stock markets facilitate the adoption of cleaner technologies in polluting industries and tend to punish firms that perform badly in environmental terms
c. Deeper stock markets are associated with more green innovation and patenting in traditionally carbon-intensive industries

Promoting public equity capital markets goes hand-in-hand with promoting additional investments in environmental, social and governance (ESG) initiatives, as public markets provide transparency and accountability to all involved financial market participants. Public capital markets could therefore play an important role in making future growth greener, in particular by stimulating innovation which leads to cleaner production processes within industries.

3.4 Public equity markets funding create an economy more robust to shocks

For society, the benefits of well-functioning equity markets include that the economy becomes more robust to external shocks. In this context, it should be considered that privatisations are often done through leveraged buyouts and highly leveraged buyouts are becoming increasingly common. [10] However, increasing debt levels may have consequences for companies' ability to survive an economic downturn.

4. What can be done to level the playing field?

The record-breaking long period of low level of interest rate is a contributing factor to the decline in IPOs as it practically means free financing for private equity and venture capital funds, given the increased access and recourse to debt financing, thus introducing leverage. Whilst, this is not a political issue, it should be noted that the monetary policy of central banks is impacting the incentive structures of companies.

4.1 Address the disclosure gap between public and private companies

Public companies have always been subject to rules related to being listed and traded on an exchange, both legal requirements and rules set by the Exchange, which naturally do not apply to private companies. However, the number of regulatory requirements, only applying to listed companies have, in recent years, increased substantially. This creates a barrier to

[8] Nasdaq, 2013, 'Ett förbättrat börsnoteringsklimat för Sveriges tillväxt – Problemanalys och förslag till åtgärder', available here.
[9] ECB Working Paper Series No 2318/September 2019
[10] Bain & Company, 'Global Private Equity Report 2019', available here.

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listing where companies may choose to stay private to not have to comply with the same levels of regulation and supervisory oversight.

In fact, a green paper published by the UK government in 2016 concluded that “increasing numbers of large businesses are choosing to operate as private businesses. In doing so, they are excluded from the higher levels of public scrutiny and formal corporate governance discipline associated with being traded on a public market”.[11] New Financial has noted that this ‘disclosure gap’ between private and public companies could be addressed by raising reporting standards for large private companies.[12] In the UK, this has been addressed by adopting requirements for private companies to follow codes of conducts of corporate governance. This type of code of conduct include the Wates Corporate Governance Principles for Large Private Companies developed by the Financial Reporting Council.[13] Similar corporate governance requirements for private companies of a certain size could also be considered at an EU level.

In the context of the sustainable finance agenda, many measures foresee further disclosures by companies in relation to their activities. FESE considers that both listed and non-listed companies should be encouraged to voluntarily disclose their business activities. To avoid creating a barrier to listing, it is important that the upcoming review of the Non-financial reporting Directive ensures that new obligations are well-calibrated and proportionate and equally apply to both listed and non-listed companies.

4.2 Support EU IPOs and public equity markets via the use of cross-over funds

We believe that initiatives to support EU IPO and public equity markets should focus on facilitating SMEs’ access to public finance. In the Netherlands, in order to stimulate investors to become active in the SME market segments, discussions are currently ongoing about creating a European cross-over funds to support listing of local SMEs. These funds would allow investors to invest in companies pre-IPO and facilitate their transition of shares prior to them becoming public.

More specifically, cross-over funds are investment funds that hold both public and private equity investments thereby smoothening the company’s transition from private to public equity markets. This instrument is built on private equity investors’ education as a way to facilitate portfolio exit in greater proportions, while boasting the patience expected by public investors, leading to improved valuation and better post-IPO journeys. By doing that, crossover (hybrid) private and public equity would increase the likelihood of creating additional investment opportunities in SMEs and, in turn, make them more attractive for investors.

Cross-over funds have been in use in the US for some time and are starting to emerge in Europe with some sector-specific[14] funds. Companies’ private valuation under cross-over investment funds, are expected to be more in line with that of public investors, leading to

[11] Department for Business, Energy & Industrial Strategy, 2016, ‘ Corporate Governance Reform: Green Paper’, available here.
[12] New Financial, 2019? ‘What are stock exchanges and why should we care?’, available here.
[13] Financial Reporting Council, ‘The Wates Corporate Governance Principles for Large Private Companies’, available here.
[14] Sofinnova, 4th April 2018,‘Sofinnova Partners launches healthcare Crossover Fund with €275 million ($340 million)’, available here

a more correlated valuation of their share price with less risk of a devaluation for the companies concerned.

Crossover funds would also help incentivise start-ups and SMEs to remain in the EU, as they are increasingly pushed to look for international capital via international venture capital and private equity funds abroad. An earlier entrance to capital markets would provide the required capital for start-ups and SMEs to continue to grow, while remaining independent, thus enabling them to remain based in Europe whilst generating qualified employment, innovation skills and capital gains for the EU.

There may be a need to ensure that the EU regulatory framework allows for the right management of this kind of hybrid funds with an objective to facilitate SMEs' access to public markets. In order to target specifically the scale up gap, as well as contributing meaningfully to the development of listed equity markets for SMEs, the hybrid funds should follow eligibility rules, such that its intervention remains focused and mission creep is avoided. Such eligibility rules can relate to (i) the nature of companies supported by the fund, (ii) the type of financing required by such companies, (iii) the nature of intermediaries with which the fund would work and (iv) and the timing moment of investment i.e. pre-IPO, at IPO and post IPO.

Additionally, co-investing from public institutions (like EIF or national development banks) in these crossover funds dedicated to SMEs would be very useful, especially in an initial phase to attract cornerstone investors, until this new activity takes off.

4.3 Address the debt/equity bias to encourage listing

Equity is more heavily taxed than debt in most countries, which creates a disincentive for equity investment, both in terms of companies not going public and encouraging delisting. Interest payments on debt may generally be deducted from profits before they are taxed, whereas equity financing does not receive any form of tax relief (and indeed may be subject to significant taxation both in terms of capital gains and dividend payments). This encourages companies to take on debt rather than equity; yet high debt-to-equity ratios increase the likelihood of bankruptcy and encourages risk-taking. Member states therefore need to take measures to address the debt/equity bias and incentivise equity investment. To address this, the Commission could also share best practices in taxation policy.