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*Istituto Affari Internazionali*

## Alternative Funding Sources for Growth: The Role of Private Equity, Venture Capital and Private Debt

by Anna Gervasoni



ASIA-EUROPE MEETING

### ABSTRACT

Recently, private equity, venture capital and private debt have received prominent backing from the EU Commission in its project to build Capital Markets Union. The fundamental role played by the financial industry in supporting SMEs, which can benefit from patient investment and active ownership, could be obstructed or encouraged by regulatory, tax and competition policies. This paper briefly describes the positive role of the industry players in developing successful and sustainable companies and hence contributing to growth and job creation. It also identifies challenges, opportunities and instruments needed to increase investments and encourage the development of new players, strengthen the existing ones, and further develop the pan-European capital market.

*Italy | Financial services | European Union*

keywords

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## 1. Capital Markets Union: opportunities and challenges

In September 2015, the European Commission launched the Capital Markets Union Action Plan,<sup>1</sup> as a part of the Juncker Plan. The document recognises the need and the relevance of capital market integration that can support the development of alternative channels complementary to bank credit financing, which is particularly important for small and medium-sized enterprises (SMEs). Having more diversified sources of financing is good for investments and businesses, but it is also essential for financial stability and for investor protection. In this context, private equity, venture capital and private debt markets are mentioned as the best ways to connect financing to the real economy.

Unfortunately, it is also underlined that nowadays the European private equity and venture capital markets are still too fragmented: this is true not only for the industry specialised in financing high-growth companies, but also for investments in start-ups or companies that need to expand their business.

There is also a wide disparity in terms of geographical distribution of practitioners: 90 percent of all fund managers are focused on eight European countries (UK, Germany, Sweden, Denmark, Finland, Netherlands, France and Spain) – why not Italy? This is a primary reflection considering the importance that Italy assumes both in Europe and worldwide: historically recognised as a quality benchmark, Italy ranks sixth in the world and second in Europe for manufacturing production and fourth in Europe in terms of exports.

<sup>1</sup> European Commission, *Action Plan on Building a Capital Markets Union* (COM/2015/0468), 30 September 2015, <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex:52015DC0468>.

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The European Commission's Green Paper on Capital Markets Union<sup>2</sup> underlines some obstacles for investments in equity, such as the European market and regulatory fragmentation and the resulting high costs of business creation and marketing of an alternative investments fund. These barriers have been partially removed by the AIFM Directive<sup>3</sup> and EuVECA Regulation,<sup>4</sup> but there are still different approaches that need to be quickly solved.

For full development of these forms of alternative financing, it is important that the legislation concerning large institutional investors, such as pension funds and insurance companies, follows the guidelines provided, not hampering the correct allocation of resources to the real economy, but allowing a continuous fundraising cycle. The Commission acknowledges that the largest institutional investors can play an important role, and desires the removal of all unjustified prudential obstacles.

Recently the most important European federations of intermediaries have stimulated the specific measures needed to make the Capital Markets Union a reality. In addition, European directives should be quickly implemented within the member countries, in order to avoid the problems we had in Italy, where the implementation of the AIFM Directive took place with an 18-month delay compared to the European deadline.

The development of the market should run in parallel with the regulatory framework of Capital Markets Union, in order to encourage long-term investments. The regulatory review could help to facilitate alternative investments, in order to promote emancipation from the banking system and boost international development.

Beyond the work and support provided by lenders who have been instrumental in industrial development in many success stories, traditionally banks look at companies in terms of default risk in lending. Differently from the bank attitude, the alternative credit market players assume a logic of selection based also on qualitative variables, aimed at the development and the potential growth of the company while also valuing intangibles often overlooked by the traditional valuation analysis.

<sup>2</sup> European Commission, *Green Paper: Building a Capital Markets Union* (COM/2015/63), 18 February 2015, <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=COM:2015:63:FIN>.

<sup>3</sup> Directive 2011/61/EU on Alternative Investment Fund Managers ..., 8 June 2011, <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex:32011L0061>.

<sup>4</sup> Regulation (EU) No 345/2013 on European venture capital funds, 17 April 2013, <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex:32013R0345>.

## 2. The economic impact of investments in equity

Investments in equity can play a role of primary importance in modern economic systems. First of all, on the company side, the opportunity of being invested in by specialised players focused on value creation enables firms to raise “patient” capital, which can be used to plan the start-up phase rather than to support development plans, new strategies, acquisitions, generational transitions or other critical phases of the life cycle.

However, since the support of private equity and venture capital is not confined to equity provision, further advantages derive from the availability of managerial know-how provided to the firm. Often growth through mergers and acquisitions offers significant advantages resulting from speed in entering new markets or gaining market share. The institutional shareholder has deep expertise based on a multitude of different business realities, and therefore has valuable knowledge the company can access. Private equity and venture capital players, for example, usually have experience in supporting the listing process and this can help in defining the optimal timing and procedures. At the same time, the new practices implemented by such institutional investors, together with the prestige of the institutional shareholder, improve the image of the company in the market, as well as its rating. More generally, it is proven that private-equity-backed targets show better economic performance than other comparable companies.

Equity investments can greatly contribute therefore to the development of the industrial system and of the economy as a whole, selecting companies with a rapid growth path and providing them with the necessary capital to develop. In this context, the expansion of the private equity, private debt and venture capital industries becomes a valuable political tool for supporting local economies.

### *2.1 The economic impact of private equity and venture capital: the Italian experience*

AIFI in cooperation with PricewaterhouseCoopers has recently carried out an analysis on the Italian market.<sup>5</sup> The study focuses on the performance of companies owned by private equity in the period 2003-2013 and is based on a sample of 425 disinvestments.

The research shows that private-equity-backed companies have a positive trend of growth over the years, showing better performance in comparison with both GDP and similar Italian companies; in terms of sales they have an annual growth rate of 9.1 percent, significantly higher than both the Italian GDP (1.5 percent) and the benchmark of similar companies (3.6 percent). Regarding employment data,

<sup>5</sup> PricewaterhouseCoopers, *L'impatto economico del Private Equity e del Venture Capital in Italia*, March 2015, <http://www.aifi.it/?wpdmact=process&did=MTc4OC5ob3RsaW5r>.

the analysis shows that the Italian employment rate fell during the period by 0.4 percent, the benchmark also decreased by 0.3 percent, whereas the private-equity-backed companies experienced 5.3 percent growth.

Even from the point of view of revenues and profitability (EBITDA), the study shows positive results, in the period from 2003 to 2013, for companies financed by private equity, which grew at a higher annual rate than similar sized Italian companies.

## *2.2 The effect of internationalisation*

The particular attention paid to internationalisation comes from the fact that European economic growth depends on improved competitiveness, which also results in better export performance. In general, the evidence shows that private equity players support the necessary preconditions that enable companies to effectively internationalise, ensuring resources and know-how, increasing risk appetite and promoting export as well as the effective management of resources.

Focusing on the main sectors in which Italy has a leading position in terms of export turnover, such as the food industry, luxury clothing and manufacturing, there is a strong correlation between the sectors selected by Italian private equity and the most important sectors in terms of export, confirming the importance that investors attribute to the international attitude.

Finally, a survey conducted by Private Equity Monitor on a sample of 65 companies, acquired and divested between 2000 and 2008, reports a 60 percent increase in exports, with foreign sales revenues contributing 48 percent.

## *2.3 A current AIFI study on value creation*

AIFI in cooperation with Cerved is currently working on a study about value creation, based on a database provided by Private Equity Monitor, which shows some very significant data regarding investments, foreign sales and employment rates of companies held by private equity firms. This research is still ongoing and will be extended, in order to explicate the role of private equity in supporting the portfolio companies. We will therefore reserve other lines of research for the future.

In general, starting from the first results of a selected sample, it is clear that the contribution of investors in target companies generates an increase in investments, reporting growth of 46 percent. From the point of view of foreign sales, the research underlines a 104 percent growth, calculated on 24 transactions. These data are very important because they emphasise that partnership with a financial investor often involves the launching of internationalisation processes and the introduction of a management logic that allows the company to improve efficiency.

Finally, considering about 80 deals, it appears that they show a 34 percent average growth in employment rate.

### 3. The role of public-private partnership

Previous analyses show that the activity of private equity, venture capital and private debt funds is fundamental for the development of an economic system; these alternative investments in equity can play a key role, as the European discussion has confirmed, and public support can do its part to promote and expand this sector. The challenge is to find ways to increase the size and the number of funds and to determine how public and private financing together can contribute to this goal.

Among institutional interventions at the European level, the European Investment Fund plays a notable role in promoting equity investments, as well as in stimulating member states with public-private schemes, in order to facilitate the access of small and medium-sized enterprises to venture capital.

In recent years in Italy, we have been developing some specific public-private partnership programmes, following international best practices. The most recent, related to an initiative of Cassa Depositi e Prestiti,<sup>6</sup> are two new "funds of funds," one for private debt and one for venture capital, managed by Fondo Italiano d'Investimento. The aim is to cover the deficiencies existing in our alternative investment markets.<sup>7</sup> Nevertheless, we need to use specific measures to remove the barriers in attracting institutional investors, such as insurance companies and pension funds. This could draw in more investors, increase investments and encourage the development of new players and strengthen the existing ones.

*Updated 26 November 2015*

<sup>6</sup> Cassa Depositi e Prestiti, *CDP: €350 million in resources for the private debt and venture capital sectors*, 28 May 2014, <http://www.cdp.it/en/media/press-releases/cdp-350-milioni-di-euro-nei-settori-del-private-debt-e-venture-capital.html>.

<sup>7</sup> For more information see the website of the Fondo Italiano d'Investimento: <http://www.fondoitaliano.it/en>.

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### Istituto Affari Internazionali (IAI)

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