On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to Call for Evidence “Request by the European Commission to EIOPA for Technical Advice on the treatment of unlisted equity and debt without an ECAI rating in the standard formula”

I. General comments

Invest Europe’s membership covers all private equity activity, from early-stage venture capital through to large private equity firms and funds investing in infrastructure. Our membership also includes institutional investors, such as pension funds and insurance companies, who are a key source of long-term financing in Europe and who invest in private equity, venture capital and infrastructure funds.

Invest Europe welcomes the opportunity to respond to EIOPA’s Call for Evidence on the treatment of unlisted equity and debt without an ECAI rating in the standard formula and appreciates that EIOPA is seeking stakeholders’ feedback before submitting its advice to the European Commission.

As rightly indicated in the Commission’s request for advice, it is of utmost importance that investments that support jobs and growth are appropriately treated in insurers’ prudential requirements. Unjustified constraints on investments in unrated bonds and loans and in unlisted equity should be removed, in order to improve insurers’ ability to invest in private placement offerings and in private equity.

The Commission’s intention to review the methods, assumptions and standard parameters used when calculating the SCR with the standard formula and in particular its intention to reassess risk weights for private equity as part of the Solvency II review - as indicated in the CMU Action Plan - are important steps that may increase investment into long-term asset classes.

While the 39% risk weighting for insurers’ investments in certain types of private equity funds was a welcome improvement, we nonetheless remain concerned that this does not reflect the actual risk insurers face when investing in our asset class. In our view the capital charge for private equity should be significantly lower than the existing 39% (or 49% in some cases). Our analysis indicates
that there is strong evidence that the capital charge for private equity in the standard formula should be in the range of 20% - 35%.

II. **Suggestion for methods and criteria**

1. **Do you have any suggestions for criteria and methods (“approaches”) to identify portfolios/types of unlisted equities to which the type 1 equity risk charge could be applied?**

In our view the capital charge for private equity in the standard formula should be significantly lower than 39%.

In order to identify assets to which the type 1 equity risk charge (or other lower capital charge) could be applied, EIOPA should look at how exposure to the asset is gained. We would suggest that the type 1 risk charge could be applied where exposure to unlisted companies is gained through:

- a portfolio of unlisted funds each managed by a third party private equity manager; or
- an unlisted fund of funds managed by a specialist manager of private equity funds; or
- a portfolio of directly held shares in unlisted companies, managed either internally or by a third party investment manager; or
- a combination of the above three methods.

We would like to underline that in the private equity industry, funds (including fund of funds) and the management of portfolios of directly held shares in unlisted companies have a distinct combination of structure, business model and investment strategy. These should be taken into account when defining the methods and criteria (“approaches”) to be used to identify which portfolios and funds that provide insurers with exposure to unlisted companies should be able to benefit from a lower risk weight.

**Nature and characteristics of private equity funds through which insurers gain exposure to unlisted companies**

The characteristics that are fundamental to identify investment in unlisted companies via a private equity fund (or portfolio of directly held shares in unlisted companies), are rooted in:

1. How the manager of the fund, or portfolio, interacts with the management team of the unlisted company;
2. The investment strategy of the fund;
3. The structure and terms of the fund; and
4. How the manager of the fund interacts with the investors in the fund.
Private equity funds operate an active management approach to investment in unquoted companies. This means that both financial and human capital are invested in the company, with the aim of being involved in actively helping the company grow and achieve the next stage of its development. Private equity funds will frequently hold a majority of shares in the business (and often the only other shareholders will be the company’s management team) and representatives of the fund manager (who will tend to have specific sector or functional expertise relevant to the company) will frequently have two or three non-executive board positions in the company.

Outside the formal board meeting cycle this active ownership model generally also sees the manager of the private equity fund (or portfolio) being involved on a variety of operational aspects of the business, including contributing to the development and implementation of the business strategy, recruitment of key members of the management team and helping management address specific issues to help build a business that will be sustainable and successful beyond the period in which the private equity fund is invested. The private equity fund manager will frequently also be instrumental in introducing good governance practices to boards and in preparing companies and their management teams for the regulatory requirements and rigours of becoming a listed company in the future.

The strategy of a private equity fund is generally defined by the particular stage of development of the companies in which the fund will seek to invest e.g. start-up, early stage, growth, small, medium or larger buy outs. The fund will articulate to its investors the characteristics it will look for in the companies it seeks to invest in, such as market position, the size of company in terms of enterprise value, as well as the size of investment in a company the fund will aim to make. It will also make clear to investors the method (or methods) by which the manager of the fund will seek to add value to the company through the period of ownership. It will, of course, also define the traditional criteria one might expect to see for in the investment strategy of any type of fund, such as sector and geographic area.

Private equity funds are usually structured as closed-end vehicles with a minimum life-span of 10 years, to ensure that the underlying companies in which investments are made have the time and opportunity to grow and develop. Unlike listed funds, private equity funds are not designed to be traded, or for investors to redeem their investment during the life of the fund. Indeed, early redemption is typically expressly excluded by the legal document, which governs the management of the fund. Although a secondary market for participations in private equity funds exists, the terms under which an investor can sell their position on the secondary market to another investor
are limited and strictly governed by the terms of the fund’s governing document. Moreover, as evidenced in the wake of the 2008 financial crisis, the long term, illiquid nature of private equity (coupled with the prudent level of exposure to the asset class within an insurer’s total assets) means that it is highly unlikely that an insurance company would either want or need to sell its holding during a period of macroeconomic or financial market stress.

It is important to note that an investor in a private equity fund has stakes in the fund and does not hold a pro-rata share of the shares in the underlying unlisted companies in which the fund is invested. Where an insurer chooses exposure through a portfolio of directly held shares in unlisted companies it is directly exposed to the shares in the unlisted companies. This distinction is crucial in understanding the investment due diligence and on-going monitoring process in each approach.

Investors participate in private equity funds by making a legally binding commitment to invest a specified amount of capital in the fund, entitling them to a proportional share of fund interests. The fund manager draws down from this pool of committed capital to fund the investment in a diversified range of unlisted companies over the course of the fund’s investment period (typically 5-6 years of the fund’s 10-year life). As the fund realizes its investment in each portfolio company the proceeds are promptly distributed to the investors.

Investors in private equity funds generally follow a very rigorous due diligence process before making the decision as to whether or not to commit to a fund. Prior to a commitment being made the investor will have, over the course of many months, met with various members of the fund manager’s team (usually on-site at the fund manager’s office(s)). Through an iterative process of due diligence, involving (among other things):

i) interviews with the manager,

ii) taking references from the CEO and FD of previous companies in which the fund manager has invested,

iii) qualitative and quantitative analysis of the progress of the companies in which the manager has invested with its prior funds,

iv) analysis of how the investment strategy and management of the previous funds managed by the manager have been implemented and executed, and how the manager of the fund manages its own fund management business,

the investor will come to a decision as to whether or not to invest in the fund.

During the course of the investor’s due diligence, the manager of the fund being raised will have been required to provide not only a significant amount of information about its own organization
and the previous investments it has made, but also to respond to requests for further and specific information as the investor works their way through their due diligence process.

Alongside the commercial due diligence which investors undertake, the fund manager will also have to interact with potential investors on the specific terms and conditions in the fund’s governing document. Not only can the proposed terms of a private equity fund be altered as a result of investors’ due diligence process, each individual investor will have agreed and set out in a side letter to the fund’s governing document any specific issues pertinent to its circumstances (such as its own legal structure or specific requirements resulting from its ESG (Environmental, Social & Governance) policy).

Once a commitment to a private equity fund has been made, the nature of the relationship between fund manager and investor through the life of the fund is unique in terms of the quality and quantity of information provided to investors, number of face-to-face meetings and level of investor access to the fund manager.

The precise level of contact and extent of information provided by a private equity manager to the investors in its funds is, to a large extent, determined by each investor. As a minimum, however, a private equity fund will have an investor advisory board to provide oversight of potential conflicts of interest and fund governance. These boards have the ability to meet with the manager and to meet independently of the manager and may call for independent advice to be provided on an issue if it is deemed necessary. The manager will also provide written quarterly reports and capital statements and a more detailed annual report. In addition, the manager may provide further written reporting at the request of an individual investor, covering issues and in a format determined by the investor. The annual investor meeting will typically update investors on the progress of the investments made by the fund and on developments within the fund manager’s own business and there will often be presentations by the CEO of the companies in which the fund has invested. In addition to the annual meeting, investors have the ability to meet with the manager to address issues the investor wishes to discuss on an individual basis throughout the year.

2. Which criteria do you suggest based on the
   a. characteristics of the portfolio, in particular the diversification achieved either directly or through funds?
   b. the transparency (type and (minimum) frequency of information) offered to the investor on the company in question, either by the fund manager or by the company itself?
c. the consideration taken for environmental, social and governance aspects?
d. the asset management skills and strategy and the insurer’s own risk management system, to ensure its ability to pursue investments in unlisted equity and to manage properly risks related to them, either directly or through funds?
e. any other factor?

We are not convinced that all of the four factors identified by EIOPA are appropriate means of defining the risk of an investment in private equity.

In our opinion, in order to properly manage the investor’s risk, exposure to unlisted companies needs to be on a balanced, diversified basis and managed by people with the relevant skills. This is the case whether exposure is gained through a portfolio of unlisted funds, an unlisted fund of funds, through directly held shares in companies, or in some combination of all three approaches.

a) Diversification has a great impact on the investor’s risk of losing the capital it invests and is indeed a critical tool in managing an investor’s risk in the unlisted company asset class. When gaining exposure through a portfolio of funds, an investor (or a manager of a fund of funds) will seek to diversify the fund portfolio by stage of investment, sector, geography, vintage year (in which the fund is raised) and fund manager. In this way investors’ risk is reduced substantially.

The risk of losing any capital in a well-diversified portfolio of private equity funds is relatively low - 1.4% for 20 funds and 0.3% for 50 funds.¹ To put this (very low) risk of an investor not recovering the cost of capital invested in a private equity fund at maturity (i.e. at the end of the life of the fund) in context, these figures are lower than has been experienced by investors in corporate bond portfolios. Holding an investment in a private equity fund to maturity is what investors do, even in the most extreme market conditions, such as those experienced during the 2008 financial crisis.

We have been unable to identify any evidence of forced sales of private equity fund holdings by insurance firms during this period. This should not come as a surprise for two reasons.

Firstly, part of the risk management approach to investing in private equity that institutional investors, such as insurance firms, take is to allocate only that level of total assets to private equity, which is deemed prudent so to do. Therefore, with an allocation of, for example, 5%

¹ British Private Equity and Venture Capital Association (BVCA) Research Paper – October 2015; Risk in Private Equity, New insights into the risk of a portfolio of private equity funds
of total assets to private equity even if there were to be a tiny percentage of capital loss in the diversified portfolio of funds held, then the impact on the total assets of the insurer would be *de minimis*.

Secondly, as experienced investors in private equity funds know through experience, even if the underlying companies in which the private equity funds invest are adversely affected in difficult economic times in the *short* term, this does not mean that any set backs are permanent. These businesses are generally able to get back on track over the time period in which they are held in the private equity fund. Exposure to unlisted companies through private equity funds is not expected to deliver quarter-by-quarter incremental income and gains to the investor, as would be expected in listed equity investing. It is primarily expected to deliver significant capital gain that is only “made real” when the fund achieves a realization (whether partial or full) upon exiting the company into which it invested, usually several years after the initial investment.

Ultimately, the level of diversification of exposure to unlisted companies is key to identifying the level of risk insurance firms face actually when investing in private equity. Gaining exposure through even a single fund of funds, managed by an external, specialist fund manager is akin to having an internal specialist team building and managing a portfolio of funds. Either approach will give the investor (indirectly) exposure to several hundred unlisted companies. If, however, an insurer’s exposure to unlisted companies were only to be gained via a portfolio of directly held shares in unlisted companies, then the number of companies to which the insurer were exposed would be significantly lower, thus making the risk of gaining exposure to unlisted companies this way higher than investing through a portfolio of private equity funds or a single private equity fund of funds.

These aspects of private equity should be taken into account when defining potential criteria or any capital requirements for insurers’ investment in the asset class. It would follow that we could envisage a different risk weight depending on whether an insurer gained exposure via funds or via directly held shares in unlisted companies.

b) Investor reporting and transparency might be an important element for EIOPA to consider. We have alluded to the type of reporting and information flow between a private equity fund manager and investors in the answer to Q1 above. However, as with other factors identified in
the Call for Evidence, it might be challenging to come up with clear, measurable criteria that could be used to identify investments that could benefit from a type 1 equity risk charge.

In the private equity fund context, investor reporting is delivered on a timely basis to enable investors to perform their investment analysis appropriately and, for example, in the case of insurance companies, to help them satisfy their Solvency II reporting and disclosure obligations. According to the Invest Europe Investor Reporting Guidelines (which are part of the Invest Europe Professional Standards Handbook and widely used across the industry) reported information should be delivered in a form agreed with the fund’s investors. It is typical for a private equity fund manager to develop standardised reporting of information for their investors at the outset so that over the life of the fund reporting is delivered according to a consistent format and timetable (usually quarterly). However, there should always be the ability to enhance and modify the content of such reports over the life of the fund. This is particularly important where external legal, regulatory and stakeholder interactions lead to a change in the accepted norms for reporting to investors.

In a private equity context, it is common for the fund manager to provide the quarterly information in one reporting package, which includes both narrative and financial information. Private equity fund managers will need to consider, and where appropriate agree with their investors, what time periods their reports should cover. Current period (i.e. quarter or six months depending on the frequency of reporting) and data since inception are likely to be required, with either financial year-to-date or last twelve months’ data common additional disclosures.

Exact timings, notification periods to investors and content of the reporting as well as audit requirements and applicable financial reporting frameworks (GAAP) are usually agreed within the fund formation documents and can vary from fund to fund depending, in part, on the requirements of the investors in that particular fund. It is very rare that this changes over the life of a fund except where new accounting standards require such a change.

c) The consideration of environmental, social and governance (ESG) criteria is an increasingly significant element in investors’ due diligence process, but it is also very difficult to quantify its impact in determining risk for investors.
The responsible investment agenda is a key component of private equity industry practice; it is not just a specialist topic for certain investors. As society is addressing the sustainability agenda, the specific consideration and management of ESG opportunities and risks in the investment process are becoming more and more important to fund managers and investors alike both to safeguard the long-term performance of their investments and to enable them to fulfil the broader social role that stakeholders expect. As such, responsible investment has increasingly become a top-of-mind issue for fund managers and investors in the private equity industry, and ESG factors continue to play an important role in their investment decisions and the on-going development of the company after investment.

It is important to keep in mind that private equity is foremost an ownership model for investments in privately held companies of all sizes and at all stages of development. The nature of the long-term partnerships formed through negotiations and ongoing interactions between fund managers and investors as well as fund managers and their portfolio companies is fundamental to how the industry operates and sets it apart from other asset classes. Given this hands-on active stewardship of businesses and long-term ownership timeframe, as an asset class private equity is particularly well suited to integrating and managing ESG matters.

The Invest Europe Professional Standards Handbook sets out an overview of the responsible investment and ESG factors that are being considered and reflected when funds invest in unlisted companies. These cover both consideration of how the business operates, in terms of the sourcing, production and distribution of its product, or service, and also how the board of the unlisted company is governed. The Handbook also provides guidance to managers of private equity funds on governance matters within their own firm and sets out a six-point code of conduct for the industry.

d) While the asset management skills, strategy and the insurer’s own risk management system also play an important role, it is very difficult to put a quantitative measure on these factors. However, this criterion would probably need to describe the insurer’s process/criteria for hiring its in-house team responsible for implementing the unlisted company investment strategy (whether that is via funds/fund of funds or directs). It would also need to describe the insurer’s in-house risk management process, of which the unlisted equity exposure would be part, along with the insurer’s process for deciding if it is going to have exposure to unlisted

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2 According to the Invest Europe Professional Standards Handbook, ‘responsible investment’ involves an investment approach that integrates ESG factors into corporate conduct, investment decisions and ownership activities.
companies and if so what level of exposure that should be and how the exposure should be gained. Additionally, it may be pertinent to refer to the existence of insurers’ processes in relation to the day-to-day management of their unlisted equity exposure. Institutional investors in private equity have developed their own internal administration and monitoring processes that reflect the approach used to gaining exposure. The information gathered through these processes is integral to managing the various risks faced by investors in implementing their private equity investment strategy.

e) Performance of the asset class as well as the skills, experience and expertise applied by the fund manager to its investments / portfolio companies might be considered as additional factors to be taken into account by EIOPA.

**Performance**

The most powerful rationale for insurers to invest in private equity is its ability to provide good returns on an absolute and relative basis. Over the long term, private equity has consistently provided higher returns to investors than comparable public companies. For example, UK-based private equity funds (many of which invest on a pan-European basis) achieved annual net-of-fees returns of 14.9% over ten years to 2014, around double that of the FTSE All-Share index, according to BVCA figures\(^3\).

The ten-year performance figures provide the most useful guide for potential private equity returns. This is because most funds will invest and then realise their portfolio of investments over a ten-year period. However, even over five or three years, private equity outperforms other investment types, as the chart shows.

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\(^3\) BVCA Private Equity and Venture Capital Performance Measurement Survey 2015
Note: The comparisons are for indicative purposes only. The performance of private equity funds is measured by IRR to investors, net of costs and fees. Returns from the FTSE All-Share are gross time-weighted returns.

Skills, experience and expertise

The hands-on nature of the asset class means that the skills and experience of the fund manager can make a substantial difference to the returns generated.

These skills might include those held in-house and gained by the fund manager over many years of managing complex investments (that are covered in our response to Q14) but also external resources/expertise the fund manager may bring via external advisers, professional services firms, operating partners etc. These resources can be targeted and designed to deal with general issues or with a specific risk, e.g. legal/regulatory, which the portfolio company might face but not have the expertise to deal with on its own.

This specific characteristic (which differentiates the private equity industry from other asset classes) and active ownership would both add value and lower the risk exposure when investing in the asset class. Both experienced non-executive directors on portfolio company boards, fund manager deal executives working with management teams, and external advisers/operating
partners are far more likely to identify risk at the portfolio company level at an early stage allowing for early interception and for mitigating actions to be taken.

III. Properties of the proposed approaches and evidence

3. What is the (quantitative) evidence on the ability of your proposed approaches to identify unlisted equities which merit the type 1 equity risk charge? How do you measure that the risk is comparable?

We have described in the answer to Q2 the different approaches to gaining exposure to unlisted companies. When an insurer invests in private equity it will be clear through which approach this is being achieved. We strongly believe that where an insurer gains exposure to private equity either through a portfolio of unlisted funds, or through a single fund of funds then that type of “unlisted equity” exposure merits, at the very least, the type 1 charge. We have presented solid evidence that the risk of losing capital (the main risk when investing in private equity) when investing in a diversified portfolio of unlisted private equity funds is extremely low: 1.4% in a portfolio of only 20 funds and only 0.3% in a portfolio of 50 funds. Just as price volatility is the key risk when investing in listed equities, the comparable key risk when investing in private equity funds is the risk of loss of capital. The main factor that would force an investor to unwillingly sell its private equity fund investments would be an expectation that they would not ultimately get back the capital invested (or the prevailing NAV of the fund). Where that risk is judged to be of the magnitude we have demonstrated here and the investor is able to hold the investment to maturity, then the relevance of changes in the interim NAV (which while not truly comparable, is the closest approximation for “price” that exists in private equity fund investing) of a fund, or portfolio of funds, falls away, while the maintenance of a well managed, balanced, diversified portfolio of funds is the risk to be managed.

4. How easily available are the data to apply the criteria?

Identifying the number of unlisted funds in an insurer’s internally managed private equity portfolio, or the number of funds in the fund of funds through which the insurer is gaining its private equity exposure is easily available.
IV. Information on unlisted equities

5. Can you provide data on the characteristics of unlisted equity investments in companies in the EEA in general (e.g. properties of the issuing companies like sector, size and leverage, volumes, diversification) and on its risk profile (e.g. volatility of cash flows and profits)?

6. How similar are unlisted companies to listed companies included in the major equity indices in terms of
   a. risk-relevant properties (e.g. sectors, leverage, diversification across business lines and geographies)?
   b. volatility of revenues, cash flows and profits?

It is extremely difficult to provide the sort comparative data requested. Companies listed on a stock exchange are, by definition, clearly identified and known to all market participants and observers of the market. There is no such single comprehensive, readily available list of every privately held company in the EEA. Even if it did exist it would be constantly out of date as new companies are created and others merge. New types of companies can be created through consolidation strategies, where several smaller companies will be brought together to create a completely new company, which did not previously exist. Within the venture segment of the market it is an impossibility to identify companies that do not currently exist, but are created in a start-up situation. Consequently, providing accurate and comprehensive information of the type described is not possible. It is fair to say, however, that the ability both to create new businesses, through the development of new technologies and concepts that only exist because of private equity investment and to invest in existing businesses with multi-billion Euro enterprise values, means that the unlisted companies market is probably more diverse by size and sector than that of listed companies.

In 2016, European private equity funds invested €53.7 billion into almost 6,000 companies, 83% of which are SMEs. It is not possible to identify what proportion of all unlisted companies in the EEA this represents. To give some context to these numbers in terms of the size of the market, we believe there to be approximately 2,030 listed companies on the UK stock exchange; 530 on the German exchange and 485 on the French stock exchange.

The broad sectors that managers of private equity funds identify for the investments they make are:

- agriculture
- biotech and healthcare
- business products and services
- chemicals and materials
- construction
- consumer goods and services
- energy and environment
- financial and insurance activities
- ICT (communications, computers and electronics)
- real estate
- transportation
- other.

It is worth reiterating that when gaining exposure through a diversified portfolio of unlisted private equity funds, the investor is gaining indirect exposure to several hundred companies (indeed many institutional investors with well established fund portfolios often end up with indirect exposure to several thousand underlying companies). Consequently, the impact at the total portfolio level of a few companies being so early stage in their existence that they have yet to achieve revenues, let alone profits, is negligible. Nor is it comparing like-with-like to compare the impact of those companies with the much more significant impact on short-term price volatility in a portfolio of listed companies that results from a large, established company experiencing fluctuations in its profits.

For information relating to the correlation of listed an unlisted please refer to the articles listed in response to Q7 below.

7. Are there any sources for data, criteria or methods or any (academic) studies on the topic that EIOPA should consider?

We would recommend EIOPA consider the following publications:

- Invest Europe Research Paper “Calibration of Risk and Correlation in Private Equity Based on the LPX 50 NAV Index”, October 2013

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V. Investment by insurers in unlisted equity

8. What are the characteristics of unlisted equity investments in companies in the EEA by internal model and standard formula insurers respectively? Can you provide any of the information referred to in question 6?

While insurance companies themselves are in the best position to answer this question we would like to reiterate that a clear distinction needs to be made between the characteristics of a private equity fund (or fund of funds) and those of a portfolio of directly held shares in unlisted companies.

While an investor in a new fund can analyse the companies that the fund manager has invested in previously they are not investing in those companies but rather in a “blind pool” of companies yet to be identified for the new fund. Investors will, of course, have a very good sense of the type of company the fund is likely to be invested in based on the fund’s stated investment strategy and the fund manager’s previous investments, but they cannot know at the outset the specific companies into which companies will be made.

Moreover, when investing in a fund, investors hold participations in the fund and do not hold a pro rata share of the shares in the underlying companies in which the fund invests. Consequently, the due diligence they conduct and the risks they need to manage are focused on the manager of the fund and how the stated investment strategy of the fund will be executed. The characteristics and risk profiles of past investments made by the manager is only a small part of the overall due diligence process. Once committed to a private equity fund, the investor does receive detailed information on the companies in which investments are made both at the time the fund invests in the company and subsequently, and this assists investors in their monitoring of their fund commitment.

9. How do insurers invest in unlisted equities (direct investment, specialised funds etc.)?

Insurers invest in unlisted companies in one or a combination of the following ways:

a) portfolio of unlisted funds which invest in unlisted companies, each fund is managed by a third party private equity manager

b) an unlisted fund of funds, which invests in unlisted funds, and is managed by a specialist manager

c) a portfolio of directly held shares in unlisted companies, managed either internally or by a third party investment manager

When insurers gain exposure through unlisted funds, it may also be the case that in some of the unlisted funds to which they make commitments there may be occasions when they co-invest directly in an underlying company alongside the unlisted fund. This co-investment in the underlying company may either be held directly by the insurer or may be held through an SPV managed by the manager of the unlisted fund. This type of co-investing is generally evaluated differently from investments in unlisted companies through a portfolio of directly held shares, as co-investments need to be looked at in the context of the exposure through the fund portfolio.

When insurers gain exposure through unlisted fund of funds, it would not be unusual for the insurer to commit to only one fund of funds, as the fund of funds will have a strategy that is aimed at giving exposure to a broadly diversified portfolio of underlying, unlisted funds. In terms of the diversification of exposure to the underlying funds to which commitments are made, a fund of funds is akin to what an insurer that is managing its own portfolio of unlisted funds in-house does.

As noted in our answer to Q2 above, risk diversification is ultimately based on the number of underlying companies to which the investor is exposed.

10. Can you provide information on the due-diligence and risk management processes that insurers investing in unlisted equities implement and their strategy? What are the main features of insurers’ internal policy on investment in unlisted equity?

Selecting the right managers in whose funds to invest and building an appropriately diversified portfolio of funds is at the heart of the due diligence and risk management process for investors gaining exposure to unlisted companies through private equity funds. While the broad approach to due diligence followed by investors in private equity funds is described in our answer to Q1 above, each investor will have their own specific process and methods of conducting due diligence. Some illustrative examples of the sorts of areas that investors in funds would tend to cover in their fund commercial due diligence would include, but is by no means be limited to, the following:

- how the fund manager’s own business has evolved and is managed, including how the team is structured, how it is incentivized, level of financial commitment from the fund manager team to the fund, how the back office is structured and managed, the ownership structure of the fund manager, the breadth, depth and quality of the investment team;
- the intended investment strategy of the fund (and the rationale for this) in terms of stage of investment, size and types of companies to be invested in, how well resourced and experienced the team is to implement the stated strategy effectively, how does the fund manager intend to add value to the investments made, how does the manager take account of ESG issues when investing, how would the strategy of this fund fit with other funds already in the investor’s portfolio;

- the fund manager’s investment processes, including approach to deal sourcing and its decision-making policies, the valuation policy of the fund, approach to reporting and investor relations, approach to compliance and risk monitoring;

- analysis of past fund performance, including qualitative and quantitative analysis of individual investments made by each fund and of the fund as a whole (to determine the fund manager’s portfolio construction and management skills as well as their company selection, deal structuring and post investment ability to add value and achieve an exit from the investments made).

### 11. How do insurers diversify their investments in unlisted equity investments?

When gaining exposure through unlisted funds insurers diversify their commitments to funds in their portfolio by fund strategy, stage of investment, sector, time (year in which the closed-end fund was raised), geography and manager. In this way the insurer is able to gain exposure across a very wide range of types of underlying unlisted companies over the whole economic cycle.

**Stage of investment:** there is little correlation between companies at different stages in their development and so it is possible to diversify risk through investments in funds which focus on different stages of investment: start-up, early and/or late-stage venture, small and mid-market buyouts and large buyouts. In addition, sub-categories of the asset class, such as secondary funds, distressed funds or private debt funds, can provide further diversification.

**Geography:** investors can gain geographic diversification by investing in global funds, pan-regional funds (such as pan-European), regional funds (such as Southern European) or country-specific funds.

**Vintage year:** funds raised at different points in the economic cycle are able to invest in different types of opportunities. Experienced investors in private equity and venture capital funds usually invest consistently through all vintage years to benefit from this.
**Sector/industry:** while many funds in the buy-out segment of the market tend to be generalist funds, investing across a range of sectors, many fund managers, particularly venture capital fund managers, target specific sectors or sub-sectors where they have particular experience of investing. There are also some funds that specialise in particular industries, such as cleantech.

**Manager:** investors need an adequate spread of funds by fund manager to manage fund manager concentration risk.

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12. **What information is provided to insurers investing in unlisted equities at the outset of the transaction and afterwards at what frequency? How does this compare to the disclosure available on listed companies?**

It is important to distinguish between the situation where an insurer invests in a fund and where it invests directly in the shares of an unlisted company. We have indicated in the answers to previous questions (Q1 and Q10) the sort of information an insurer will be provided with and request as part of their due diligence when investing in private equity funds and their subsequent monitoring of the progress of these funds.

The European private equity fund industry has developed reporting guidelines that are designed to provide ‘best practice’ advice to fund managers on how to report to their investors. These Guidelines - produced by the Invest Europe Professional Standards Committee - are widely used across the industry and are reviewed and updated regularly to ensure that they remain appropriate and to take account of changing circumstances, including the changing needs of investors.

As Invest Europe’s membership includes both fund managers and investors, these Guidelines benefit from detailed input from both constituencies. The Invest Europe Investor Reporting Guidelines and the IPEV Valuation Guidelines, both included in the Invest Europe Professional Standards Handbook, recommend that the fund documents should contain provisions regarding the fund manager’s obligations to provide reports to investors. These provisions should address the following matters:

- the frequency of reports to be made;
- the information to be contained in these reports;
- the form and frequency of responsible investment reporting;
- the basis of valuation that will be used for such reports;
- the manner in which the reports are to be made (e.g. in writing, by email, via a secure website).
Typically, investors in private equity funds receive quarterly information providing details about the companies in which the funds have invested and developments in the fund manager’s own business/team, which are relevant to the management of the fund.

The underlying company level information will vary from fund to fund and be dependent on the type of fund and investment strategy being pursued by the fund. But generally the information is a mixture of qualitative and quantitative data to inform investors about the on-going progress and performance of the company relative to the expectations when the fund invested in the company. The level of detail in terms of the reporting of company financials relative to budget and forecasts will vary depending on the type of investments being made: for example, in start-up and early stage companies there may be no revenue, let alone any profits, but information on cash burn and progress relative to development milestones can be reported. For funds with investment strategies aimed at larger, more developed companies, then the financial information reported to investors in private equity funds becomes focused on more traditional financial indicators such as profits, margin growth, revenues etc.

13. How much consideration is taken for environmental, social or governance aspects in unlisted equity investments in general and for the investments by insurers in specific? How are environmental, social or governance aspects made operational (label, scores etc.)?

The consideration of ESG as a separate factor might be an important element of due diligence process. However, this will vary from investor to investor. While some investors might have quite a rigorous quantitative approach to factoring in ESG to their due diligence, many others have a more qualitative approach. For some, the issues highlighted by ESG policies have traditionally been an integral part of due diligence, rather than being identified as a separate issue.

In light of this, please note that this question has been answered from the perspective of the European private equity industry as a whole, based on the industry’s professional standards and guidelines. Our response does not therefore reflect specific strategies of individual member firms. The professional standards set out in the Handbook provide a general framework, leaving appropriate flexibility for fund managers and investors to implement them in a tailored way, adapted to their business’s own model and processes. Individual fund managers and investors will be at different stages in their integration of ESG considerations, with some more developed than others. But the industry as a whole is developing rapidly in this area.

Private equity is designed as a long-term investment activity. Without the liquidity of the public markets, investment strategies in the industry centre around building long-term value. Although
the wider impact of their activities is something that investors and the portfolio companies into which funds invest have been taking into account for some time, and many aspects of judging the risks of investing in a particular company have always included issues that are now identified under ESG considerations, fund managers are more and more aware of the benefit that a specific focus on the management of ESG issues can bring for value protection and creation. Putting systems in place to systematically reduce costs and minimise risks and to exploit opportunities, such as promoting supply chain sustainability and improving employee engagement, all generate benefits.

Investors have similarly encouraged private equity fund managers to consider this dimension to their activity, not least because of increasing demands on these investors from their stakeholders and from regulation. Furthermore, institutional investors are constantly improving their knowledge thanks to the work of regional and global organisations (PRI, GRI, Global Compact, CDP, Integrated Reporting, etc.). However, there remain contrasts between jurisdictions and between investors as to their level of engagement with these issues. For many institutional investors consideration of ESG issues will be integrated as part of their overall fund due diligence process. This can be done by the investment team itself or, particularly for larger investors, the ESG policy may well be dealt with by a separate team that operates across all asset classes in which the investor invests.

Overall, larger organisations can deploy more resources and more specialised resources, but Invest Europe and other organisations are developing and disseminating industry standards (for example, the Invest Europe Professional Standards Handbook) and tools (such as questionnaires) to better empower smaller organisations and specifically those with limited resources.

14. What information can you provide on the asset management skills of the insurer or private equity fund(s)?

Overall, one of the most compelling indicators of the skills of the institutional investors and of the private equity fund managers is the performance of investors across market cycles. Returns data spanning more than 20 years (and three economic downturns) shows that European private equity funds comfortably outperformed other investment classes. Based on cumulative returns data for fund vintages stretching back to 1990 until 2012, Thomson Reuters data shows that European private equity funds performance had an average IRR of 9.1% for all forms of private equity investment.
Over the last 15 years, the private equity investor community has grown and matured substantially. There is an established and increasingly deep pool of talented teams and individuals that specialize in private equity fund investing on behalf of institutional investors. Insurers and other institutional investors choosing to invest in private equity will build their team from this pool of talent, using specialist recruitment firms focused on identifying the best investment professionals to manage the investments. The ability to manage a portfolio of private equity funds is recognized today as being as much a specialist field as the ability to manage a portfolio of listed equities or a bond portfolio.

Evidence of the skill of the managers of private equity funds comes from the demonstrable growth and operational improvement made in the companies they support. The managers of private equity funds have built up a wide range of tools that can be deployed quickly - typically in the first year of ownership of the companies they support - to begin creating value. These have a direct impact on company performance and as a result on the returns they provide to their insurer investor.

Many private equity fund managers are run by principals with decades of experience that have experience of investing in many companies across multiple market cycles. The background and experience of these fund managers is diverse, bringing financial, operational and entrepreneurial skills to the investment teams. Increasingly private equity fund managers are able to attract very senior business and industry people to act as advisers working alongside their investment teams and within the companies in which they invest. Ultimately returns are driven less by leverage and multiple expansion than by the experience of fund managers in choosing the best companies and their ability to help guide them to success.

Further, to identify and engage with the best acquisition targets, private equity fund managers use tools to create structural improvements in the companies they support, not just to boost operational performance but to effect a more significant, lasting transformation. At one level, this process of professionalization involves the fund managers installing new reporting processes, new systems and more discipline. More importantly, private equity fund managers are able to attract high-calibre middle and upper management personnel from successful large listed companies to join the management teams of the unlisted companies in which they invest. These new recruits bring with them the skills necessary to oversee the transformation into a more sophisticated business. Such individuals would not be tempted to make such career changes if they were not convinced that the quality of company and involvement of the private equity manager were of sufficiently high calibre.
Fund managers can also help in launching procurement reviews, tapping the collective bargaining power of a fund manager’s entire portfolio; strong manager relationships with the banking community can improve lending terms for the companies they support; and lessons learned within other portfolio businesses can be shared.

The private equity fund management industry has matured considerably over the last 30 years in Europe. Just like the unlisted companies in which their funds invest, there is considerable diversity of size and scale of business from smaller, more newly established managers operating from a single office, to very long-established managers with large teams (comprising over 100 investment professionals) with offices across Europe and globally. While a small venture fund manager may only invest an average of €1.3 million per company, the average investment for mid market buy outs is almost €50 million and for the very largest investments made by the very largest fund managers it is €443.6 million\(^6\). Companies receiving investment of this size expect to be dealing with large, sophisticated investment managers.

While new managers continue to emerge (often being created by experienced individuals that have worked at other firms for many years previously), they operate in an environment in which they compete for investor capital with the most sophisticated managers that have been established for many years and have raised and managed multiple funds. In addition, investors have also developed and enhanced their skills in due diligence and have become ever more demanding of their fund managers, scrutinizing their actions throughout the life of the fund. Consequently, the quality threshold in terms of the investment team and institutionalization of its own business and processes, for even the smallest private equity manager that wishes to raise and manage money from institutional investors successfully, is at least comparable to that in much longer established asset classes. The very long term nature of the relationship between investor and fund manager, the frequency and level of interaction between them during this time and the need to re-convince investors of their skills each time they raise a new fund, all act to keep pressure on the fund managers to strive to develop their skills and management of their own firms.

\(^6\) Invest Europe: average amount invested per company 2012-2016
VI. Further technical information

15. In addition to requirements on transparency, listing requirements may include conditions on earnings record, governance etc. To what extent do the unlisted companies that meet your criteria meet the listing requirements for the major exchanges and what impact does this have on their risk?

Listed and unlisted companies might share certain characteristics. However, the very fact that one is in private ownership and the other is traded on a public market means that they are going to have different disclosure and reporting requirements as a direct result of their very different ownership structures. By definition, unlisted companies are generally in a period of significant change and development. Some will not have developed all the characteristics or features that are appropriate for a company that is publicly owned (or seeks to be).

In determining risk, we believe that it is unhelpful to compare the transparency that an insurer receives in respect of its shareholding in a public company with the transparency the insurer receives in respect of its shareholding in private companies held through a private equity fund. As the insurer is effectively relying on the private equity fund manager’s expertise, a better comparison is between the transparency that an insurer receives in respect of its shareholding in a public company with the transparency the private equity fund manager receives in relation to the unlisted companies in which its fund (and indirectly the insurer) participates.

Listed and unlisted companies have fundamentally different governance structures. Listed companies have thousands of shareholders (if not more) that do not participate in the daily and board level management of the company. They make their investment decision initially based on a listing prospectus and thereafter based on statutory disclosures, market analysis and other such factors.

In private equity the decision to investment into a company is based on careful commercial, financial, tax, and legal due diligence (at a minimum) with the help of professional advisers and based on full access to the books and management of the company. After making the investment private equity players have board appointment rights, actively guide management between board meetings and continue to have full access to the books, management reporting and management itself. Listing requirements have to be understood as a reflection of these different governance models and as such they are mostly not relevant for the unlisted companies and their hands on investors.
Our response to Q10 explains the importance of selecting the right private equity fund managers that apply best investment and governance practices.

16. Should corporates that solely invest in unlisted equities also be included? What method should be used for these types of corporates?

N/A

VII. Effects

17. For the methods and criteria you suggested above: What are the volumes of unlisted equities that would qualify (both in absolute terms and as a share of (a segment of) the unlisted equity market)?

18. What share in the portfolios of internal model and standard formula insurers respectively do they currently represent (relative to all investments and unlisted equities)? How might this change in the future?

These two questions are very difficult to answer. It is impossible to identify fully the size of the unlisted company market.

Unlike in listed investing, there is not a pre-defined, publicly available list of companies from which private equity fund managers can choose their investment options. Therefore, it is not possible to identify a definitive list of unlisted companies and then identify, with the appropriate degree of quantitative certainty, which companies on this list meet what criteria. Sifting through thousands of potential investment opportunities and determining which ones may or may not fit the investment strategy of the private equity fund (or direct portfolio) is the very essence of what managers of private equity funds do.

It is, however, possible to reasonably accurately identify the number of private equity funds and fund of funds through which insurers can gain exposure to European unlisted companies. There are 2,407 private equity fund managers managing 6,400 funds\(^7\). There are 130 fund of funds managers managing 550 fund of funds\(^8\).

\(^7\) Source: Invest Europe / EDC
\(^8\) Source: Preqin
About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry at EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe’s private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe’s leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members’ role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry’s professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.