For the long term: private equity and pensions
EVCA is the voice of European private equity and venture capital. We promote the interests of our more than 1,200 members, to ensure they can conduct their business effectively.

EVCA engages policymakers and promotes the industry among key stakeholders, including institutional investors, entrepreneurs and employee representatives.

We develop professional standards and research reports and hold professional training and networking events. EVCA covers the whole range of private equity, from early-stage venture capital to the largest buyouts.
If there is one thing that Europe can agree on it is that growth is the only way to ensure our future prosperity.

How to achieve that growth, however, is far from consensual. The growing clamour for regulation to eradicate irresponsibility and short-termism is understandable. But in some cases it may have unintended - and unwelcome - consequences.

That is why this issue of Briefing is dedicated to pension funds and the role private equity can play in protecting the next generation.

It is right that the European Union wants “a sustainable retirement income for EU citizens now and in the future,” but it’s wrong that current plans to change the IORP Directive are seen as part of the solution.

If we reduce the ability of pension funds to invest in private equity and venture capital, we reduce Europe’s ability to grow (pages 4 and 5). As an industry, now more than ever, we are confident of achieving that growth responsibly.

Our governance is strong, as our latest Handbook of Professional Standards attests (page 11) and, in the grand scheme of things, responsibility is about how you run your business (page 8 and 9). Here, private equity is an example to follow: alignment of interests and long-term focus embody the most important principles of responsible investment.

Best wishes,
Dörte Höppner, Secretary-General
Europe’s pension funds are faced with a pressing issue: Europe’s population is ageing. By the European Commission’s reckoning, the number of retired people compared with those financing their pensions is forecast to double by 2060, making it harder for Europe’s pension funds to meet their long-term liabilities.

A crucial part of ensuring they can meet these liabilities is for pension fund managers to invest in long-term, growth asset classes. Private equity clearly falls into this category – funds typically have a 10-year life and it generates returns by investing in companies, providing finance and support to enable them to grow.

The result is stable, risk-adjusted returns that, according to many studies, outperform comparable public market investments. Many of Europe’s largest pension funds have trusted private equity to help them meet their goals – between 2006 and 2010, pension funds accounted for more than 36% of all funds raised by the European private equity industry.

The match between pension funds’ aims and long-term horizons and private equity’s ability to provide strong returns over the life of a 10-year fund is evident. Yet that is only part of the story. Pension funds are a crucial part of ensuring that Europe’s economy grows: through private equity funds, they have invested €53bn in European companies in the past four years alone.

Much of this has flowed through to the engine of economic growth – the region’s small- and medium-sized companies. Indeed, some 83% of private equity-backed companies are SMEs.

Pension fund investment in private equity delivers growth in the real economy, through job creation, investment and tax revenues.

Yet part of the solution to two of Europe’s biggest challenges – boosting economic growth and ensuring pensioners can fund their retirement – is at serious risk. The European Commission is currently proposing changes to the IORP Directive that would potentially make pension funds subject to similar capital adequacy rules as insurance companies under the Solvency II (S2) regime.

Under S2, solvency capital requirements are calibrated to correspond to the value at risk over a 12-month period so that liquidity becomes a more important consideration than the capital at risk. The result would be to force pension trustees to change investment strategy away from long-term asset classes such as private equity.

The proposed revisions to the IORP Directive could force pension funds to focus on short-term, lower-return assets rather than long-term asset classes such as private equity. This switch could not only threaten the incomes of Europe’s pensioners but also reduce the capital available to its companies.

The long and the short of it

Between 2006 and 2010, pension funds accounted for more than 36% of all funds raised by the European private equity industry.

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funds, which have long-term liabilities to meet. It also increases the investment risk faced by pension funds as they will be forced into having less well-diversified portfolios.

The cost of retirement provision would also increase as pension funds would become unable to access higher-returning assets. This would further exacerbate the closure of defined benefit schemes to new entrants, removing the guarantee of a secure income for millions of Europe’s pensioners.

However, it would also significantly reduce the amount of capital for long-term asset classes such as private equity and infrastructure. The result would be that capital available to Europe’s companies diminishes, leaving them unable to fund long-term investment in the European economy in areas such as R&D and plant and machinery. This runs counter to the European Commission’s objective of improving financing for SMEs by making an efficient European venture capital market a reality.

Long-term, illiquid projects such as infrastructure improvements would also be starved of private capital. Yet these are precisely the areas that need funding to generate long-term, sustainable growth in the European economy at a time when governments lack the capital to support these activities. For example, the largest offshore wind farm in the world, which generates enough clean energy to power 320,000 homes, is in Europe. This project, financed by European occupational pension plans, may not have been possible if this regulation had been in place.

At the same time, the proposed regulation would likely increase systemic risk. Long-term investors in global financial markets play a stabilising role, yet under the proposals this would be undermined as they are forced to sell equity investments to comply with the rules. Pension funds under the IORP Directive manage assets of €2,500bn. Under S2, which specifies a weight of 39% for global equities and 49% for other equities, such as PE, they would be required to hold extra assets of €1,000bn. The Bank for International Settlements estimates that pension funds would have to reduce their exposure to European shares by 5% – a loss of €750bn to Europe’s public markets.

These exaggerated risk weightings could also result in a loss of value for pension funds. Following changes in regulation, banks have sold around €20bn of private equity portfolios. Assuming a discount of 10%-20% on these sales, they will have lost between €4bn and €5bn of value. Applying the same type of regulation would result in significant value erosion for Europe’s pensioners in the short term and deny them a source of value creation over the longer term.

Europe’s savers and pensioners deserve a more certain future. If Europe is to provide for an ageing population and achieve sustainable growth, the virtuous relationship between long-term asset classes and pension funds must be protected.
Perspectives

Mike Powell discusses how private equity fits within a pension fund’s investment objective, while Craig Donaldson offers his perspective on what private equity can offer pension funds.

Why do you invest in private equity?
We divide asset classes into three main categories based upon their principal risk and return characteristics relative to our liabilities: risk-reducing assets such as government bonds, risk-diversifying assets that reduce risk and return-seeking assets. Private equity fits squarely into the last category. We expect it to be able to generate returns that are at least 3% above public market equities. So our principal rationale for investing is to generate high returns.

There is a secondary benefit, although this is not explicit in our allocation strategy: there are positive externalities to private equity. In so doing, that should benefit us in other asset classes, too.

And is it meeting your return expectations?
Yes. It has been our highest returning asset class. Even though our private equity programme is relatively new—it is five years’ old—it has returned well above our benchmark rate of return. We have seen annualised returns of 8% to 9% above public equities from our private equity portfolio.

What, other than returns, can private equity bring that other asset classes do not?
Another reason for investing in private equity is access to returns streams, assets and strategies we might not otherwise have. Our private equity programme has a broad mandate so, in addition to investing in traditional areas such as buyout funds, we also invest in areas such as private debt including lending to SMEs and distressed debt or turnaround strategies.

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Private equity is also imperfectly correlated with public markets and so it can have a smoothing effect on the volatility of the pension scheme that is inherent in investing in public equities and other risk assets. In our experience, private equity also tends to provide its strongest out-performance of public markets in times of market stress, which benefits the scheme when it is needed the most.

How do the characteristics of private equity fit with your objectives as a pension fund?
Private equity is a natural fit for a pension fund because it is a long-term asset class. We need assets that generate long-term returns above inflation so that we can meet our liabilities. The asset class that matches our liabilities most perfectly is index-linked bonds. However, the current level of return offered is too low to generate the returns that the pension scheme needs. An asset class such as infrastructure provides long-term, inflation-linked returns but with a potential return well above that of index-linked bonds.

What would be the effect on the pension fund if it became more expensive for you to invest in private equity and infrastructure?
It would restrict our ability to invest in the private equity asset class and that would have a significant effect on the scheme. We have a 10% allocation to private equity and, given the returns have so far been 8% to 9% above public equities, the effect on returns would be material. We’d either have to accept lower returns or increase in our risk profile to maintain returns.

Mike Powell is head of alternative investments at Universities Superannuation Scheme, the main pension scheme for employees of universities and other associated institutions in the UK.
Why should pension funds invest in private equity?

Returns. Private equity has delivered superior risk-adjusted returns for their pension fund investors over the past decade. For example, recent data has shown that private equity has significantly outperformed public equity in the past decade. In the UK, private equity delivered a return of 13.4% IRR on a yearly basis, compared with just 3.7% from the FTSE All-Share.

Recent data also suggests that private equity funds and bonds are the only investment strategies to have generated positive returns for public pension funds across the one-, three-, five- and 10-year periods (as of Q2 2010). Other asset classes fall into the red for at least one of the periods.

Given currently low base rate yields, private equity investment is more important than ever in achieving this returns outperformance.

What benefits are unique to private equity?

Private equity operates a model of corporate governance that sees fund managers investing in the fund alongside the other investors. The private equity manager normally only receives a share of the profit of the fund after the investors. This means the interests of both the manager and investors - in this case pension funds - are well aligned. In turn, the private equity manager becomes an owner-operator of the companies in which they invest, reducing the agency problem prevalent in publicly owned equivalents.

Private equity also gives investors access to growth markets and specialist sectors often inaccessible within other asset classes such as the stock market or bonds (for example, smaller, younger and faster-growing companies).

Private equity is also often the best way to enter emerging markets and sectors. Given the hands-on approach of private equity managers, it is potentially a less risky way to gain access to, say growing businesses and markets in sub-Saharan Africa or China, where public markets may offer little in the way of transparency and investor protection.

What do you think will be the ultimate outcome of the proposed solvency regulations on pension funds?

New regulation along these lines is likely to cause pension funds to reduce allocations to private equity, and in turn investment into the real economy. There is a significant risk that this virtuous circle of wealth creation will be severed to the detriment of the economy at large and the current and future retirement incomes of Europe's workers. Ultimately, these reduced allocations will result in worse retirement benefits for retirees, given the historic out-performance of the asset class.

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A low interest environment - resulting in negative yields from both government and corporate bonds - coupled with an ageing European population, means that fixed income products are unlikely to be able to deliver the growth required for pension funds to meet their liabilities as they fall due.

Craig Donaldson is head of client services and strategy at HgCapital, a mid-market private equity firm that has two investment offices in the UK and Germany.
Growing returns

Private equity generates its returns for investors primarily through growing the businesses it backs, rather than through leverage or multiple expansion, as recent academic research and numerous case studies demonstrate.

Contrary to popular opinion, private equity generates its returns through supporting growth in the companies it backs, contributing significantly to the European economy. A recent study examining mid-market investments conducted by the Center for Entrepreneurial and Financial Studies at the School of Management, Technische Universität München, demonstrates that returns in this segment are overwhelmingly driven by operational activities that increase company earnings.

The average gross internal rate of return in the study was just over 40%. Of this, over 65% was accounted for by revenue growth. By contrast, leverage was found to be a secondary driver, accounting for under 37% of returns.

The results suggest that, with evidence of such a magnitude of earnings enhancement, private equity investment is a significant force in supporting company growth and therefore job creation. However, it’s not just research that demonstrates its importance to the European economy; the industry can point to countless examples in which it has driven growth. These are just some.

**Callenberg Group**
A small, local Swedish business at the time Segulah invested in 2001, Callenberg grew to become a global provider of engineering services to the marine and offshore industry. When Segulah became involved, Callenberg had a great reputation in the global marine industry but had been through a series of owners and lacked focus, and needed finance and expertise. Segulah supported the business by strengthening the management team, bringing industrial expertise to the board and setting a clear path to growth together with management.

The result was three major acquisitions between 2003 and 2005. The private equity firm was able to bring significant M&A experience as well as help with successful integration of the new businesses.

The results speak for themselves. By the time Segulah sold the business to Norwegian company Wilhelmsen Maritime Services in 2007, it had increased employee numbers fourfold to 500 across seven locations in Europe, the US and Asia, grown turnover from €25m to €100m and improved operating margins. What was one of Sweden’s few remaining marine engineering companies had been transformed into a truly global player.
Pets at Home
When Bridgepoint invested in pet accessories and supplies retailer Pets at Home in 2004, it spotted a niche in the retail market that was highly fragmented. The business had been growing steadily, had 100 stores and employed 2,700 people. Yet there was still plenty of growth to go for and that required both investment and hands-on support.

One of the issues was high staff turnover. Through a series of measures including improved training, Pets at Home reduced this from nearly 80% to under 20% a year. In addition, the business saw £90m of capital investment, enabling it to direct resources towards product development, launch online, expand its veterinary business, improve sourcing, substantially enhance marketing and branding and roll out new stores.

With Bridgepoint’s support, Pets at Home created 1,500 jobs, opened 150 new stores and grew market share from 9% in 2004 to 14% in 2008. It doubled its revenues during the investment, increased earnings before interest, taxes, depreciation and amortisation (EBITDA) fourfold and saw margins improve from 10% to 18%. When Bridgepoint sold the business in 2010 to KKR, the firm returned eight times its original investment to investors.

Magotteaux
Magotteaux clearly demonstrates private equity’s ability to add far more than capital. When IK Investment Partners initially invested in this Belgian company, Magotteaux had excellent engineering credentials, but lacked the performance culture necessary to take it to its next stage of development. It also needed investment in R&D and support in understanding which new markets to target.

With IK’s expertise and backing, Magotteaux put in place operational excellence programmes to lower sourcing costs, reduce working capital and increase on-time delivery. It also implemented a major investment programme in its Belgian and overseas operations and invested €120m in R&D and expansion into fast-growing emerging markets such as Thailand and India. The R&D spending alone resulted in the launch of several new products. The company also gained valuable insight from IK, which understood that Magotteaux’s technology could be applied to the mining sector. The company also overhauled its health and safety procedures, resulting in a halving of man hours lost.

Increased efficiency, coupled with geographic and market expansion, has brought the company and, by extension the economy, substantial rewards. During IK’s ownership period, headcount increased by 15%, sales rose to €500m and EBITDA jumped by 66% to €66m. In addition, the mining sector now accounts for more than 50% of Magotteaux’s revenues and profits – up from a small portion in 2007.

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BY THE NUMBERS
Magotteaux during IK ownership

15% ↑ increased headcount

€500m sales rose

66% ↑ EBITDA jumped to €66m

50% Percentage of revenues and profits that mining now accounts for
The EU Commission is reviewing the European pension fund directive, which lays down rules for occupational retirement provision (IORPs). The Commission, together with the European Insurance and Occupational Pensions Authority (EIOPA), is expected to propose new rules for IORPs based on insurance regulation known as Solvency II (Directive 2009/38). But Solvency II is not the right basis for regulating pension funds.

Workplace pension funds aim to provide pension scheme members with the benefits that their employer has promised (defined benefit plans) or that have accumulated through investing the employer and employee contributions (defined contribution plans) in an individual account. That is all they do. Scheme members do not have a choice between pension funds, and join the scheme proposed by their employer. There is therefore no competition between funds.

The long view

Pension funds receive a regular stream of employer and employee contributions over a long period of time. Liabilities are long-term and the investment can and should be. Pension funds can invest in many assets, including venture capital, private equity, infrastructure projects or other less liquid assets. They can ride out market storms, at least better than those who have solvency rules that force them to jump every which way the markets happen to turn. If the pension funds can do this, they contribute to the stability of the whole financial markets. And, with €3.5trn of assets, European pension funds are big enough to make the difference.

Removing risk

If insurance company-type rules were to apply to IORPs, risk-taking opportunities would pretty much disappear. Pension funds would be forced to build large capital reserves and shift their asset allocation to bonds. This would bid farewell to the possibility of getting the good returns necessary for actually paying pensions. It would also increase risk concentration and systemic risk in the financial system. Insurance regulation takes a short and mid-term approach, as insurance contracts may be cancelled or insurers may need to pay out on a policy. Pension funds don’t. They have various adjustment or “risk-mitigating” mechanisms they can use if additional funds are needed. The pension plan sponsor or a pension protection scheme can help.

Pension funds can ride out market storms, and contribute to the stability of financial markets

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Pension funds deserve their own type of solvency regulation. Setting a uniform security level, which would force them to keep large capital reserves, would be very bad policy and false security. Real security for pensions is the ability to invest in such a way that there is growth and employment. This can’t be done without taking risks. The European Federation for Retirement Provision has warned the European Commission and EIOPA that it is crucial to look at long-term sustainability of workplace pensions, rather than short-term solvency standards.

Matti Leppälä is the secretary general/CEO of the European Federation for Retirement Provision (EFRP), which represents national associations of workplace pension funds.

Standard bearers
In his opening remarks to the EVCA Responsible Investment Summit in January 2012, EVCA chairman Karsten Langer argued that the private equity industry is not part of the problem in European governance but part of the solution.

Alignment of interest, active investors and long-term focus ensure that responsible investment is taken seriously by the industry, not because it sounds good, but because it makes business sense, he argued.

The summit heard from EVCA members on how they are embedding the principles of responsible investment in their business models.

The need to demonstrate transparency and accountability has never been greater. And the need to ensure that we not only anticipate corporate governance standards but also actively participate in shaping and implementing them is the driving force behind the new EVCA Handbook of Professional Standards.

The fully revised draft includes new sections on GP communication and transparency, LP conflicts of interest, the LP Advisory Committee, keyman provisions and secondary transactions.

Once approved by the board, the EVCA Handbook will become the only industry-wide set of standards governing the relationship between GPs, LPs and portfolio companies to be authored by both limited and general partners.

You can download it from www.evca.eu.

Disclose conflicts of interest
Maintain confidentiality
Act with integrity
Do no harm to the industry
Keep your promises
Act in fairness

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