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Open to All: Private equity and retail investors

Executive summary

- Retail clients only constitute to date a small proportion of investors who invest in long-term funds managed by private equity managers.
- Invest Europe has three recommendations to ensure retail investors can benefit from the performance of the asset class, directly or indirectly, in light of their risk profile.
- Invest Europe's tailored solutions range from an extension of the "professional upon request" definition to sophisticated individuals, to improvements to the ELTIF regime and the creation of retail pension and insurance products.

Introduction

The private equity industry covers a wide range of closed-ended fund managers which all share the same business model, from small venture capital to large buy-out and infrastructure firms. They raise capital from investors looking for long-term yield which is then "pooled" into long-term (typically 10 years), illiquid, closed-ended and unleveraged funds and invested in direct equity investments into a dozen of businesses for an average of 5 years. Once these businesses have grown and/or evolved, thanks to both the capital and the know-how of managers, shares held in these businesses will be sold or listed on the stock market through an IPO. Profits made are then returned to the investors towards the end of the fund's life[1].

Private equity is a sought-after asset class due to the performance of its funds. In 2020, European buy-outs delivered a net IRR of 15.06% (3 times higher than similar companies captured by MSCI Europe), growth funds of 13.66% (2 times higher) and venture funds of 11.09% (1.4 times higher)[2]

A long-term investment

Private equity backed businesses have a different path to profitability than public ones. At least a few years will be required before the capital committed and the actions taken by the manager bear fruit.

[1] For more details on how private equity functions, please look at our briefing paper "The Good, the Hedge and the UCITS".
[2] See our report: The Performance of European Private Equity Benchmark Report, 2020

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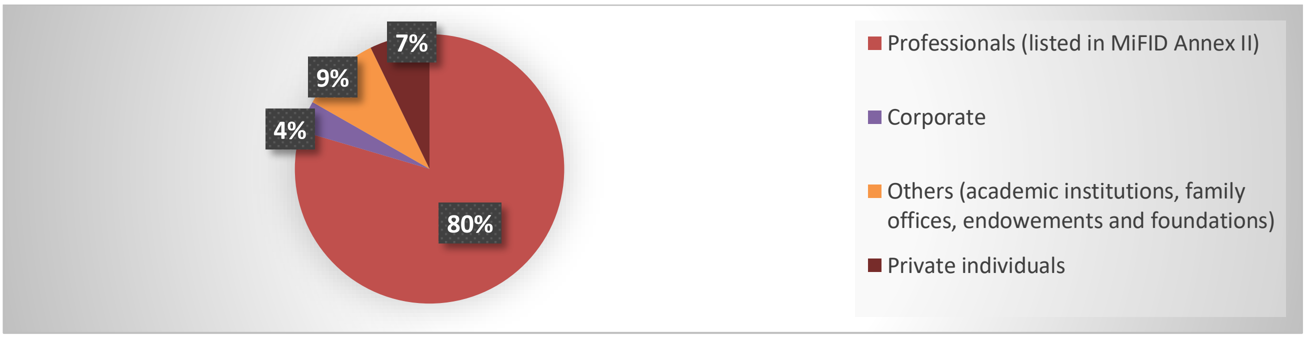
The fact that selling early is essentially not an option for any private equity investor **makes it *de facto* a long-term, illiquid investment**[3]. The consequence is that committing capital to a private equity fund requires careful consideration and a strong liquidity profile from investors.

Types of investors

Sources of capital that flow to the asset class reflect this. Professional and knowledgeable investors being less likely to have to sell their interests in the fund before the end of the fund's life, at least 80% of investments comes from investors that are by definition classified as professional under the MiFID investor categorisation[4] and around 5% from corporates (which are likely to also be eligible given their typically large size).

As half of the remaining share will come from institutions, such as universities, or family offices or foundations (9%), <u>private individuals only constitute around 7% of the private equity investor base</u>:



<u>Graph:</u> Source of funds – Investors Commitment – All private equity[5]

These can be divided in 3 sub-categories:

I. ***Sophisticated investors with (very) large amounts of capital at hand (committing more than €100K in a single investment)***

<u>Relevance</u>: Most of the current private equity individual investors are in this category and most funds will be open to them[6].

<u>Problem</u>: Despite their level of understanding of the market in which they invest, these investors are currently often categorised as retail clients under MiFID. This prevents fund managers from marketing to them under the AIFM Directive or forces managers to prepare disclosure documents that are inappropriate to their level of sophistication, ultimately lowering their ability to invest into EU start-ups and established companies.

[3] Although a secondary market in fund interests may exist, the terms under which an investor could sell their position on the secondary market to another investor are generally very limited.
[4] Annex II, Section I, paragraph (2) of MiFID
[5] Invest Europe, Investing in Europe: Private Equity activity 2020
[6] Given the amount of capital they bring, they will in most cases negotiate their commitment "equal-to-equal" with the manager.

Solution: Amendments to the MiFID investor categorisation (introduction of a "minimum size of investment" criterion, integration of expertise beyond financial markets) will more appropriately reflect the professional nature of large and sophisticated investors in long-term funds (MiFID II, Annex II).

If you want to know more: Excerpts of the industry's Response to the EU Retail Strategy Consultation

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The share of private fundraising is nearly twice as high for venture capital (13%) because this category often includes successful entrepreneurs backing a venture capital fund in a sector they are familiar with.

II. Investors with a good understanding of the market looking to invest capital with no liquidity concerns (investing typically between €5K and €100K in a single investment)

Relevance: While only a few private equity fund managers currently offer products to this type of "mid-sized" investors, a growing portion of them are starting to do so.

Problem: There is no efficient EU retail marketing passport at the moment. Moreover, existing EU retail documentation, like the Key Information Document (KID), is too standardised to give proper and simple information to retail investors in long-term funds.

Solution: Introducing modifications to the ELTIF label, as currently scheduled by the European Commission, would drive the interest of fund managers in this voluntary passport, and hence in marketing at EU level to certain retail clients. Meanwhile, amendments should be introduced to the KID framework so that the document better reflects the risk profile of long-term products.

If you want to know more: ELTIF Position Paper – Excerpts of Response to EU Retail Strategy Consultation

III. Small, often inexperienced investors, with liquidity concerns and investing typically small amounts (below €5K)

Relevance: The very long-term nature of the private equity asset class and liquidity concerns of small retail investors undeniably make it difficult for them to access the asset class directly, either because of their own risk profile or because it is too costly for managers to grant them redemption rights.

Problem: What is problematic for these investors is therefore not so much the lack of direct access but the fact that only few institutional investors (whether pension funds, credit institutions or insurance entities) offer sufficient products that would allow them to access the asset class **indirectly** and benefit from the asset class returns as pensioners and savers[7]. European institutional investors have been cautious in investing in equities, and particularly private equity, because of either cultural mindsets or regulatory restrictions, but the increased importance of Defined Contribution (DC) schemes, which are looking for much needed returns, highlights the need for better indirect access to the private equity asset class.

[7] See for example, European Commission, *Monitoring progress towards a Capital Markets Union: a toolkit of indicators*, May 2021

Commitments from US pension funds into European businesses through private equity are 3 times higher than EU ones[8]. This not only poses a real issue for European businesses in need of investments, but also to European savers in search of indirect investment opportunities generating higher performance.

Solution: Develop and promote European best practices including on issues such as overcoming market immaturity, developing tax incentives and lowering investment barriers.

What changes do we recommend NOT introducing?

The tailored solutions proposed above would best fit both the nature and risk-profile of retail investors and the realities and costs of private equity fund distribution channels. In light of those, we would also argue that:

- **No retail AIFMD passport should be created:** most AIFMs are not marketed (directly) to small retail investors. Besides UCITS, the ELTIF passport should become the vehicle of choice to allow retail clients to invest in long-term products;
- **No mandatory liquidity provisions should be imposed on illiquid funds:** long-term products are not short-term products held for a long period – the time required for investments to grow should continue to be mirrored in retail investors' holding periods;
- The creation of a **semi-professional category** (covering investors that are not deemed professional upon request) would not address the concerns of large long-term investors.

Financial education and **appropriate acknowledgment of long-term funds' characteristics** should be at the core of promoting retail investment into long-term funds, as opposed to the creation of new fund structures that would not fit with the realities of the market and may force small-term investors to invest directly into products they could have had indirect - and hence more diversified – exposure to.

Who we are

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.

[8] See: "Investing in Europe: Private Equity activity 2020"

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

For more information please visit www.investeurope.eu.

Contacting us

If you believe, as we do, that relevant changes to the retail frameworks would contribute to building a Capital Markets Union and help the financing of businesses through additional channels, we are at your disposal to discuss these issues further.

For more details, you can contact Martin Bresson (martin.bresson@investeurope.eu) or Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.