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Private equity in Europe: Which features for this rapidly growing market?

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Summary

The European private equity market, as measured by the activity of Europe-based specialized intermediaries, has grown significantly over the last decade, as can be seen by the tremendous increase in funds raised and investments made. In 2006, European private equity funds grew to as much as €90 billion, vs. €48 billion in 2000 and only €8 billion in 1996. Yet private equity includes several different types of investment. Financing for new or expanding businesses in need of capital for their development (venture capital) coexists with financing for acquisitions of already established companies, whether listed or, more generally, unlisted on a stock market (buyouts).

Over the last ten years, buyouts have grown to become, in value, predominant in Europe: in 2006 they rose to €39 billion (excluding debt), or more than 75% of the total amount of investment flow. They benefit from a variety of factors, related both to economic conditions, such as abundant liquidity and low interest rates, and to structural conditions such as companies' refocusing on their main business line, the retirement of numerous business leaders, etc. However, venture capital, which still bears the scars of the collapse of technology stocks, and expansion capital each show slower growth: in 2006, investment in these two segments reached €11.3 billion.

Institutional and individual private equity investors participate in the market via special vehicles such as investment funds, venture capital firms, and financial holding companies. Where allowed by regulations, these funds or investment firms are sometimes listed on stock markets. In continental Europe, banks play an important role as investors (for example, nearly 30% of funds raised during the period 2001-2005 in France). In the United Kingdom, pension funds (domestic and especially foreign) are the main players, accounting for around a third of funds raised between 2001 and 2005. There could be a convergence between a greater number of institutional managers in some continental European countries (such as French insurance companies) and a corresponding decrease in banks. Overall, it is still difficult to estimate medium to long-term demand perspectives. On the one hand, certain factors argue for steady growth, such as the current rather limited participation of European institutional investors, the increase in long-term savings volume, and the required capital of companies, especially small and medium-sized enterprises. On the other hand, private equity must find its place in the standardization procedures of defined contribution pension plans, which place the responsibility of strategic allocation of assets on individual investors. At this stage, there is great uncertainty as to how such long-term investment decisions will be made.

In theory, private equity returns should offer compensating risk and liquidity premiums. Available empirical studies, especially those from the academic world, lead nevertheless to contrasting results concerning private equity performance compared to its competitors, and specifically listed stocks. On this basis, it seems

difficult to conclude that there is either an out- or under-performance of private equity over the medium or long term. Furthermore, private equity funds performances taken individually are extremely variable, depending on the quality of the managers: funds with outstanding performance coexist with under-performing funds. It is thus crucial that the investor rigorously choose the structures and managers in which to invest. Finally, private equity investment overall and over time seems correlated to stock markets. The degree of correlation could be sufficiently weak, however, that the addition of a private equity fund to an asset portfolio might increase diversification.

Private equity targets mainly unlisted small and medium-sized companies. However, the rapid growth in large-scale LBO deals is a potential source of risk for the market regulator. Four main risks have been identified for this specific sector:

- The large flows into buyout funds could lower risk premiums, or significantly lift acquisition prices, which amounts to the same thing. This could, over time, result in weaker performances and poor capital allocation for the final investor. This risk is exacerbated by valuation difficulties for portfolio investments, given the absence of a public market for the underlying shares, and despite diligence and recent efforts by private equity investors to improve and standardize valuation methods.
- The currently favorable borrowing conditions for buyout deals could lead to excessive debt, provided by participants that would not necessarily carry the credit risk to maturity and could sell their receivables on the secondary market. The main risk would be a weakening of the credit quality of the institutional debt portfolio.
- The growth of large-scale buyout deals of listed companies could, in the short term, reduce the number of companies listed on stock markets. Such a change would raise questions concerning the transparency of economic activities and, more generally, the efficiency of the financial system. Nonetheless, this risk is still moderate, and should be measured by taking into account a long-term perspective and the role of private equity investors in the future pace of IPOs. Indeed, at the end of a cycle, delisted companies are often listed again, either in a similar form or after restructuring.
- Private equity investors are for the most part institutional investors who, in theory, have the financial capacity and scope to withstand the intrinsic risk of this type of investment. The risk of over-distribution of private equity investment products to retail investors seems low for the time being, even though the recent listing of investment funds, such as KKR PEI in the Netherlands, raises the question of distribution channels and the potential consequences for retail investors of greater access to this type of investment.

The identification of these risks – once again, mainly large-scale LBOs – allows several plans to be drawn up for action in the near future:

- In March 2007, the IOSCO published a report on the valuation procedures for illiquid assets held by hedge funds. The principles recommended in this publication could be useful for a similar study on the valuation of unlisted assets held by private equity funds, taking into account the valuation standards developed by international professional associations.

- The risk of excessive debt in buyout deals raises the question of the market's understanding of credit risk and, where applicable, the role of rating agencies. Each year the AMF oversees the preparation of a report on rating agency activity which should ascertain, in cooperation with banking authorities, that the credit risk from leveraged buyout deals is fully measured by rating agencies.

- The "go private" trend and the decline of securities listings on the major stock markets raise the question of competitiveness with respect to different financing options available to companies. A more focused AMF study will be undertaken to better identify the reasons, both regulatory and economic, that lead companies to go private or to balk at listing;

- Finally, the listing of private equity funds should stimulate consideration by the market regulator of the transparency of these funds' practices and the necessity (or not) to design a European regulatory framework for this area, again with account taken of the recommendations put forward by the representatives of private equity associations. The risks of poor allocation of savings flow, implying over- or under-investment in private equity funds, suggest that a significant increase in the means for educating individual investors should be considered.

Introduction*

The private equity market comprises all investments held by individual and institutional investors in unlisted companies. Long active in the United States, this market has recently seen brisk growth in Europe. Private equity has become a commonly employed financing mode, not only by small companies at start-up phase but also by large companies in order to assure growth or in preparation of a buyout. In the latter case, listed companies can be involved, which use private equity in order to go public to private. Similarly, this financial investment instrument has become increasingly popular with investors. Indeed, in Europe, in 2006, the amounts raised by specialized intermediaries reached unprecedented levels for this type of investment, and Ppreliminary statistics for 2006 show an even stronger growth trend.

Despite this rapid expansion and the media coverage of biggest deals, private equity remains an area little known by the overall financial community. The following study is therefore intentionally educational. More precisely, it aims at the following objectives:

- to present the private equity market's organization and operational principles, as well as their economic basis. This requires a detour through academic research in order to explain, for example, the economic impetus for buyout deals;
- to demonstrate the evolution of activity on the European private equity market, notably via the division of this market between venture capital and buyouts, and to describe the different types of investors such as pension funds and banks;
- to assess, based on statistics and available studies, private equity returns and determinant factors;
- given current trends, to raise questions and to underline sources of risk in terms of financial stability and savings protection[1].

* The author thanks Caroline Pichon, intern in the AMF Research Department, for her help in preparing this paper.

[1] This paper does not address certain important questions, such as the risks of possible market misuses and conflicts of interest by private equity participants. For an analysis of possible conflicts of interest, see the Adhémar report (published by the COB in March 1999), which addresses the organization rules and ethics applicable to FCPRs. In addition, a recent report (November 2006) by the Financial Services Authority analyzes the risks created by ongoing changes within the private equity market.

1. Definition of private equity

Private equity is defined as an equity investment in the capital of a company made in order to allow the financing of the company's start-up, development, or buyout/disposal phase. This equity investment is mainly financial, though it can also be strategic (contribution of a network of professionals, management skills, etc.). Private equity is usually divided into three elements: venture capital, which allows the financing of the creation and development of new companies, especially in new technologies; expansion capital, which allows investors to accompany the growth of companies; and buyouts, which correspond to investments made for the acquisition of companies already established[2]. In Europe, as in the United States, the majority of investments made in private equity now involve buyouts. France is a perfect example of this situation, with buyouts representing nearly 80% of the total amount invested in private equity[3] in 2005.

1.1 The different categories of private equity

Venture capital is used in the context of young companies, especially those with an innovative business in need of financing. These companies are found mainly in the new information and communication technology sectors, life sciences, etc. Though often in the minority, financial shareholders are actively involved in company strategy. Within venture capital can be distinguished the *seed stage*, where the goal is to finance the R&D of an initial concept, and the *early stage*, which corresponds to the financing of the product's development and its initial commercialization. Expansion capital comes in at a later stage in the company's life, when financial investors make investments in existing companies which are sometimes already profitable but which need significant contributed capital in order to consolidate their financial structure and to finance a new stage of their growth.

Buyouts correspond to investments made in the context of an acquisition of a company by management or by outside investors. The LBO is the main form of buyout used. This is the general term for leveraged buyout deals, i.e. using debt. In practice, one or more investors buys a target company via a holding company (usually created especially for the deal), which is first capitalized and then borrows from a bank or the market. Private equity investors are composed of financial investors and, in some cases, individuals from the management team of the target company[4]. The holding company pays off interest and principal on its debt using profits generated by the target company.

[2] This breakdown has been retained by the AFIC (Association Française des Investisseurs en Capital). In the United States, venture capital, which includes both venture and expansion capital, is often contrasted with buyouts, which correspond to buyout deals.

[3] The order is different when the number of deals is taken into consideration instead of the value of investments. In France, the number of buyout deals in 2005 represented only 23% of the total number of transactions.

[4] More specifically, an MBO (management buyout) is used when the LBO has been implemented by the company's management team. The term MBI (management buy-in) is used when the LBO has been implemented by outside investors.

1.2 Exit strategies

Venture capitalists operate by selling their equity investments, usually in the more-or-less long term. Even if there has been an emergence of secondary funds willing to buy such equity investments, the exit can be rendered more difficult by the absence of a public market for the stock, which would provide liquidity to the shares held and thus facilitate their disposal. Thus, there are four main potential exits for private equity investors. The most spectacular is the initial public offering. This is possible when financial markets have the capacity to absorb companies of sometimes modest size. For example, in the United Kingdom the *Alternative Investment Market* is very active in IPOs of companies from private equity; in France, the recently created Alternext[5] constitutes a favorable factor for this exit strategy. The second possibility, the biggest in terms of number of deals, is the sale to an industrial investor. The third possibility is the sale to another investor, if need be via a LBO called a secondary LBO, when it targets a company having already been bought by the same technique. One other exit strategy is the sale of the company to the management team[6].

[5] Alternext, created May 17, 2005, is a market dedicated to SMEs in need of expansion financing. It is regulated but not controlled. At the end of 2006, there were 69 companies listed on Alternext.

[6] According to AFIC statistics of private equity in France, in 2006 the leading exit strategy was by sale to another fund (43% of divestments measured at historic value), followed by sales to industrial investors (27%). Initial public offerings (and share disposals) represented only 15% of divestments, with sales to management 13%. The order is different if the number of deals is taken into consideration, instead of the total value: in 2006, the leading exit strategy was the IPO and the disposal of listed shares (28% of total number of divestment deals), ahead of sales to industrialists (26%) and sales to management (21%).

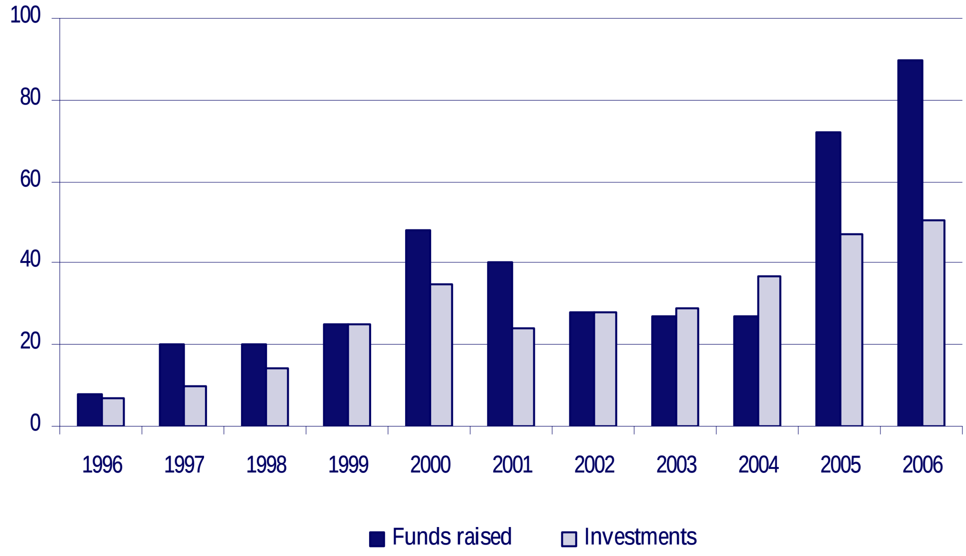
2. Private equity in Europe

2.1 A market posting a robust growth trend

The European private equity market has shown robust growth since the mid-90s. Investments made by private equity investors, whose development is rather smooth, grew steadily and rapidly with the exception of the spike in 2000 (**graph 1**). Investments grew from €7 billion in 1996 to €50 billion in 2006 (provisional statistic). Funds raised, a more cyclical activity, saw much more uneven change: after the peak of 2000 there was a decline, then no growth until 2004. The following year saw strong market renewal, with funds raised reaching €72 billion, then €90 billion in 2006. France had a profile similar to the rest of the continent, with nevertheless more significant changes in investments, and a slowdown in funds raised in 2006 (**graph 2**). The French market has grown briskly over the last 15 years, following the overall European trend.

Graph 1: Investments and funds raised by private equity - Europe

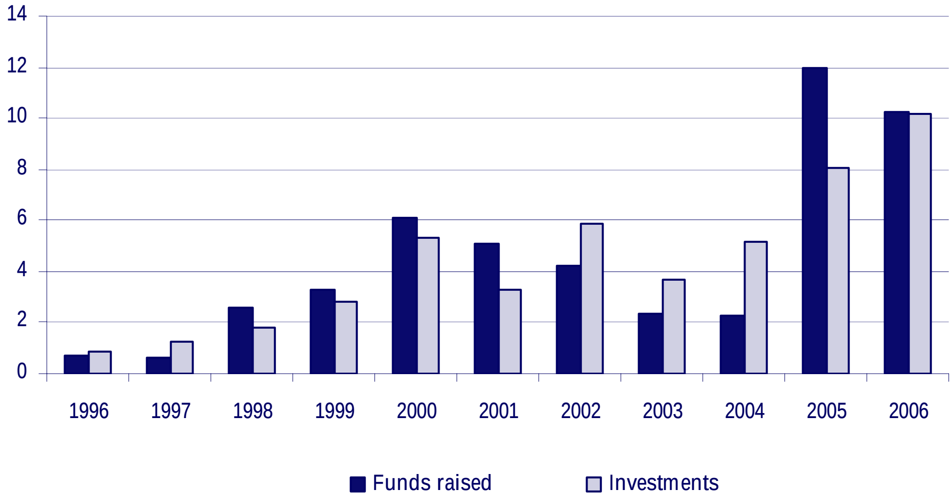
(in € billions, provisional statistics for 2006)



Source: EVCA

Graph 2: Investments and funds raised by private equity - France

(in € billions)

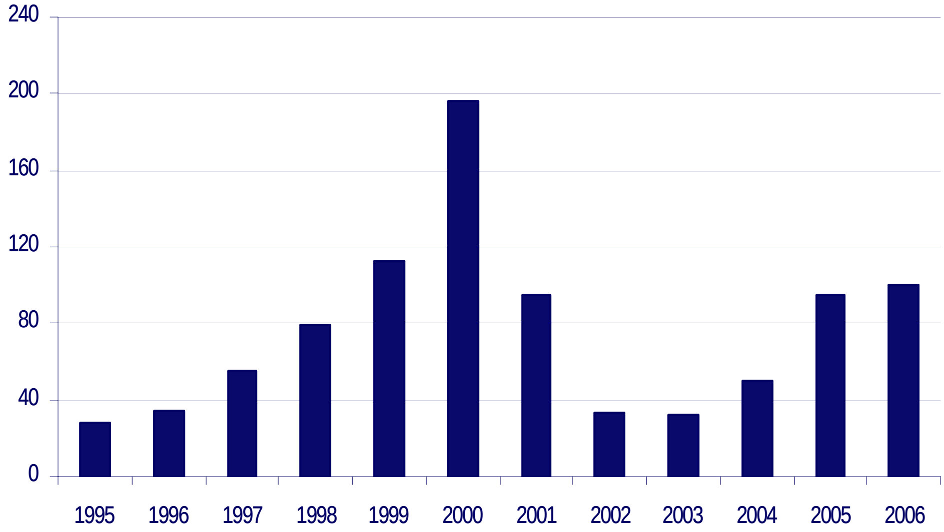


Source: AFIC

The European market is dominated by the United Kingdom, which is the key center for raising capital and managing private equity funds. In 2005, funds raised in the UK represented 63.3% of total funds raised in Europe, far ahead of France (15.8%), Germany (3.8%), and the Netherlands (3.3%). Despite the significant growth of the European market, overall it remains behind its counterpart in the United States. In 2006, the amount of capital raised by American funds reached €100 billion (**graph 3**). The United States' leader status is not just a reflection of the large size of its economy. The financing channels of this country have long played a significant role in private equity, whether as a component of expansion capital or a component of buyout capital. Several factors explain the size of private equity in the United States (Gompers and Lerner, 1999; Baygan, 2003): for example, the efforts undertaken by the American government through the implementation of the SBIC (Small Business Investment Company) program, tax incentives, and a regulatory environment that encourages pension funds to invest in illiquid stocks (prudent man principle of the ERISA law). It seems that the latter point has played an essential role, in that institutional investors are the main suppliers of private equity funds. Furthermore, their geographic investment scope goes beyond the United States, with numerous investments made abroad, and especially in the United Kingdom (cf. *infra*).

Graph 3: Funds raised by private equity – United States

(in € billions)



Source: NVCA

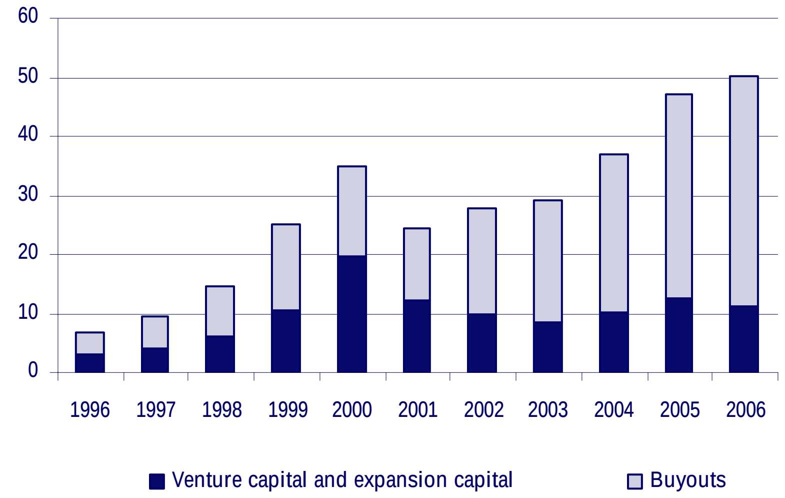
2.2 The driving force of buyout capital deals

The changes in the overall amounts of funds raised and invested in Europe have been accompanied by significant changes in market structure. Specifically, there has been a decline in investments for venture capital and expansion capital, to the benefit of buyout capital (graph 4). This movement has been very obvious, as the share of venture and expansion capital in total investments has fallen across Europe from 46.5% in 1996 to 22.5% in 2006. France has followed this scenario. An analysis of the same period shows that the rapid development of private equity in France reflected mainly the growth of buyout capital (graph 5). Until the end of the 90s, there were very few LBO deals in French private equity. During the period 1996-1999, the average annual amount invested in this segment was around €700 million. There has been a surge in this type of deal since 2000, peaking in 2006 at €8 billion, or 79% of total investments[7].

[7] In the United States, statistics provided by the NVCA suggest that the private equity market followed the same pattern, though with certain differences due to the maturity of this market. The collapse of technology stocks in 2000 weighed heavily on venture capital fund raising. The buyout segment, already robust in the second half of the 90s, did not advance as quickly at the beginning of the decade as its counterpart in Europe. Nonetheless, buyout funds raised in 2005 accounted for 78% of the total funds raised for private equity in the United States.

Graph 4: Investments by growth stage - Europe

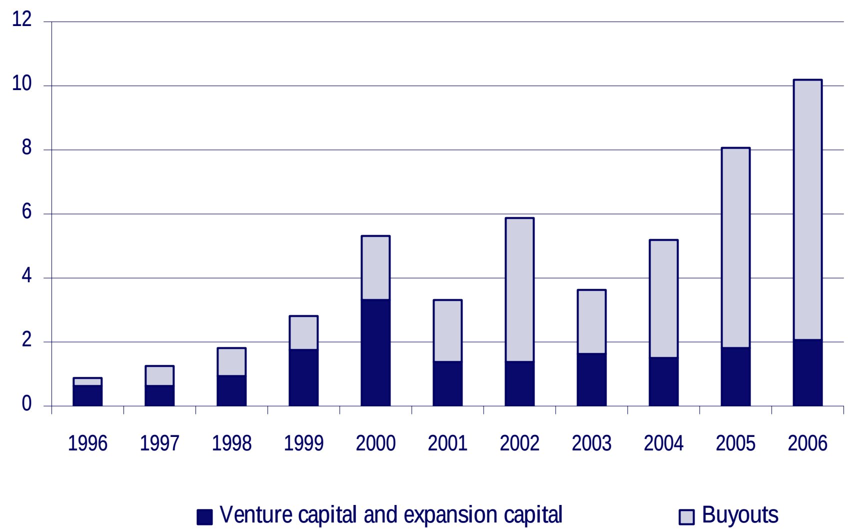
(in € billions, provisional statistics for 2006)



Source: EVCA

Graph 5: Investments by growth stage - France

(in € billions)



Source: AFIC

The higher weight of buyouts raised the overall size of private equity deals and, by correlation, increased the concentration of investments around a smaller number of companies. In 2005, again using France as an example, 6% of companies (those with annual sales of over €200 million) were the targets of 45% of total investments made by investors in domestic capital[8].

Beyond this question of size between the two largest segments of private equity, there is also the trend of certain buyout funds towards bigger and bigger deals, even if the number of small deals continues to dominate. In 2006, the biggest deal involving a European target (BAA Plc) was at nearly €21 billion, and the total amount for the ten biggest deals reached €82 billion (**table 1**). In France, the size of transactions has also grown, with the 10 top deals totaling around €16 billion in 2006. Furthermore, a large part of buyout deals is performed outside the private sphere, and involves companies listed on stock markets. Thus, in 2005, out of a total amount of buyout deals announced for European target-companies of €103 billion, €43 billion involved listed companies (**graph 6**). For 2006, the same statistic reached €86 billion, for total deal flow approaching €190 billion.

Table 1: The 10 biggest buyout deals in Europe in 2006

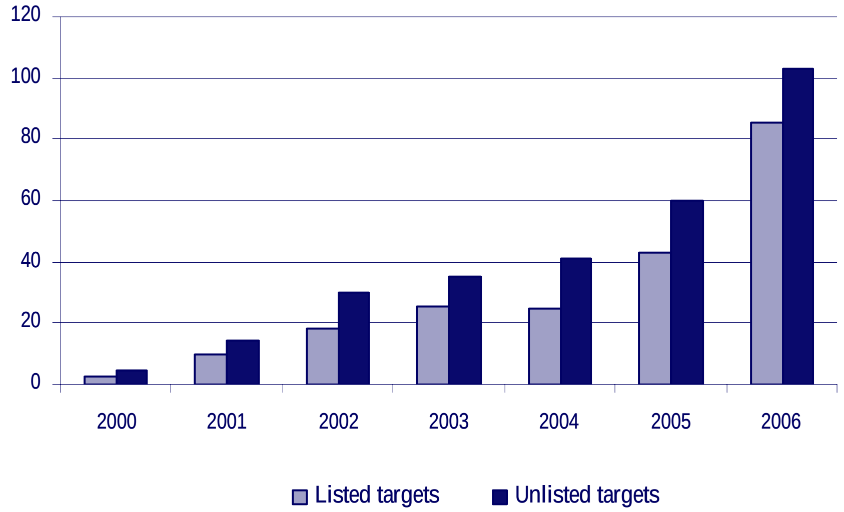
Target	Buyer	Estimated value (in € billions)
BAA Plc	Multiple buyers	**20.8**
Thames Water Plc	Macquarie Bank Ltd	**11.3**
TDC A/S	Nordic Telephone Co APS	**10.5**
VNU Group BV	Valcon Acquisitions BV	**8.1**
AWG Plc	Osprey Acquisitions Ltd	**7.9**
NXP BV	Multiple buyers	**7.2**
Telediffusion de France	Multiple buyers	**4.7**
ProSiebenSat. 1 Media AG	Multiple buyers	**3.9**
Kion Group Gmbh	Multiple buyers	**3.9**
Associated British Ports	Admiral Acquisitions UK Ltd	**3.6**

Source: Bloomberg

[8] In 2005, LBOs represented 78% of the total number of private equity investments made by French investors. The proportions are inversed when the number of companies involved is taken into consideration, where the LBO share is only 25%. The statistics clearly show that LBO deals are more limited in number, but bigger in average size. In 2005, the average size of an LBO investment was €13 million, vs. €1 billion for expansion capital deals.

Graph 6: Buyout deals targeting European companies

(in € billions)



Source: Bloomberg

2.3 Factors explaining market development

The development n funds raised in Europe since the middle of the 90s and the substitution of buyouts for venture capital and expansion capital are due to a number of factors, both economic and structural. The changes observed in the macroeconomic and financial context during this period provide a first explanatory factor. The slowdown in economic activity, starting in 2001, the collapse of technology stocks, and more generally the poor performance of financial markets until 2002 all contributed to limiting the funds raised during the first half of this decade, probably more in the venture capital segment than in the buyout segment. Academic research documents this link between the macro-financial environment and private equity flows (Gompers et al., 2005):

- Market conditions determine exit possibilities for funds via IPOs. A bullish market context thus provides a good price environment for selling companies in a fund portfolio (Jeng and Wells, 2000). These exits allow private equity investors to renew their capacity to raise funds in that they strengthen investor confidence in management skill;

- Share prices observed on stock markets, when they are high, signal that the companies are operating in growing markets. This is the traditional Tobin's Q ratio, by which an investment depends on the difference between the market value of a company and its asset replacement cost. This encourages investors to take equity stakes in companies, and not only those listed on the market. High stock prices are therefore likely to stimulate as much the demand for capital (companies) as the offer of capital (investors);

- Economic growth stimulates business creation and innovation, which in turn stimulates entrepreneurs' demand for capital. The development of new projects then stimulates the capital offer from investors.

Buyout capital might probably have significantly benefited from the poor performance of stock markets at the beginning of the decade, and the slowdown of economic activity. The decline in stock prices, first of all, made the buyout of certain companies whose stock price had fallen excessively low more attractive. The combination of a deteriorated market environment with very low interest rates spurred growth in leveraged deals, despite their intrinsic risk (increased variability of dividends) and thus their uncertain effects on companies' cost of capital. At the same time, the buyout capital segment also benefited from certain structural factors (Le Fur *et al*., 2002):

- increased professionalism of different participants (bankers, lawyers, etc.), growth of second-tier and mezzanine debt, and the introduction of innovative financial products (securitization of high yield loans through collateralized loan obligations, secondary LBOs) that provide liquidity to investors (lenders – banks in particular – and equity investors);
- refocusing of certain companies on their main business line, via the disposal of certain investments in sectors considered to be secondary. This movement is linked to pressure from institutional shareholders, concerned with limiting the sometimes risky diversification that follows an abundance of free cash flow;
- the inheritances of family companies created in the 60s and 70s. Managers reaching retirement age might prefer to sell their company to a fund that will keep teams and the company name in place, rather than selling to a competitor.

2.4 Specific risks related to the growth of buyouts

The growth of buyout deals, and in particular the biggest transactions concerning listed companies, raises a certain number of potential risks. Buyouts are often based on the use of significant leverage. This is the first source of fragility, which can take on different aspects (Banque de France, 2006):

- Leverage, if excessive, might become a too strong constraint for the acquired company and can leave her over-exposed to increased bankruptcy risk in the event of an economic downturn. A study by the rating agency Moody's (2006) shows that when companies are classified as non-investment grade at the time they are bought, the implementation of the purchase tends to result in deteriorated credit quality and a higher default rate, except for companies with the lowest ratings[9];
- Loans at the origin of the buyout are often subject to disposals by banking participants, via securitization transactions. This leads non-banking participants to carry a credit risk with which they may not be familiar. This can also result in the risk of moral hazard within the banking sector, banks being potentially less inclined to rigorously select and monitor their loan portfolios of which a significant part can always be sold on a secondary market;
- Loans are given to companies which are (or will be, in the case of public to private transactions) outside the regulatory environment of stock markets. Debts are thus carried from companies which show a lower degree of transparency.

This latter point also raises the question of the attractiveness of stock markets and a new trend, via private equity funds, towards delisting. If capital flows towards private equity remain strong, they could result in an increasing number of companies moving into the growing universe of private companies. As was mentioned above concerning leverage, this would imply decreased transparency in the equity investments held by investors. However, this risk is low at present, and should be assessed with a long-term perspective that takes into account the role of private equity investors in the growth of companies and IPOs. At the end of a cycle, delisted companies are often listed again, either in a similar form or after restructuring.

[9] Specifically, these negative effects on credit quality appear only for companies rated at the upper end of the non-investment grade category (B and Ba). For companies with the lowest ratings (Caa to C), the buyout tends to have the opposite effect, with improved credit quality.

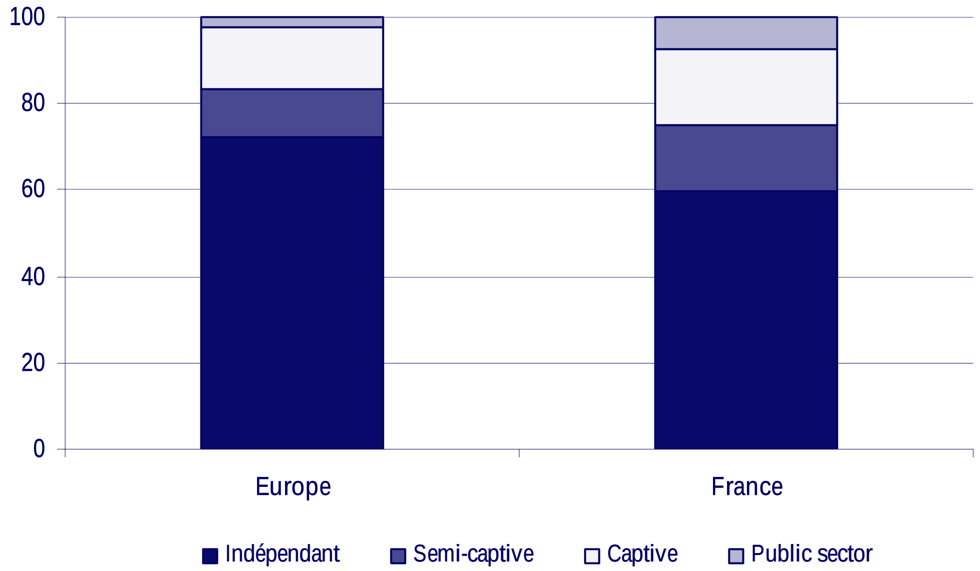
3. Private equity investors

3.1 The role of intermediaries or private equity investors

The growth of the private equity market went together with the emergence of specialized intermediaries who invest and manage the capital raised from different investors. The arrival and rapid growth of these funds or private equity firms can be linked to the birth in certain countries of an asset management industry. Restricted at first to traditional financial instruments, asset management now tends towards less traditional assets, such as real estate and private equity. This can be seen in the creation, within the major asset management companies, of subsidiaries specifically dedicated to this activity. These entities can be called on to manage the assets of the banking or insurance group to which they belong, or they can invest funds from investors with whom they have no financial relationship. They permit traditional investors, mainly institutional, to have access to a new class of assets without having to develop an internal capacity of analysis and portfolio monitoring, whose cost is disproportionate to the often modest amount of invested capital. For example: according to the EVCA, in 2005, independent funds in Europe were responsible for 72% of total investments made by private equity, vs. 15.4% for captive funds and 11.4% for semi-captive funds (which invest funds from their parent company and also from outside investors, **graph 7**).

Graph 7: Breakdown of investments by type of fund – Europe and France

(year 2005, %)



Source: EVCA

The exact forms that private equity funds can take vary from one country to another. In Anglo-American countries, the most common model is the limited partnership, a structure composed of two types of partners. Limited partners provide capital and are not actively involved, if at all, in the portfolio management. They are liable only for the amount individually invested. The general partner is in charge of portfolio management and is liable for the debt and obligations of the limited partnership. The general partner's remuneration is in two parts: management fees, which compensate the manager for the administration and management of funds, and the carried interest, which is a share of the profits generated by the fund. The life of the fund is limited in general to 10-15 years. It can be broken down into an investment phase, which can be spread over five years, followed by an exit phase from investments held (disposals, IPOs, etc.), with capital gains distributed to investors.

France's investment vehicles are close, in philosophy, to the Anglo-American model. This is the case with FCPRs, the most common[10] vehicle, which borrows from previous model certain characteristics such as the duration of the fund or the mechanism of management incentive. There are also investment structures such as venture capital firms, which have the form of investor-owned companies (*sociétés par actions*). The fund's life is in theory unlimited, which can be an advantage for the manager and the investor, adding stability to the capital.

Some of these structures, investment funds, and companies may choose to be listed on stock markets, where regulations allow. In France, two examples are Altamir and Amboise Investissement, which are venture capital firms belonging to the Apax Partners Group and listed on Euronext Paris[11]. Internationally, in May 2006, KKR listed one of its limited partnerships, KKR PEI, on Euronext Amsterdam, raising €3.9 billion during its IPO. In the United Kingdom, the London Stock Exchange includes 18 listed securities that are primarily invested in unlisted assets. The biggest of these is 3i, whose market capitalization at the beginning of 2006 was nearly £5 billion[12].

10 The FCPR is a mutual fund whose principal activity is to invest collected savings in unlisted shares. Within the FCPR range is notably the FCPI (Fonds Communs de Placement dans l'Innovation, which must be composed of 60% of securities of unlisted companies) and the FIP (Fonds d'Investissement de Proximité, whose assets are composed of 60% of unlisted securities which all belong to the same geographic zone). The FCPR, FCPI, and FIP are respectively defined in Articles L.214-36, L.214-41, and L.214-41-1 of the Monetary and Financial Code. These last two types of FCPR are open to retail investors, whereas the FCPR with simplified procedures is reserved for institutional clients.

11 In addition to listed venture capital firms, investment firms can also be listed, such as Wendel or Eurazeo in France. These firms hold equity investments in both unlisted and listed companies.

12 This listing trend can be seen by the creation of private equity indices, such as the LPX 50 which was created in 2003 by the Swiss company LPX Gmbh and launched in March 2004. It includes the 50 biggest funds and listed private equity firms from around the world. A detailed analysis of listed private equity funds on the LSE can be found in a study published by UBS (January 2006).

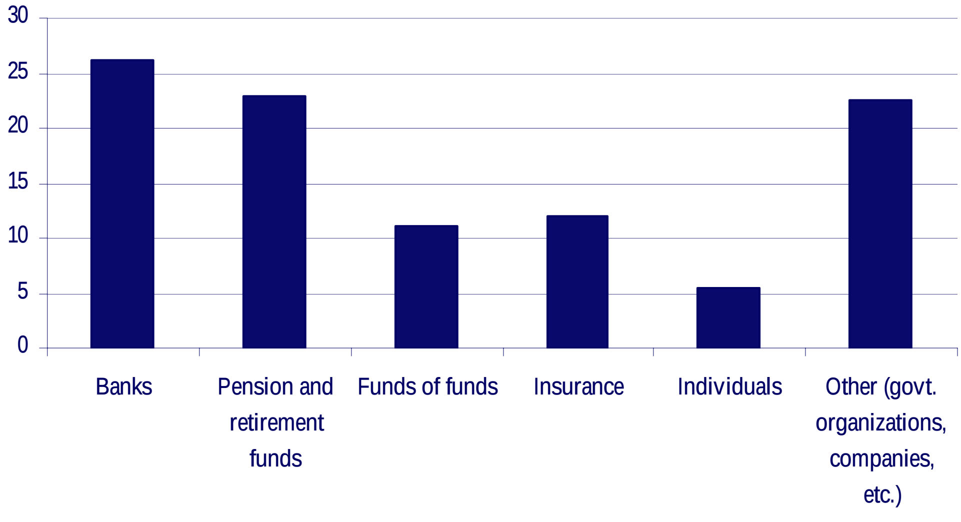
3.2 The role of pension funds in the United Kingdom and of banks in continental Europe

Private equity is an asset characterized by low liquidity and high risk. Therefore, it is suitable for investors with long investment horizons, who have the means to block part of their portfolio and to expose it to significant risk. This category includes institutional investors such as insurance companies, particularly pension funds, whose horizon, determined by the nature of their commitments, is unusually long. This category also includes banks, whose proximity to companies (particularly through the management of current accounts) predisposes them to efficient management of asymmetrical information, higher in the case of private equity. Finally, there are individual investors with significant investment capacity. Beyond the idea of portfolio management/diversification, some participants, such as industrial companies and certain government entities, may also participate in the private equity market in order to promote technological innovations.

In Europe, banks are the main market participants, and the source of more than 25% of funds raised (**graph 8**). Next are pension funds and other investors, including both government entities and companies. The role of individual investors is quite small, as they represent only 5% of funds raised. Individual investors have very little exposure to the risks previously mentioned – both economic (transaction price perhaps excessive) and structural (low transparency, low liquidity, etc.) conditions – that are associated with the holding of private equity shares. Global statistics would not cover strong national divergences, which are the result of the organization channels specific to domestic financing. As a basic outline, there is the Anglo-American model, as in the United Kingdom, and the continental European model, used especially in France.

Graph 8: Sources of funds raised for the private equity market – Europe

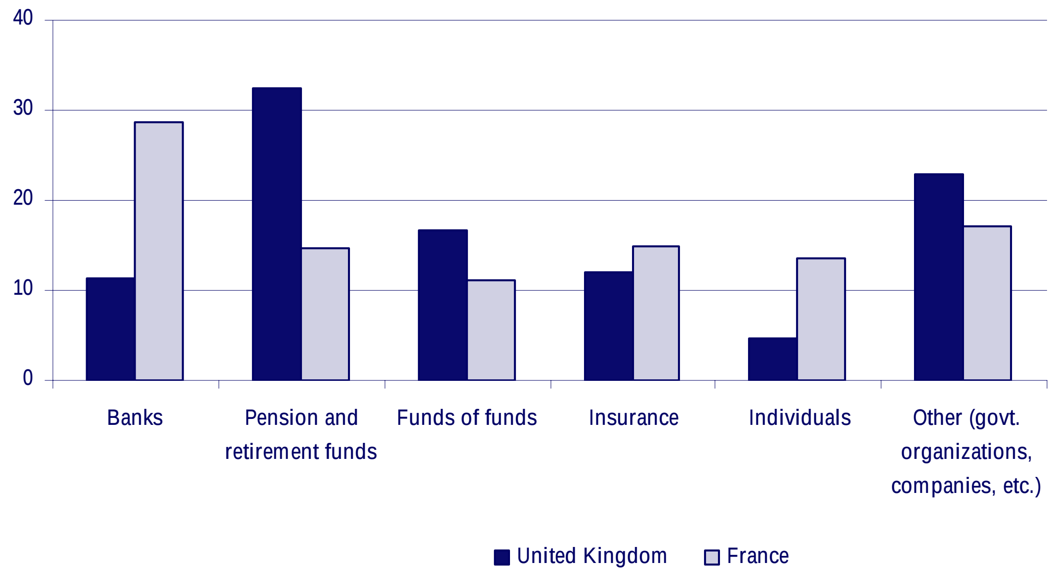
(average for the period 2001-2005, %)



Source: EVCA

In the United Kingdom, institutional management is the biggest source of financing. Pension funds and funds of funds are the source of nearly half of all financing allocated to private equity (**graph 9**). Contrary to the continental European model, banks play a smaller role, with only 11.3% of funds raised. The British system has another major difference: the massive presence of foreign investors (**graph 10**). A more detailed analysis of financing sources shows that the most active pension funds by far are foreign pension funds, American for the most part. British pension funds, even if they are the biggest domestic investors (ahead of domestic banks), represent only a small part of total funds raised (8.3%)[13]. These statistics show the trend of American institutional investors to take massive positions in private equity, including abroad. The investment policy of the American pension fund Calpers provides a good example of the attraction of unlisted companies. The amount invested in private equity by Calpers was estimated at the end of Q1 2006 at a little over €10 billion, or around 5% of the total asset portfolio. The foreign presence in the UK is a reflection of the participation of major international players in investment banking. Most funds raised are thus earmarked for major buyout transactions, a segment representing more than 90% of the British private equity market.

Graph 9: Sources of funds raised for the private equity market – France and the United Kingdom (average for the period 2001-2005, %)

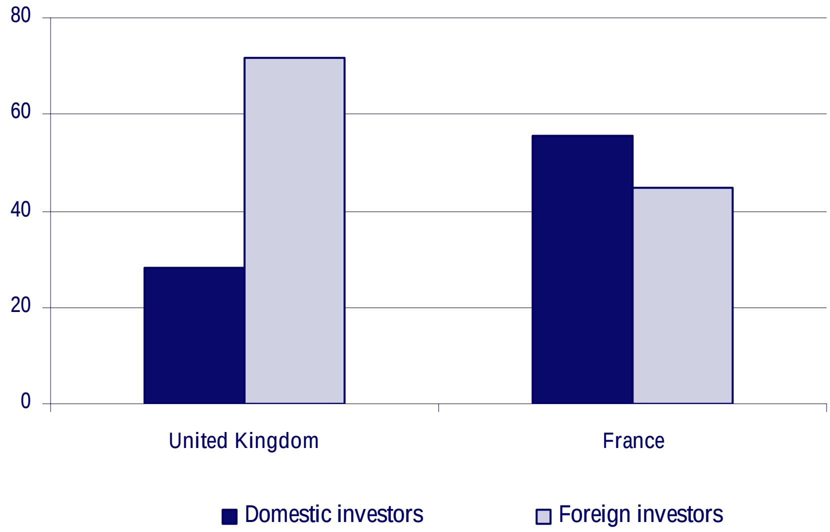


Sources: AFIC, BVCA

[13] The low level of involvement of British institutional investors in the private equity market is also addressed in the Myners report (2001) on institutional management.

Graph 10: Sources of funds raised by country – France and the United Kingdom

(average for the period 2001-2005, %)



Sources: AFIC, BVCA

By contrast, private equity in the majority of continental European countries, and particularly in France, is largely dependent on banks (**graph 9**). On average, over the period 2001-2005, French banks provided nearly 30% of total funds raised. Traditional institutional investors, such as insurance companies, play a rather small role in the private equity market, considering the large pool of savings that they manage. To illustrate this: Out of total annual investments of €70 billion (average over the period 2001-2005) from French insurers, only €772 million went to private equity. At the end of 2005, their outstanding shares in FCPRs were no more than €2 billion (out of total outstanding investments of around €1,130 billion). Regarding this, it is worth noting the weak response to the implementation of tax incentives for life insurance contracts in mutual funds partially invested in private equity[14]. For example, according to the FFSA (Fédération Française des Sociétés d'Assurance), total funds invested in DSK contracts in 2005 amounted to scarcely €437 million, vs. total subscriptions of €121 billion in the French life insurance market.

Several reasons explain the relative lack of interest on the part of institutional investors in most continental European countries, and particularly of insurance companies, given the absence of pension funds in many countries. The commitments of insurers are for the most part incompatible with the constraints intrinsic to

[14] Taxation on savings in France is complex, given that numerous financial instruments are each taxed differently. Aside from traditional regulated savings products, whose income is tax-free, taxation is adjusted by the French government based on the duration and/or risk of the product under consideration. Investment vehicles in unlisted stocks are thus among the most tax-advantaged, as income received at exit can be added, depending on the individual case, to the tax incentive allowing the amount initially invested to be deducted (with a ceiling applied). For example, FCPIs benefit from tax-free income as well as a tax deduction of 25% of the amount invested (ceiling applied). In life insurance, capital gains for DSK contracts (which are invested up to 10% in private equity) are not taxable, whereas contracts invested in traditional mutual funds are taxed at 18.5%.

capital investment (Trainar, 2004). For example, in France, life insurance contracts have a tax life of eight years, which is rather short in terms of private equity. In addition, certain contracts offer guaranteed capital, which is not easily compatible with investments in risky assets. Finally, current regulations are dissuasive, whether through investment policy constraints (setting of low limits for unlisted shares) or through accounting practices for unrealized capital gains or losses[15].

3.3 Demand perspectives

In the future, European institutional investors, especially insurers and pension funds, will probably add to their position on the private equity market. However, it is still difficult to know just how strong this movement will be, with certain regulatory or economic hindrances potentially slowing demand. First, the growth of long-term savings in European countries automatically boosts the demand of institutional investors for all asset classes, including private equity. Second, beyond a volume effect, private equity would benefit from reallocation of investments, under the impetus of a series of factors:

- insufficient supply on bond markets and unattractive yields. The pursuance of the pattern observed since the beginning of the decade could lead institutional investors to search for an additional return based on "alternative" assets, in hedge funds, shares of private equity funds, and securitization vehicles.
- the introduction of very long-term savings products, which allow financial intermediaries to avoid liquidity risk and which imply an inflation hedge. In France, the implementation of Perp and Perco constitute a first step in this direction, even though the regulatory investment ratios are limited.
- the recentness of the private equity market and the under-investment of major European investors. Private equity constitutes a new asset for many investors. Because of this, it is under weighted in portfolios. Some simulations suggest that an investor who wants to maximize portfolio risk/return, and who has access to all available assets, should devote between 5% and 10% of total assets to private equity (Artus and Teiletche, 2004; Kaserer and Diller, 2004). Even though some American investors, such as the pension fund Calpers, are already operating within this range, this is not the case for most European investors, even in the United Kingdom.
- regulatory changes in certain countries. In France, the maximum limit for unlisted shares as percentage of commitments of insurance companies was raised in 2004 from 5% to 10%[16].

[15] The yield curve for private equity funds, in the form of a J-curve, combined with the principle of accounting at market value, leads to unrealized losses during the first few years of the investment.

[16] This change was supported by a call from French insurers for bigger positioning in private equity.

Along with these positive factors, several negative ones could slow the demand of institutional investors. First of all, the retirement savings systems currently in place or under creation are now mainly defined contribution pension plans. In this type of plan, households decide on strategic asset allocation and financial intermediaries are often limited to offering a reduced range of investments, generally shares in UCITS mutual funds. Institutional management, through collective investment schemes, is no longer responsible for making allocation decisions. It is not clear that private equity will fully make its way into this system, as seen by the meager investments in France via the DSK contracts. Next, in many continental European countries, the private equity market is a young market. Lower returns resulting from excessive fund raising, or a credit accident provoked by an abusive use of leverage, could lead investors to permanently abandon private equity for more traditional assets.

4. Private equity returns

4.1 General characteristics

Private equity is an asset class with very specific properties. It is above all an asset with low liquidity, even though the growth of secondary funds tends to reduce the liquidity problem. It is by nature a long-term investment, with moreover no secondary market to facilitate transactions. The yield curve of a private equity fund provides a good illustration of this low liquidity. During the first few years, cash flow is negative because of the progressive implementation of investments and the management fees paid out. It is not only after approximately five years that the portfolio's investments begin to generate income/capital gains, and the activity begins to be profitable for investors. This is a simplified description, especially concerning the lapse of time between the time when investments are made and their divestment. It can be better applied to venture capital funds, which focus on young companies, than to expansion funds or buyout funds, which in theory involve companies that are already profitable. In France, the average holding period of an investment is 3.7 years (AFIC).

A second characteristic of private equity is low transparency. Investments are by definition made in unlisted companies that are not subject to the same strict disclosure rules as publicly traded companies. Additional factors are the absence of analyst coverage and the lack of public information concerning the valuation of investments, as because of the absence of listings and stock exchanges. The result is unequal information and problems leading to adverse selection and moral hazard, which cannot be resolved without the intensive due diligence (before the investment) that private equity investors perform along with the strict monitoring of companies in which they hold investments. For the last few years, private equity investors, via their professional associations, have begun formalizing the valuation procedures of their equity investments, as well as their reporting to the individuals and institutions from which they have raised funds, in order to limit the uncertainty that is inherent in unlisted shares[17].

One final characteristic of private equity is that in theory it presents high returns and risk:

- In the case of venture capital, financed companies often have high growth potential, but their business is not yet consistent and they are often hindered by significant uncertainty (technical and commercial success of innovations, etc.)[18]. Furthermore, small start-up companies are largely dependent on the overall economic climate;

[17] Cf. the document *International Private Equity and Venture Capital Valuation Guidelines*, published by the AFIC, the BVCA, and the EVCA in March 2005 (new edition in October 2006), as well as the *EVCA Reporting Guidelines* (published by the EVCA in June 2006).

[18] Under these conditions, there is only a low probability that investments held by a private equity fund will give a balanced performance. The high probability of failure of certain investments implies that the overall performance of a fund depends on the outperformance of a limited number of companies.

- An important component of private equity, and especially buyouts, involves massive use of leverage. However, heavily-indebted company's profits are highly sensitive to the economic cycle.
- The high costs of analyzing and monitoring companies, along with the necessary expertise, leads investors to focus their portfolio on a limited number of companies. This concentration can increase the performance of portfolio investments (best knowledge and greater involvement of fund managers), but it also exposes the portfolio to specific risk in addition to systematic risk[19].

The returns expected by investors from a private equity investment should match the risks that we have just mentioned. Low liquidity, asymmetrical information resulting from looser communication requirements compared to those for listed companies, the uncertainty of the investment’s profitability (related to the nature of the company's business or to its financial structure), the difficulty of diversifying portfolios, should lead investors to demand greater returns than those calculated for more traditional assets such as publicly traded stocks.

4.2 Long-term performance

Private equity performance is difficult to measure because of the absence of public stock prices for the companies in the portfolio. It is only during particular events, such as divestments and IPOs, that it is possible to provide an objective valuation for investments and to calculate investment performance. In the absence of such events, the value of portfolio investments must be estimated by the fund manager using conservative hypotheses which over time tend to smooth valuation changes. As previously mentioned, European private equity investors have made significant efforts in recent years to improve and standardize valuation methods for their investments. Along with these questions of valuation, the profile for investment and distribution of income is also specific, mainly through a rather long procedure for implementing investments and distributing income. This specificity prevents private equity returns from being measured in the same way as those of investments in more liquid assets, such as listed stocks.

The traditional method for calculating the return of a private equity fund is based on the comparison between outflows (investments) and inflows (income, capital gains) over a specific period, preferably a long one. From these flows, the IRR (internal rate of return) can be calculated, which makes equal the discounted value of the investments and that of income/capital gains received during a specific period. Such a calculation is, of course, impacted by the hypotheses retained for valuing the portfolio at the beginning and end of the period[20].

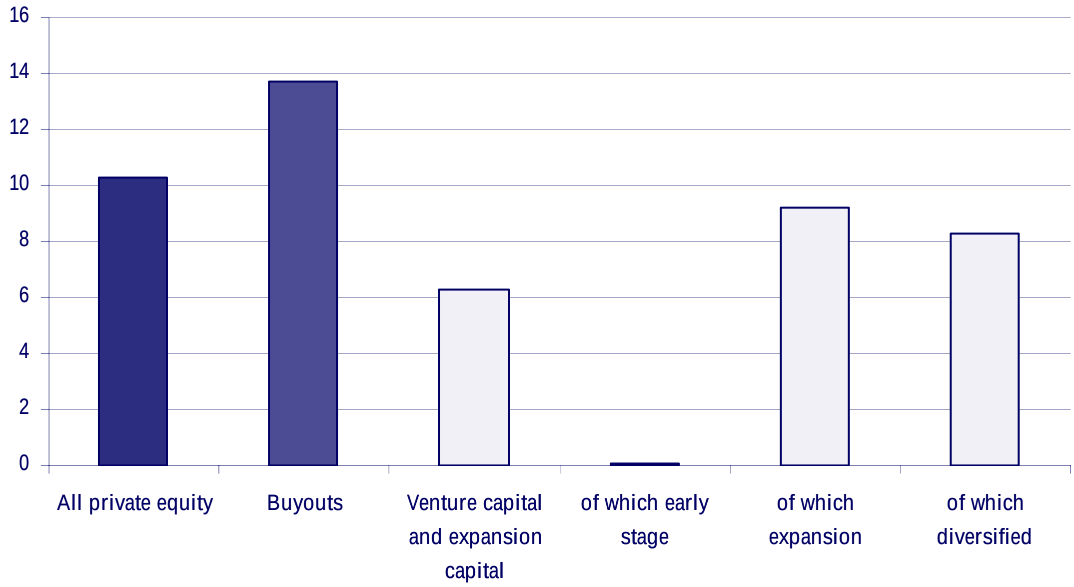
19 For all asset types, risk is composed of an unsystematic part and a systematic part, the latter representing the relationship between overall market conditions and the asset's performance. The first of these two risks can be reduced, or even eliminated, through diversification. The result, in theory, is that it will not provide additional returns. The second risk, on the other hand, cannot be reduced, and it will determine the extent of the risk premium. More precisely, the risk premium expected for a given asset is a function of the economic risk to which the company is exposed, increased by the risk resulting from leverage. For private equity, the impossibility of correctly diversifying the portfolio adds a specific residual risk, which must be remunerated. However, we should mention that funds hold, as a general rule, between 10 and 15 investments, which significantly reduces a portfolio's specific risk.

20 Cf. Artus and Teiletche (2004) for a detailed analysis of this problem of return measurement and comparability with returns of traditional listed assets.

Estimates made by EVCA and Thomson Venture Economics using this methodology show that IRRs (net of management fees) were 10.3% in Europe for all private equity funds created during the period 1980-2005 (**graph 11**). The breakdown of profitability by segment reveals significant performance disparities. Specifically, venture capital and expansion capital performance overall, limited by a yield of nearly zero of the early stage funds (0.1%), appear significantly inferior to buyout funds, respectively 6.3% and 13.7%. Expansion capital funds, which participate only in the later growth stages of a company's life and not in the early stages, have an IRR of 9.2%.

Graph 11: Performance of private equity funds in Europe

(IRR calculated at the end of 2005 for a sample of funds created in the period 1980-2005; in %)



Sources: EVCA, Thomson Financial

As we have emphasized, it is difficult to compare the returns of private equity to those of more liquid assets; the IRR cannot be compared to the usual returns of other assets. One method consists of calculating an IRR for listed assets, assuming that investment and income flows have the same rhythm as for private equity. The calculations made by EVCA using this method suggest that private equity as a whole does not significantly outperform over a long period compared to competing traditional assets. More precisely, while private equity largely outperforms European stocks as represented by the Morgan Stanley Euro Index, its performance is fairly close to that of small caps (HSBC Small European Company Index) and bonds (JP Morgan Euro Bonds, **Table 2**)[21].

[21] Note that the period under discussion was characterized by a large drop in long-term interest rates, which improved bond performance.

Table 2: Returns compared to private equity

(IRR calculated at the end of 2005 for a sample of funds created in the period 1980-2005; in %)

	Private equity	Morgan Stanley Euro Index	HSBC Small European Company Index	JP Morgan Euro Bonds
Venture capital and expansion capital	6.3	6.4	9.8	10.1
- of which Early stage	*0.1*	*4.2*	*10.0*	*10.6*
- of which Expansion	*9.2*	*8.4*	*10.3*	*9.2*
- of which Diversified	*8.3*	*6.3*	*9.9*	*9.6*
Buyouts	13.7	2.7	8.7	10.7
Total Private Equity	10.3	4.3	9.7	10.5

Sources: EVCA, Thomson Financial

The differences noted earlier in comparing returns of different segments of private equity are found here in the comparison to listed assets. Buyouts significantly outperform asset classes overall, whereas venture capital and expansion capital together present similar performance to that of European stocks, but far weaker than that of small caps and bonds. Excluding early stage investments, expansion capital outperforms European stocks, but not other asset classes.

Performance measures of private equity can nonetheless be marred in different ways, and not taking these into account can lead to skewed results. These biases result from practices used by managers to value unrealized investments. They can also come from samples used for performance estimates, with unrealizable investments (bankruptcies, unprofitable companies, etc.) tending to be excluded from the population (selection bias). Certain academic studies, though still rare because of a lack of available data, have endeavored to measure private equity returns while correcting the raw data for these different biases. Focused for the most part on the United States because of the depth and age of the market there, they often yield contrasting results, moving from outperformance to underperformance of private equity funds compared to other available assets, especially listed shares. Ljungqvist and Richardson (2003), for example, find that private equity funds had average performance that was markedly better than that of the S&P 500: 5% to 8% per year during the period 1981-2001. This outperformance rewarded both the additional risk born by investors and the lack of marketability of the assets[22]. Groh et Gottschalg (2006), who focus solely on buyout funds, also observe a marked outperformance of this asset class compared to a portfolio of listed securities with identical characteristics, such as companies' financial structure. Phalippou and Zollo (2005a) obtain

[22] These results can be compared to the theoretical simulations for liquidity premiums performed by Artus, Pochon et Teïletche (2005), who estimated that the liquidity premium expected for private equity is around 2% for an investor with little information and 4% for a perfectly informed investor who accepts a higher opportunity cost because of the quality of available forecasts and potential profits.

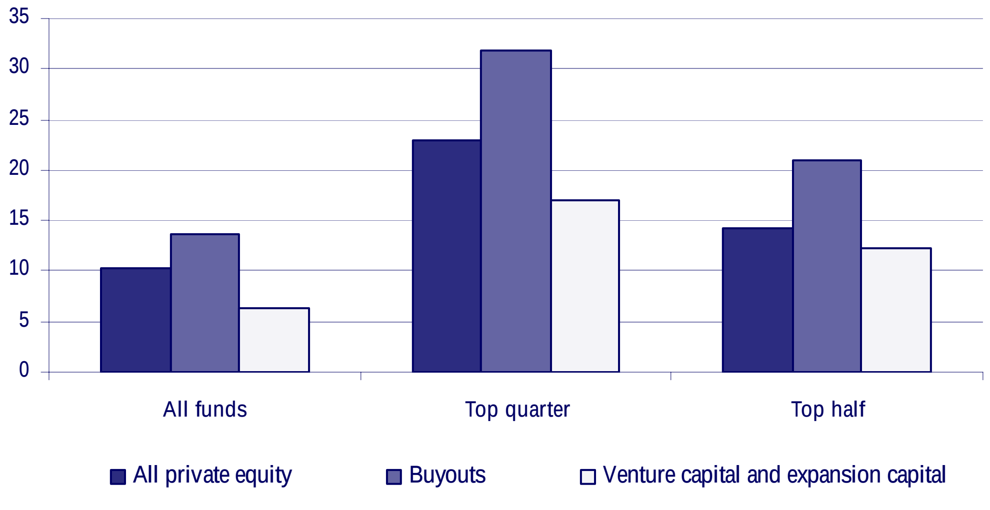
opposite results. They demonstrate that during the period 1980-1996, the annual return of private equity overall was on average 3% less than that of the S&P 500. Finally, for the same index and nearly identical period (1980-1997), Kaplan and Schoar (2003) obtain equivalent performance for private equity and publicly traded stocks. In total, all available studies suggest that absolute and relative performance measures of private equity are largely dependent on the methods used to correct the different biases. Because of this, it is difficult to draw a conclusion on the long-term performance of private equity as a whole.

4.3 Performance dispersion and management skill

The preceding results, covering large samples of funds, can be completed and enriched by an analysis of the individual performances of different funds. EVCA statistics demonstrate that performances are not uniform, and that funds with mediocre returns coexist with funds with excellent performance. Thus, for European funds, the average performance of the top quartile of funds is nearly 23%, all categories considered (of which 31.8% for buyout funds and 17.1% for expansion funds, **graph 12**). A clear difference remains if the sample includes the top-performing half of the funds. This dispersion is in part attributable to fund size. Large funds seem to show better performance on average than smaller funds, whatever their nature (buyout or expansion).

Graph 12: Performance dispersion of private equity funds

(IRR calculated at the end of 2005 for a sample of funds created in the period 1980-2005; in %)



Sources: EVCA, Thomson Financial

Academic literature supports these observations, and provides justifications: management skill seems to be a decisive factor. Large funds benefit from a high level of skill, partly because of their age and partly because of the number of investments made. On the contrary, younger, smaller funds suffer from a lack of expertise and a lower position on the learning curve[23]. This relationship between the size of the fund and management skill is likely to be self-sustaining, as outperforming funds raise money from investors more easily. The dispersion of returns linked to the skill of management teams can also be found in studies aiming to determine the return "persistence" of private equity funds. Kaplan and Schoar (2003), notably, demonstrated the phenomenon of persistence: a manager who has already successfully managed a fund will similarly manage the next fund for which he is responsible[24].

4.4 The source of buyout performance

The positive effect of leverage from debt assumed in order to prepare the acquisition of a target is often the focus of attention. With the cost of capital being less than the cost of equity, the increase in debt's weight within the company's resources would automatically translate to lower average cost of capital, thereby increasing company value. Theoretical models concerning the relationship between the value of companies and their financial structure clearly show that this approach of debt is largely erroneous, to the extent that the weakening of the financial structure of a company comes with higher risk that must be borne by all stakeholders. Following the pioneering work of Modigliani and Miller (1958), it can be demonstrated that increased leverage raises the variability of dividends received by shareholders, who expect additional remuneration as compensation. Leverage also increases default risk, which leads to higher cost of borrowing. Finally, using leverage can have the opposite effect to what was hoped for, i.e. a decline in the value of the company.

A second— and more convincing—argument is often put forward to economically justify the appeal of LBO deals and the use of leverage: taxes. As interest paid on debt is deductible from taxable earnings, the use of leverage allows remuneration growth that is allocated to shareholders. This leads to, all things being equal, a rise in company's value.

The most solid argument for explaining the interest of LBO operations can be found in agency costs. LBOs solve problems resulting from conflicts of interest between shareholders and company managers. Two main mechanisms are at work, respectively linked to the LBO financial structure and the shareholding structure:

[23] Economies of scale also constitute a factor that explains the higher returns of larger funds. Furthermore, the relationship between size and performance does not appear to be linear (Kaplan and Schoar, 2003): size begins to be a handicap after a certain point, as the rarity of investment projects can lead managers to take positions in less promising companies.

[24] NB that the persistence tests applied to traditional multi-manager funds generally conclude to an absence of persistent performances.

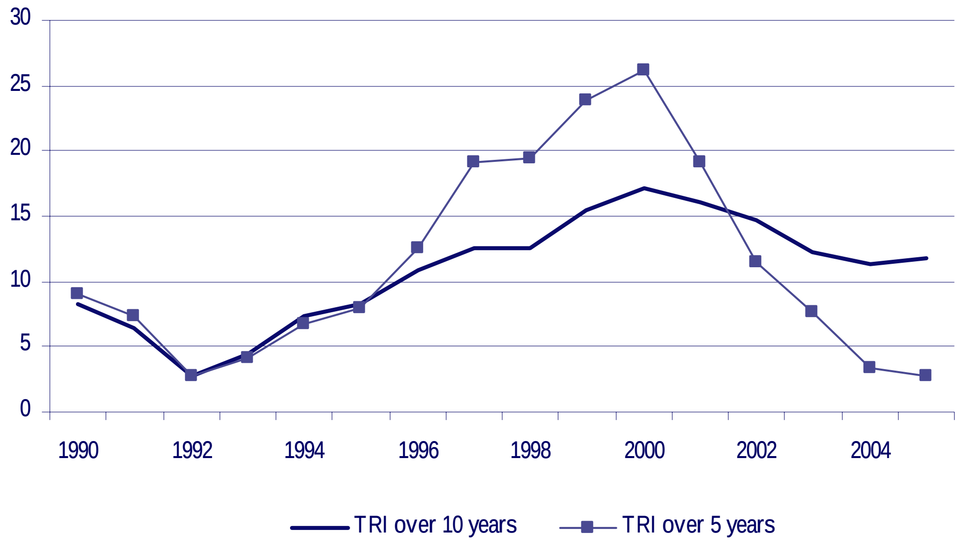
- high interest costs resulting from the debt generated by the buyout compels managers to implement rigorous management. In addition, payment of interest lowers liquidities at the managers' disposal (free cash flow), which could be used more effectively from the shareholders' point of view.
- LBOs have the effect of creating a reduced shareholding structure, within which the risk of unwelcome individuals seeking to control management is greatly reduced. The presence of shareholders with significant stakes in the company encourages closer monitoring of company management. Furthermore, the implementation of a management team that is also a stakeholder in the company's capital aligns the interests of managers and shareholders.

4.5 Strong performance and its correlation to other assets

IRR calculated for shorter periods show the performance's change overtime. **Graph 13** shows the change of IRRs calculated over moving periods of five years and ten years[25]. Naturally, the IRR for 10 years is smoother than that for 5 years. The 90s were marked by continuously high long-term returns, followed by an inversion at the beginning of the decade after the bursting of the internet bubble and the deterioration of macroeconomic conditions. This decline is nonetheless moderate compared to the correction inflicted on the stock market. Five-year yields suffered more from the stock cycle, while remaining in positive territory. 2005 was the low point, with IRRs of around 3%.

Graph 13: Private equity performances in Europe

(TRI estimates for different horizons, funds created during the period 1980-2005, in %)



Sources: Thomson financial, Datastream

[25] For each date t, the calculation is made by taking as initial investment the estimated investment portfolio value at the beginning of the period (t-10 or t-5), while the cash inflows are given as the sum of income/capital gains received during the period, to which is added the estimated value of the portfolio at the end of period (t).

The relative performance of private equity returns, in a nonetheless unfavorable context, raises the question of the degree of correlation between private equity and other available assets. This is an important element that enters theoretically into the determination of returns demanded from private equity funds and into how much place they should have in investors' portfolios. The idea that the return on private equity is de-correlated from the macro-financial context and the performance of stock markets seems highly erroneous, given the results of academic research[26]. Phalippou and Zollo (2005b) show that returns on private equity investments are even higher in growing economies with a buoyant stock market throughout the same investment period. Several arguments are intuitively in favor of such a correlation:

- the beginning and end investment values are influenced by stock market conditions. For example, an exit by IPO will be carried out at a price proportionately higher if the overall stock market is at greater valuation levels, as measured by multiples;
- economic growth is an important condition for the development of innovative small companies.

However, all available estimates suggest that the degree of correlation between private equity and other assets (listed stocks in particular) is weak enough to confer on private equity the virtue of contributing positively to portfolio diversification (Bance, 2004; Artus and Teiletche, 2004; Kaserer and Diller, 2004).

4.6 The phenomenon of 'money chasing deals', or fund raising as a performance determinant

The private equity market presents a certain number of characteristics that make it difficult to establish an equilibrium price (for investments) that reflects risk and return perspectives commonly seen on the stock market. According to empirical estimates (Gompers and Lerner, 2000; Diller and Kaserer, 2005), there should be a direct and causal relation between the amount of funds raised from investors, the price of transactions on the primary market (deals), and the performance of these investments. These characteristics are as follows:

- the absence of a true secondary market (apart from the possibility of selling to a secondary fund), and thus of a public price for investments: the adjustment is made for the most part when the transaction takes place on the primary market;
- the pressure for private equity funds to invest capital raised and, more generally, the inflexibility of the capital offer, whether increasing or decreasing;
- competition among private equity funds to invest their capital;
- the limited number of available projects.

[26] Here it should be pointed out that certain managers value unrealized investments at acquisition cost, a technique which contributes to artificially lowering volatility and reducing the correlation with market indices.

Given these conditions, increased amount of capital raised tends to impact transaction prices on the primary market. Price movements can be excessive given the risk-return ratio of the investment project, to the extent that the excess capital offer must be absorbed by the market when managers cannot reallocate the funds to another asset class. The result is lower return perspectives for investors because of entry costs that are too high. Another factor can contribute to lower investor returns: the time between the raising of funds and the investment is longer when there is fierce competition between managers, due to the length of time necessary for research. Nonetheless, note that the possibility for managers to call for funds only at the time investments are made weakens this argument.

Even if such an operating system is valid, the extremely rapid acceleration in fund raising seen in Europe since 2005 in the buyout segment could lead, over time, to lower returns than in the past, and than those required by investors who provide the capital.

5. Overview of risks and possible actions for market authorities

Private equity targets mainly unlisted small and medium-sized companies. However, the rapid growth in large-scale LBO deals is a potential source of risk for the market regulator. Four main risks have been identified for this specific sector:

- The large flows into buyout funds could lower risk premiums, or significantly lift acquisition prices, which amounts to the same thing. This could, over time, result in weaker performances and poor capital allocation for the final investor. This risk is exacerbated by valuation difficulties for portfolio investments, given the absence of a public market for the underlying shares, and despite diligence and recent efforts by private equity investors to improve and standardize valuation methods.
- The currently favorable borrowing conditions for buyout deals could lead to excessive debt, provided by participants that would not necessarily carry the credit risk to maturity and could sell their receivables on the secondary market. The main risk would be a weakening of the credit quality of the institutional debt portfolio.
- The growth of large-scale buyout deals of listed companies could, in the short term, reduce the number of companies listed on stock markets. Such a change would raise questions concerning the transparency of economic activities and, more generally, the efficiency of the financial system. Nonetheless, this risk is still moderate, and should be measured by taking into account a long-term perspective and the role of private equity investors in the future pace of IPOs. Indeed, at the end of a cycle, delisted companies are often listed again, either in a similar form or after restructuring.
- Private equity investors are for the most part institutional investors who, in theory, have the financial capacity and scope to withstand the intrinsic risk of this type of investment. The risk of over-distribution of private equity investment products to retail investors seems low for the time being, even though the recent listing of investment funds, such as KKR PEI in the Netherlands, raises the question of distribution channels and the potential consequences for retail investors of greater access to this type of investment.

The identification of these risks – once again, mainly large-scale LBOs – allows several plans to be drawn up for action in the near future:

- In March 2007, the IOSCO published a report on the valuation procedures for illiquid assets held by hedge funds. The principles recommended in this publication could be useful for a similar study on the valuation of unlisted assets held by private equity funds, taking into account the valuation standards developed by international professional associations.

- The risk of excessive debt in buyout deals raises the question of the market's understanding of credit risk and, where applicable, the role of rating agencies. Each year the AMF oversees the preparation of a report on rating agency activity which should ascertain, in cooperation with banking authorities, that the credit risk from leveraged buyout deals is fully measured by rating agencies.

- The "go private" trend and the decline of securities listings on the major stock markets raise the question of competitiveness with respect to different financing options available to companies. A more focused AMF study will be undertaken to better identify the reasons, both regulatory and economic, that lead companies to go private or to balk at listing;

- Finally, the listing of private equity funds should stimulate consideration by the market regulator of the transparency of these funds' practices and the necessity (or not) to design a European regulatory framework for this area, again with account taken of the recommendations put forward by the representatives of private equity associations. The risks of poor allocation of savings flow, implying over- or under-investment in private equity funds, suggest that a significant increase in the means for educating individual investors should be considered.

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