

## THE DEVELOPMENT OF PRIVATE EQUITY AND VENTURE CAPITAL IN EUROPE

In the past decade, the European private equity market has grown substantially and has become a significant source of finance and expertise for many European companies. This box provides a brief explanation of the economic role of private equity and venture capital and presents recent developments in the private equity market.

The private equity market provides equity capital to firms not quoted on a stock market. Its two major components are the venture capital and buy-out (e.g. management and leveraged buy-out (MBO/LBO)) segments.<sup>1</sup>

Venture capital refers to professionally managed equity or equity-linked investments in privately held high-growth companies that require financing and entrepreneurial expertise to pursue their growth objectives. Venture capital investors tend to focus on early-stage firms in technology-intensive industries which have difficulties in raising funds from the banking sector or the primary financial markets. Typically these are firms facing a high degree of uncertainty with regard to their ultimate profitability as well as high information gaps between entrepreneurs and investors. By taking a long-term equity position in respect of the companies they invest in, and by usually monitoring and adding value to these companies, venture capitalists can help to better align the incentives of investors with those of the management of the company.<sup>2</sup> From a macroeconomic perspective, by offering high-growth firms access to financing and industry expertise, an efficient venture capital market could have a significant impact on growth, employment creation and long-term competitiveness.<sup>3</sup>

By contrast with the venture capital segment, the buy-out industry normally focuses on more mature industries which might require additional equity funding for further growth or to undertake major internal governance or balance-sheet restructuring without being subject to the shorter-term pressures of the public equity markets. In some cases, however, buy-out strategies may have caused economic disruptions to the activities of the acquired companies, often as a result of being based on excessive debt financing.

In Europe, the single currency created more integrated pan-European debt and equity markets and a more competitive corporate environment, which also helped to foster, for the first time, a significant private equity market. The growth of this market was initially driven by the boom in high-technology industries in the late 1990s and 2000, thereby financing and nurturing a significant number of European companies at an early stage of their development. Following the decline in stock prices in 2000 and 2001, activity in the European market for private equity declined significantly, although it remained relatively high from a historical perspective (see Chart A). Hence, funds raised by private equity firms stabilised at a fairly high level of around €27 billion per year between 2002 and 2004.

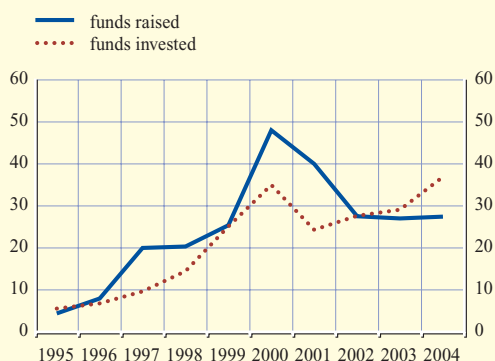
1 Although their relative importance is much more limited, private capital also includes other segments, such as capital replacement or mezzanine finance.

2 See Gompers, P. and J. Lerner, 2002, "The Venture Capital Cycle", MIT press.

3 In the European Union, the development of an efficient venture capital market has been encouraged by the European Commission. See, for instance, European Commission, 2003, "Communication on the implementation of the risk capital action plan", COMM (2003) 654, Brussels.

Chart A Activity in the European private equity market

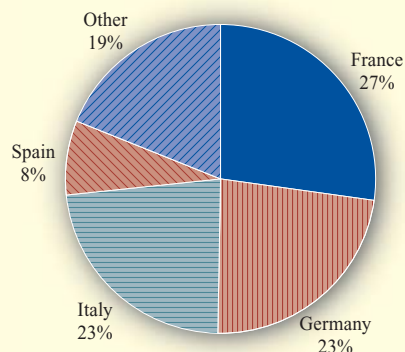
(EUR billions)



Source: EVCA/Thomson Venture Economics/Pricewaterhouse Coopers.  
Note: Includes all western European countries.

Chart B Amount invested by country in the euro area in 2003

(percentages)



Source: European Venture Capital Association.

At the same time, the private equity “overhang” (i.e. of money raised but not yet invested) created in the late 1990s and 2000-01 was reduced further in 2004 as investments continued to surpass funds raised. Since the readjustment of stock market prices, there has been a move towards less risky investments. In fact, buy-outs in mature industries have been dominant in recent years. The importance of buy-out deals may have been driven by the restructuring efforts made by European companies in recent years, which in many cases have led to the sale of non-core businesses. With respect to the geographical breakdown of private equity invested in the euro area, according to the European Venture Capital Association France accounted for slightly more than a quarter of all funds (27%) in 2003, with Germany and Italy both achieving shares of around 23% (see Chart B).

Despite having increased significantly over the past few years, recourse to venture capital in Europe is still relatively modest as compared with other markets. Although statistical comparisons are not straightforward, as definitions of what constitutes private equity and venture capital tend to differ between the United States and Europe, according to the OECD and the National Venture Capital Association venture capital investment in the high-technology sector as a percentage of GDP was around four times smaller in the European Union than in the United States in 2002.

All in all, the European private equity market can perform a useful macroeconomic function which complements that of the banking sector and primary capital markets. In particular, venture capital financing could be particularly useful for young firms facing higher uncertainty and lower investment liquidity. Private equity could also be used to carry out significant restructuring in more mature industries. During the last decade venture capital has become a significant source of financing and support for a considerable number of euro area companies in the earlier stages of their development. While the European venture capital market currently attracts a significant amount of funding, as outlined in the Lisbon Agenda, a further deepening and development of this market would support the full exploitation of the economic growth potential in Europe.