Rt Hon Liam Byrne MP
Chair, Business and Trade Select Committee
House of Commons
SW1A 0AA

18th January 2024

Dear Liam,

Follow up to BVCA appearance on 9 January 2024

Thank you very much for giving me the opportunity to appear in front of the Committee on 9th January to address the questions that the Committee has about the private equity (PE) industry. As the Committee highlighted, there can on occasion be a comprehension gap between the industry and politicians; at the BVCA we are committed to addressing that to achieve a higher level of understanding of what the industry does.

Transparency

I wanted to follow up with some further information on transparency in the industry, in particular the Walker Guidelines for Disclosure and Transparency in Private Equity, administered and monitored independently by the Private Equity Reporting Group (PERG).

As I mentioned at the session, through the BVCA's work on the Walker Guidelines on transparency, large UK private equity-backed companies currently provide significant levels of disclosure, comparable to that provided by FTSE 250 companies. The PERG, set up in 2008, monitors implementation and reviews PE's compliance with the Walker Guidelines annually, with support from the BVCA, PwC and EY.

The 16th annual PERG report was published today (18th January) and shared with the Committee this morning. Full details of this year's report and previous reports are available on the PERG website.

The Guidelines cover public to private transactions where the enterprise was valued over £210m, with either 50% of their revenues generated in the UK or 1,000 full time employees in the UK, and other transactions where the enterprise was valued over £350m with either 50% of their revenues generated in the UK or 1,000 full time employees in the UK.

In this latest report, over 80 of the UK's largest PE-backed portfolio companies are currently in scope (an increase from last year's figure, which I mentioned to the Committee last week). They are required to provide additional disclosures in their annual financial statements and make these accessible on their company website.

As examples, the annual audited financial statements must include additional information in the form of disclosures on the strategy and business model of the company, and important ESG topics such as environmental matters and policies in place for employees, for example, on recruitment and recognition. These disclosures align with those required of FTSE 250 companies. Any stakeholder can access in-scope company financial statements at the PERG website here. In the 16th annual PERG report, Stagecoach and ASDA were highlighted for their excellent levels of disclosure.

A mid-year update on the key happenings and trends from the last six months, similar to a trading update provided by a listed company, is also required. The PE firms must also publish disclosures on their own website covering their leadership, their investors and case studies about their portfolio companies. They must provide data on the performance of portfolio companies under their ownership, covering important topics such as pensions, capital employed and leverage.

The Committee was interested in the reasons why some investors might choose to incorporate elements of a UK group holding structure in Jersey. As I explained during the session, it is important to note from a transparency perspective that, as subsidiaries of UK companies, the financial statements of any Jersey companies in such a structure will be integrated and explained in the consolidated group financial statements of the relevant UK companies. These consolidated statements are available in the UK at Companies House.

Leverage

I would also like to expand on the use of debt financing within the overall PE industry, which we touched upon during the hearing.

The BVCA does not collect data on overall debt levels across the industry. However, data is available from commercial providers (such as Pitchbook LCD and Baird[1]) and this makes clear that leverage in European PE buyout investments has been consistent post-financial crisis and tends to be lower than pre financial crisis. There was an increase in the immediate pre pandemic and early pandemic period, but the past two years have returned to the historic trend.

PE firms, PE lenders and PE-backed businesses have weathered a wide range of macroeconomic and financial conditions over the past four decades, without causing or exacerbating wider problems in the real economy or the financial system. The industry, as a whole, has continued to invest in the growth of UK businesses, including during long periods when base rates were at consistently higher levels.

This relative stability in debt ratios and investment activity is linked to the nature of the PE model, which is focused on generating growth in investee companies over several years. This model for financing investments and optimising long-term growth is well understood by a diverse market of specialised and experienced lenders. These lenders know that PE firms'

[1] https://www.rwbaird.com/corporations-and-institutions/investment-banking/insights/2023/08/operating-in-a-trough-h1-2023-review-of-european-pe-activity/

success is tied to the growth of their portfolio companies over the long term, and that firms will continue to inject more capital, overhaul strategy, optimise financing arrangements and 'go for growth', rather than look for a quick exit. This focus on portfolio company growth was evident in TDR's testimony to the committee and is shared across the industry as a whole.

Regulation

Finally, although we did not explore the regulatory framework of the industry in great depth, I wanted to provide some further detail which I hope will be helpful to the Committee.

Much of the UK's regulatory regime for PE is inherited from the European Union. We have engaged consistently in recent years with regulators and the government on post-Brexit arrangements, with the clear objective that the UK should maintain world class standards in its overarching regulatory framework. Most jurisdictions, including the UK, regulate PE firms carefully and as part of that only permit the marketing of PE limited partnership funds to professional institutional investors, with limited exemptions. The rules create a comprehensive and robust regulatory landscape through which regulators supervise PE firms and ensure that investors are subject to appropriate levels of protection.

In the UK, the FCA supervises PE firms under a range of frameworks established in the last 30 years, including:

- the Senior Managers and Certification Regime (SMCR), which regulates culture, governance and accountability within financial services firms;
- the Markets in Financial Instruments Directive (UK MiFID) which sets out a range of organisational, conduct and transparency requirements relating primarily to individual portfolio management;
- the Alternative Investment Fund Managers Directive (UK AIFMD), which provides sector specific regulation for the fund management of professional alternative investment funds;
- the Investment Firm Prudential Regime (IFPR), which sets out additional capital requirements and remuneration rules for firms subject to UK MiFID; and
- the FCA's broader rules on the fair treatment of investors, conflicts of interest, remuneration practices, risk management, valuation and disclosure.

On the question of broader systemic risk, a number of features of PE funds limit any risk presented by the industry to the financial system. These include that: the industry uses 'closed-ended' funds (so there is no prospect of a 'run' on the fund causing a sudden collapse in the value of its assets); funds do not carry substantial fund-level leverage (so any losses to investors are not magnified by fund debt); PE firms' own economic model is resilient and makes any sudden collapse of a firm unlikely; and the legal relationship between a PE firm and the funds it manages, allows its funds' investors to replace the firm with an alternative fund manager in the unlikely event of this becoming necessary, without damaging the fund's investors or assets.

Together, the closed-ended nature of PE funds, the inherent illiquidity of their investment approach, and the ringfencing of portfolio company liabilities all insulate portfolio companies from contagion, both as regards issues affecting other portfolio companies and as regards systemic liquidity issues that may affect investors. This essentially protects them from any poor performance experienced by other portfolio companies and from financial market turbulence.

From a prudential perspective, PE firms are themselves subject to prudential regulation by the FCA, in terms of both governance and regulatory capital standards, in common with other financial institutions such as banks and insurers. As noted above, UK PE firms, who meet the criteria, are subject either to Investment Firms Prudential Regime or AIFMD, and in some cases both. Firms regulated under MiFID are subject to IFPR, which was introduced in 2020. For PE firms, this has significantly increased their capital requirements and introduced detailed new rules on remuneration and disclosure. These go beyond what is typically required of PE firms in the EU and, in some areas, beyond what the Prudential Regulation Authority (PRA) requires of certain banks. UK AIFMD also contains prudential rules, including regulatory capital requirements for firms to hold initial capital, "own funds" and professional indemnity insurance.

I do hope the above information is useful, and I would of course be happy to provide the Committee with any further information that you would find helpful.

Yours sincerely,

Michael

Michael Moore
Chief Executive, BVCA