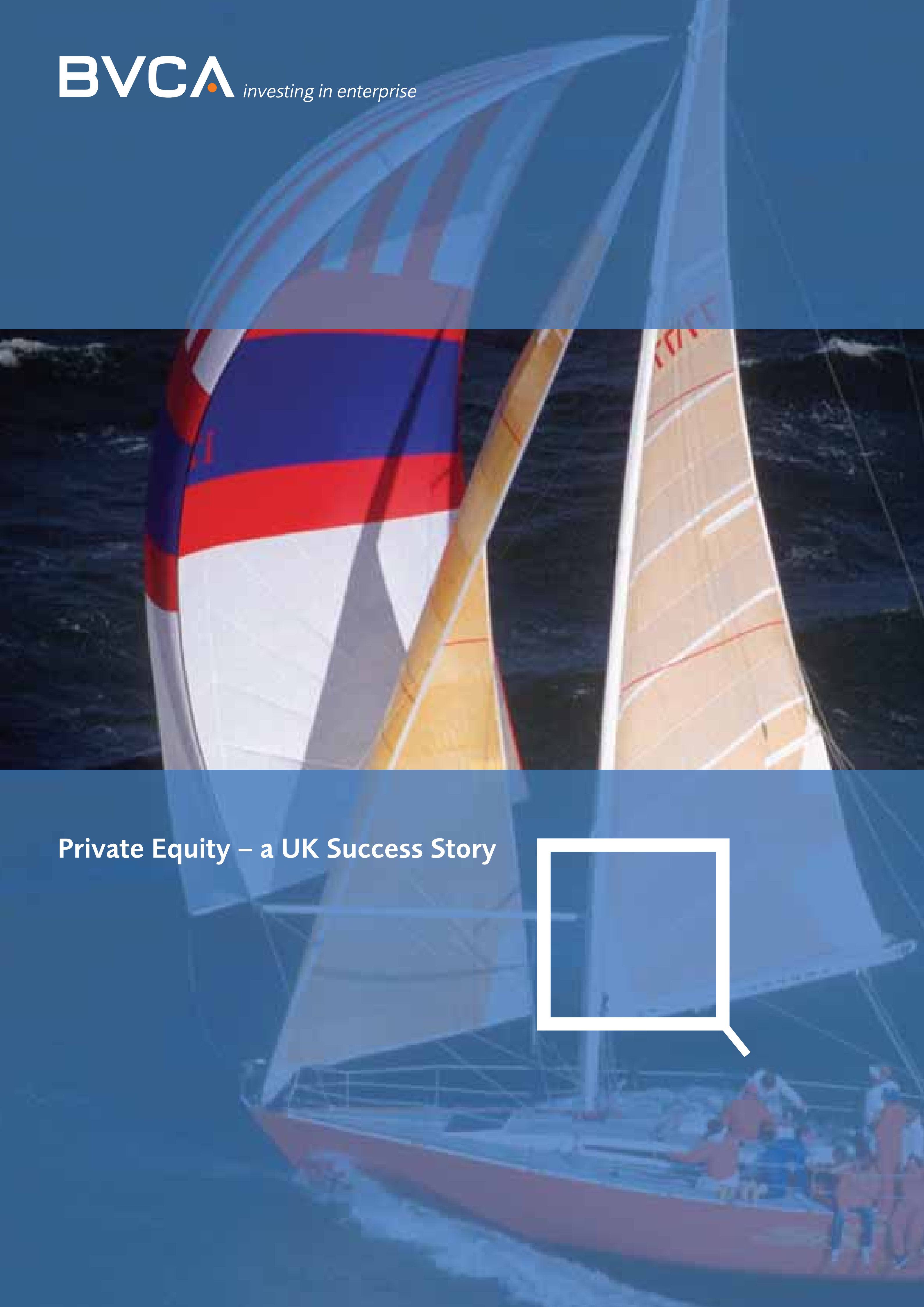


BVCA investing in enterprise

Private Equity – a UK Success Story

Contents

Contents – continued

Foreword

The UK private equity market is the largest and longest established private equity and venture capital market in Europe. On the world stage it is second in size only to the United States. It is also widely considered to have led the field in Europe in terms of having developed a favourable infrastructure for the industry.

This report has been commissioned to bring together, for the first time, all the various factors that have contributed to this success.

In the UK we invest in every sector of the economy across all regions of the country. BVCA member firms invest in companies who employ around a fifth of UK private sector employees. Across Europe the UK industry now accounts for 52% of the whole market by value.

The private equity and venture capital industry is a UK success story, but it operates in a highly competitive and commercial environment. We cannot take our position for granted. So at the BVCA we are constantly looking to promote the UK industry and the UK as a place to invest into and from which to conduct business.

Analysing the key strengths of our industry is an essential part of this process. From mature support networks to benign regulatory and taxation frameworks to investment opportunities and access to continental Europe – all are addressed here.

By pulling together all the ingredients which have contributed to the UK's success, we hope to show why the UK is Europe's largest private equity market.

We also hope to show investors looking at Europe why so many institutional investors choose UK-based firms as their private equity managers and why the UK private equity industry, and London in particular, has become such an important gateway to the European private equity market.

Vince O'Brien

BVCA Chairman
February 2006

Executive summary

The growth of an industry

Private equity transaction values in the UK and Europe have shown a steady upward trend since the early 1980s. In the UK the industry accounts for an increasing proportion of GDP and has maintained its position as the largest and most active single regional market within Europe.

UK private equity has outperformed other key asset classes. The most recent BVCA performance study highlights the outperformance of private equity in comparison with both the FTSE All-Share index and hedge funds on a three, five, and ten-year basis. (Chapter1)

The UK economy

UK businesses have driven considerable economic growth over recent years; the UK has seen above European average GDP growth as well as rises in productivity and employment.

Private equity has helped in shaping the UK economy, providing capital for businesses in industries, particularly in the service sector, which has recorded increased investment activity in the recent past. Over the period 1999-2005, private equity has accounted for approximately 30% of UK M&A. (Chapter 2)

Private equity investment community

The UK is characterised as both an environment conducive to private equity investment by private equity investors (GPs) and as having a highly developed network of supporting organisations aiding the identification and execution of transactions. The Big Four accountants, mid-tier groups, investment banks and small, specialist corporate finance houses all help drive dealflow and, in so doing, themselves have a considerable economic impact, generating an estimated fee income in excess of £1bn each year. Furthermore, London's reputation as a leading financial centre means that many of the European industry's supporting organisations are located in the UK. (Chapter 3)

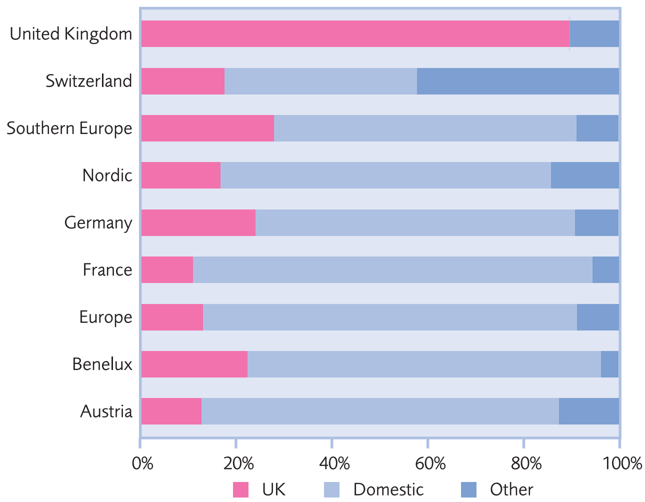
The supply of capital

The proportion of non-domestic money managed is higher in the UK than in any other country, reflecting the demand for UK-based GPs by non-UK LPs. This demand, assisted by the development of the UK limited partnership, has led to more funds of funds and intermediary organisations locating in the UK. (Chapter 4)

A gateway to Europe

Over the past decade, UK GPs have increasingly invested outside the UK. The UK accounts for just under half of Europe's pan-regional[1] GPs, with these groups increasingly conducting their business away from the domestic market; in 2004, almost 60% of average UK-based pan-regional GPs' investment was completed outside the UK. Furthermore, historically the UK has tended to be where North American organisations have established their European operations. (Chapter 5)

Market share of private equity houses, by location of GP



Source Unquote (2005)

Note Includes only GPs which have made two or more investments over the period 2001-5

[1] Here defined as groups which have completed deals in three or more countries over the period 1996-2005.

The availability of investment opportunities

In terms of the pool of potential investment targets, the UK has a large stock of companies, balanced between small, medium-sized and large businesses. In 2004, the UK accounted for the largest proportion of European seed and start-up investment. The UK also has the largest stock of mid-market businesses, while London holds a position as a major international finance centre for larger businesses. (Chapter 6)

Regulatory, legal and fiscal framework

The UK is recognised as a business-friendly environment. The tax regime, merger regulation and ease of starting a business have been identified as key aspects of the attractiveness of the UK.

In the recent past, several government initiatives aimed at encouraging investment in the sub-£2m segment of the market have been launched including Venture Capital Trusts, Regional Venture Capital Funds and Enterprise Investment Schemes, while new proposals such as Enterprise Capital Funds are in the offing.

Of particular benefit to the UK private equity industry has been the user-friendly nature of the UK limited partnership. (Chapter 7)

Entrepreneurial culture

In the UK, the continued development of an entrepreneurial culture is being pursued both via education and through the establishment and maintenance of structures and procedures encouraging entrepreneurial and economic activity. On a European-wide level, the Lisbon Agenda has set an EU target to become the most entrepreneurial global economic bloc by 2010. (Chapter 8)

1. The growth of an industry

- Transaction values in the UK and Europe have shown a steady upward trend since the early 1980s.
- The UK private equity industry accounts for an increasing proportion of GDP, while also continuing to be the largest and most active single regional market within Europe.
- UK-based private equity fund managers as a whole have outperformed the stock markets over three, five and ten-year time horizons.

1.1 Introduction

The UK is home to a very well-established private equity market and remains the largest single European market in terms of both the volume and value of transactions recorded. It also has the largest number of active players and is the home of GPs with a markedly diverse range of interests, including a large proportion of groups active within the broader continental European market.

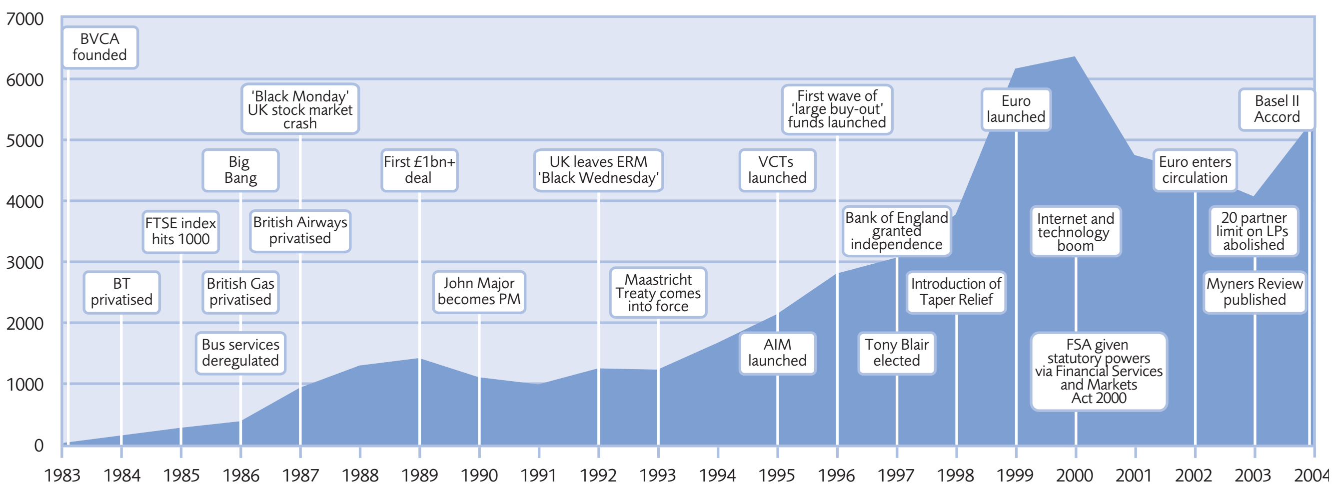
Following the example set in North America, the UK saw early moves towards the emergence of a private equity industry in the 1940s. In 1945, FCI[2] and ICFC[3] were created to provide larger amounts of capital to facilitate the rationalisation of key industry sectors in the UK and to supply long-term finance to small and medium-sized businesses respectively (Coopey & Clarke, 1995). The European private equity industry started to gain momentum in the early 1980s, with both the UK regional trade association (the BVCA) and its European equivalent (the EVCA) founded in 1983. The rapid emergence of the industry then began in earnest, with regional venture capital associations following in France and Germany over the course of the decade. (See Figure 1a for the development of UK private equity and key events.)

Trends seen in the UK market have been mirrored by European-wide shifts within the private equity industry. The European market has grown, partially due to the removal of the political and economic barriers in Central and Eastern Europe, and average deal sizes have continued to grow. The announcement of the first ever €10bn+ (£6.7bn+) transaction in 2005 serves to further highlight this trend. Additionally, the amount of capital raised by UK-based GPs for investment in buy-outs exceeded previous records in 2005, with funds raised during the year including the largest ever European buy-out vehicle.

Figure 1a

UK private equity: development and key events

Equity invested in UK deals (£m)



Source BVCA (2005); Events – various sources (see Appendix 2)

[2] Finance Corporation for Industry (backed by City financial institutions, including insurance funds).

[3] Industrial and Commercial Finance Corporation (the forerunner to 3i, backed by the clearing banks and the Bank of England).

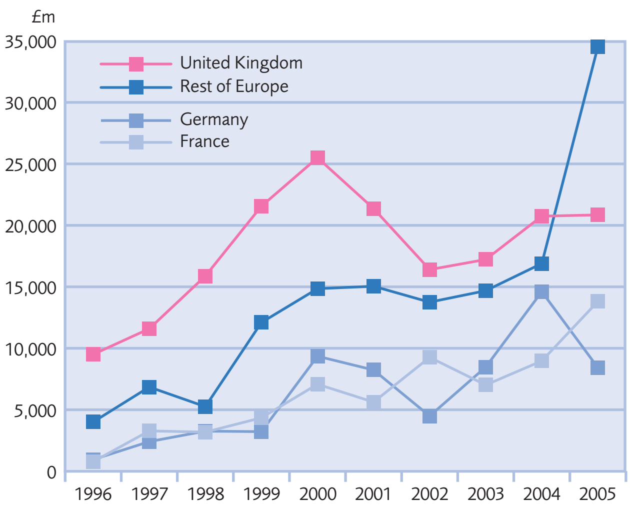
1.2 Membership of the BVCA

The resilience of the private equity industry is perhaps not that surprising, given the long-term investment thesis it pursues. Indeed, a quick comparison of BVCA membership highlights that the ongoing development of the industry has been built on expansion; of the investment houses which were members of the BVCA in 1985, 80% are still trading 20 years later (BVCA, 1985; 2005). While some of the names have changed, all these organisations have both remained active within the private equity community and, as a result, have seen through two key cycles of economic growth and slowdown.

1.3 Transaction values

Historically, the value of transactions completed in the UK has been over twice that recorded on an annual basis in other single regional European markets (see Figure 1b). The scale of the UK market has also meant that it maintains a less volatile pattern of activity than has been seen in some of the smaller markets.

Figure 1b
European private equity investment by deal value

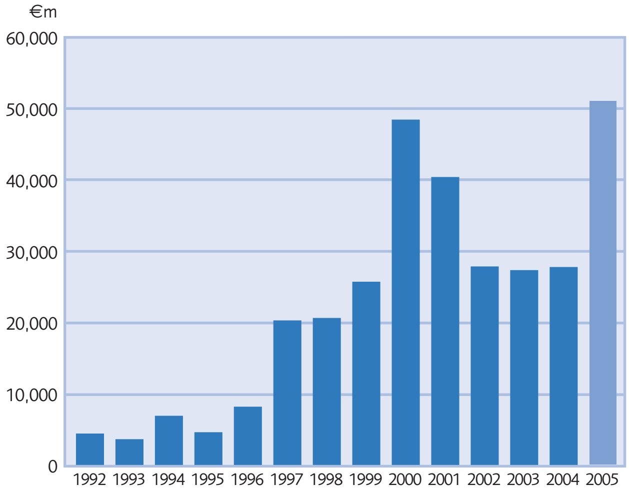


Source Unquote (2005)

1.4 Fundraising

UK-based GPs have built strong track records over successive funds, enabling them to raise increasingly larger vehicles (see Figure 1c). In particular, recent years have seen the development of the large buy-out market and the associated growth of UK-based pan-European investment houses, following the pattern seen in the US.

Figure 1c
European private equity funds raised



Source EVCA/Thomson Venture Economics/PricewaterhouseCoopers (2005)
Note 2005 figure is to end-Q3

1.5 Market development

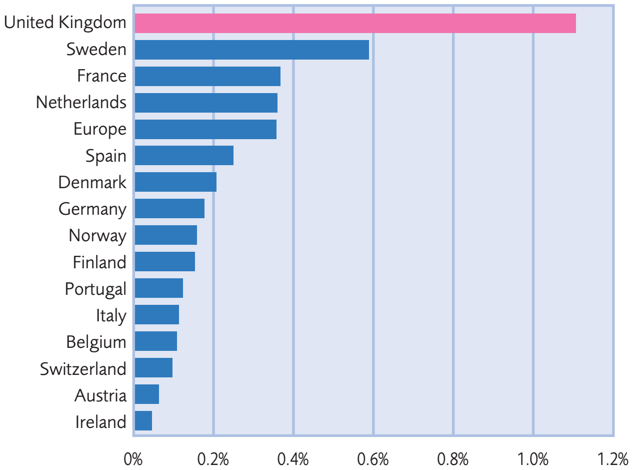
In the UK over recent years, private equity activity has consistently accounted for a larger proportion of national GDP than has been the case in the other regional markets. In 2004, the figure stood at over 1.1%, compared to a European average of 0.35%. (See Figure 1d).

Despite being the most mature market in terms of private equity as a proportion of GDP, the UK has continued to experience growth in the scope and scale of private equity activity. Compound annual growth across the UK private equity market as a whole stands at 20% over the past ten years, with the figure for the buy-out market being 24%. In addition, the market has increased as a proportion of GDP, with the 2004 figures representing a high-water mark in recent history. The experience of the UK, and in particular its ongoing growth, serves to highlight the potential remaining within the continental European markets.

That said, there has been a rise in average deal size outside the UK which has been particularly marked since 2000. While Germany and France have recorded some of the largest European transactions over this period, other markets with lower absolute numbers of deals have also come to the fore. For example, 2005 saw five £500m+ transactions completed in Spain; a market which had only previously recorded around three such deals in the last ten years. These trends highlight not only the ongoing acceptance of private equity as a viable source of financing on an expanding range of transactions, but the potential which remains within European markets for future activity.

Figure 1d

Private equity as a proportion of GDP, 2004



Source EVCA/Thomson Venture Economics/PricewaterhouseCoopers (2005)

1.6 Performance

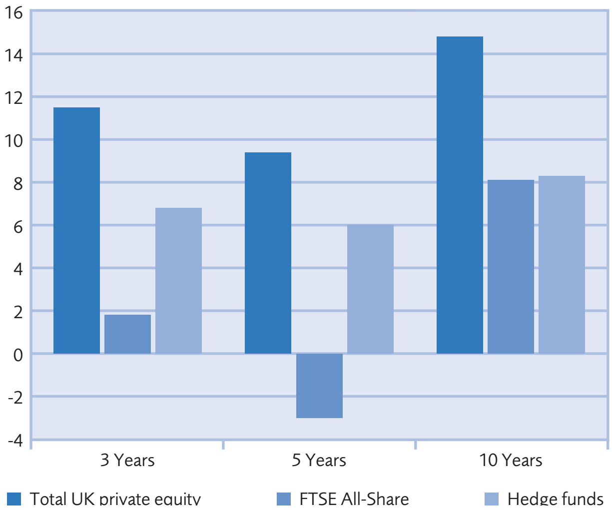
The high survival rates of private equity houses in the UK is testament to the track records of these groups, which have secured the ongoing support of their LPs. A key element in the longevity of the industry has been its ability to generate a decent return on investment.

Performance data collected from UK-based managers shows consistent outperformance of comparative investment indices (see Figure 1e). The most recent BVCA performance study highlights private equity returns having outperformed the FTSE All-Share index and hedge funds on a three, five and ten-year basis.

Figure 1e

Private equity performance

UK managers versus key indices

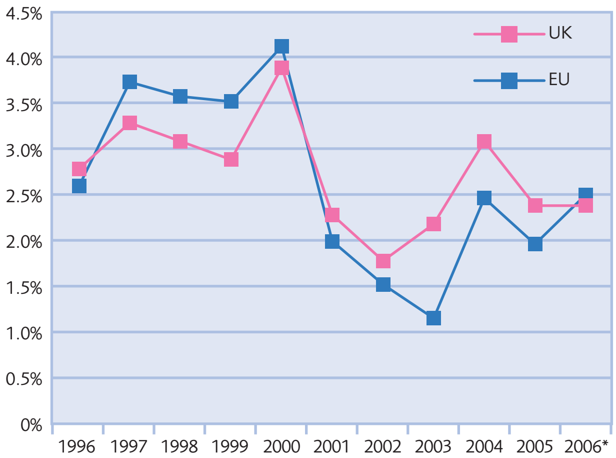


Source BVCA/PricewaterhouseCoopers (2005)

2. The UK economy

- Over recent years, the UK has recorded rising levels of employment and productivity growth which have exceeded levels seen in the wider European market.
- Private equity has helped facilitate the shift towards a service-based economy, increasingly providing capital for those businesses in the service sector.
- Private equity has accounted for approximately 30% of UK M&A over the period 1999-2005.
- In each year between 2000 and 2005, the London Stock Exchange recorded more IPOs than any other European exchange and therefore provides a viable exit route for private equity-backed companies.

Figure 2a
GDP growth
The UK versus EU



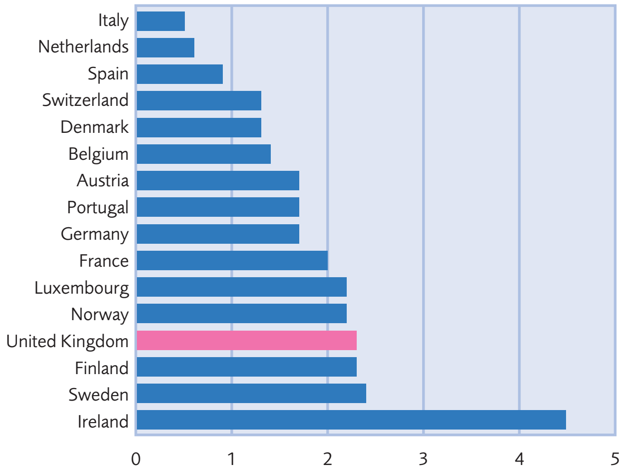
*forecast
Source OECD (2005)

2.1 Introduction

UK businesses have proved to be significant generators of economic growth, highlighting the quality of the business stock in the region. Over recent years, the UK economy has experienced GDP growth in excess of many other key European markets (see Figure 2a). The strength of UK businesses and the UK economy is also reflected in the rising rate of employment growth and productivity recorded in recent years. In both cases, percentage rises recorded in the UK have outperformed the European average and other key comparable markets, with only smaller markets (therefore growing from a smaller base) outperforming.

Rises in productivity have been marked in the UK, with the OECD recording a 2.3% rise over the period 1995-2004 against a European average of around 1.8% (see Figure 2b).

Figure 2b
European rates of productivity growth (1995-2004)



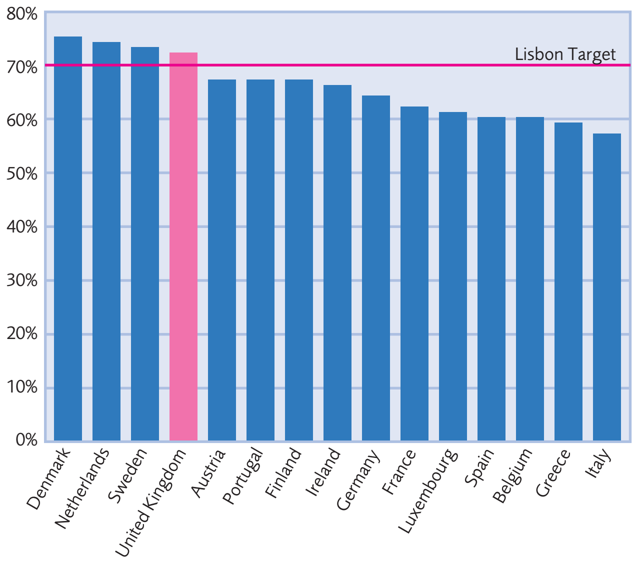
Source OECD (2005)

Levels of employment in the UK in 2004 were the fourth highest in Europe (IMF, 2005), with UK levels already exceeding the 70% 'Lisbon Target' set as a benchmark for European countries to achieve by 2010[4] (see Figure 2c).

[4]The 'Lisbon Target' was established at the Lisbon European Council in 2000 to give the EU a new strategic goal of becoming the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion (Europa, 2005).

Figure 2c

European rates of employment, 2004



Source International Monetary Fund (2005)

2.2 Economic evolution

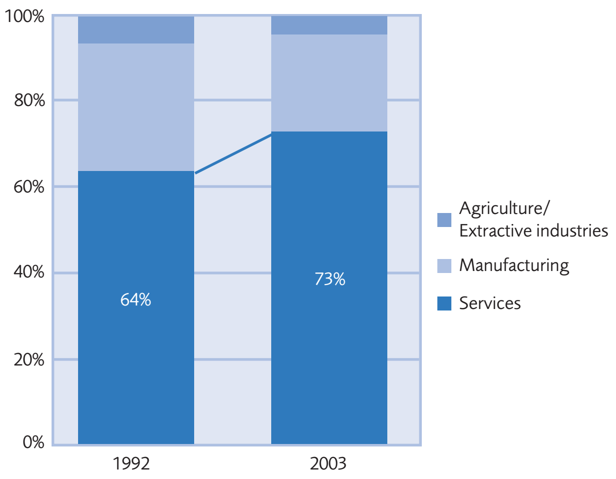
The UK economy has been characterised by a shift towards service-based industries over the last 25 years at the expense of the traditional manufacturing industries.

Even over the last ten years, the proportion of GVA[5] accounted for by service firms has risen by almost 10% (see Figure 2d). In 1992, service industries accounted for just under two-thirds of GVA; this figure stood at just under three-quarters in 2003.

Figure 2d

UK economic structure, 1992 versus 2003

GVA by industry type



Source National Statistics (2005)

2.3 Role of private equity

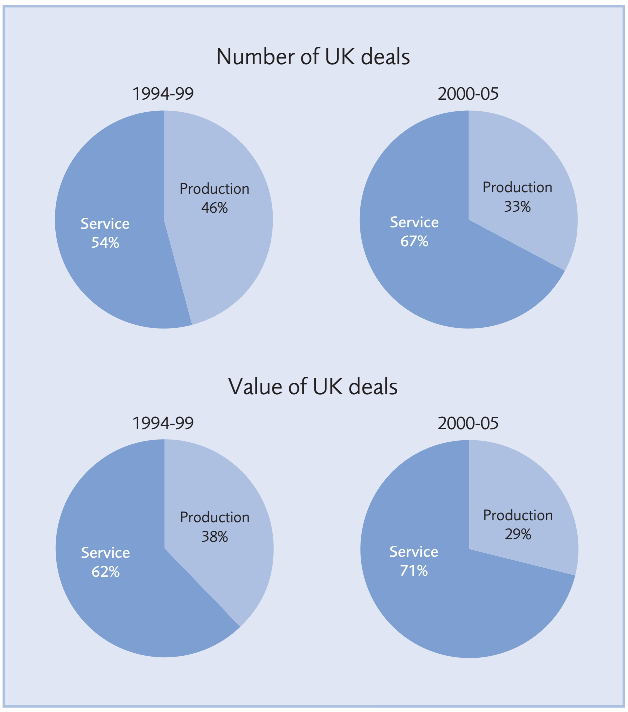
The private equity industry has been an integral part of the process of economic change. Deal activity has recorded a marked shift towards the service sector in terms of both the number and the total value of private equity transactions recorded over recent years (see Figure 2e). For example, private equity has been an important source of capital for businesses in industries, such as transport and leisure, which have experienced privatisation or deregulation over the past decade.

[5]GVA: Gross Value Added is the current measure of economic activity used by National Statistics, comparable to GDP in many cases.

Figure 2e

The rise of the service sector

The role of private equity by number and total value of UK private equity deals by industry type, 1994-9 versus 2000-5



Source Unquote (2005)

2.4 M&A activity

Since 2001, UK private equity has accounted for an increasingly significant proportion of overall M&A activity; Unquote and Bloomberg data suggest that UK private equity deals have represented an average of just under 30% of all UK M&A deals (by number of transactions) over the period 1999-2005. In terms of the comparative total value of those deals, some estimates put the figure at nearer 50% (CMBOR, 2005), highlighting the role of private equity in ever larger transactions.

2.5 Secondary markets and private equity

The UK's position as the most active single regional market for M&A in Europe not only highlights the potential for activity but also the availability of a valuable exit route (via trade sales). The size and health of the UK M&A landscape therefore provides an important source of liquidity in the UK market.

2.6 The public markets

The structure and operation of the quoted markets is of similar significance, with IPOs historically being one of the most significant exit routes for private equity investments. Europe currently has a number of important quoted markets, including the stock exchanges of London, Paris, Amsterdam and Berlin. The position of the London Stock Exchange as one of the major global stock markets is therefore an important element for GPs active within the UK.

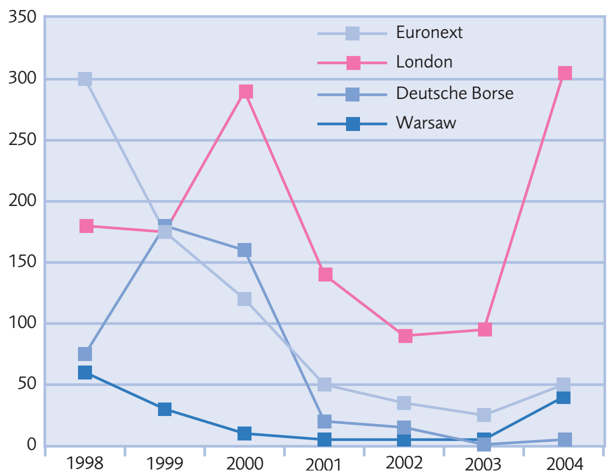
The UK markets are among the most active in terms of the number of IPOs recorded on an annual basis (see Figure 2f), with the UK stock exchange having the additional attraction of both mature and successful primary and secondary markets.

While the main market has been a key exit route for larger private equity-backed businesses, AIM has proved an important next step for smaller venture and mid-market businesses.

Figure 2f

European IPOs

Number of IPOs per year recorded on selected European stock exchanges, 1998-2004



Source PricewaterhouseCoopers (2005)

3. The private equity investment community

- The UK is characterised as both an environment conducive to private equity investment by GPs and as having a highly developed network of supporting organisations aiding the identification and execution of transactions.
- Given London's reputation as a leading financial centre, many of the European industry's supporting organisations are located in the UK.
- The advisory industry that has developed around UK private equity has become significant in itself, generating over an estimated £1bn in fee income each year in the UK.

3.1 Introduction

The UK GP population is the largest in Europe, with around 210 groups having been recorded as making equity investments during 2005 alone. Furthermore, the industry employed over 1,600 executives in 2004. The next largest, France and Germany saw around 150 and 120 groups active, employing 773 and 914 executives respectively (Unquote, EVCA, 2005). In addition to the institutions, organisations and individuals ultimately providing the capital, and the private equity fund managers themselves, there is a range of other supporting organisations.

3.2 Supporting private equity

The highly developed nature of the UK's financial community has been an important element in the continued growth and success of the private equity industry. Given London's reputation as a leading international financial centre, many of the industry's supporting organisations are located in the UK.

Many of Europe's most active debt and mezzanine providers, for example, are UK-based and play a central role in the provision of finance to support private equity transactions across Europe. Similarly, in terms of sourcing investment opportunities, the UK is characterised by a highly-developed network of advisory firms which are helping to ensure a constant flow of transactions.

3.3 Debt for LBOs

The prominence of the buy-out market within the overall European private equity industry highlights the central role of leveraged finance providers. With around 60% of the funding for each leveraged transaction taking the form of debt, the working relationships between the private equity houses and banks are clearly of significance in ensuring the smooth execution of deals. Likewise, the presence of an active private equity industry has helped encourage the development of a large supporting debt community.

Over the period 2001-2005, four of the five most active providers of debt to private equity backed LBOs across Europe as a whole were UK-based organisations, broadly reflecting historical trends in investment. UK-based debt providers are most active in the domestic market; however, they are also major players in the broader European marketplace. In Germany and France, for example, UK-based banks participated in 11% and 13% of buy-outs respectively. Across Europe as a whole, UK-based lenders provided senior debt in 27% of continental European buy-outs and 82% of domestic transactions.

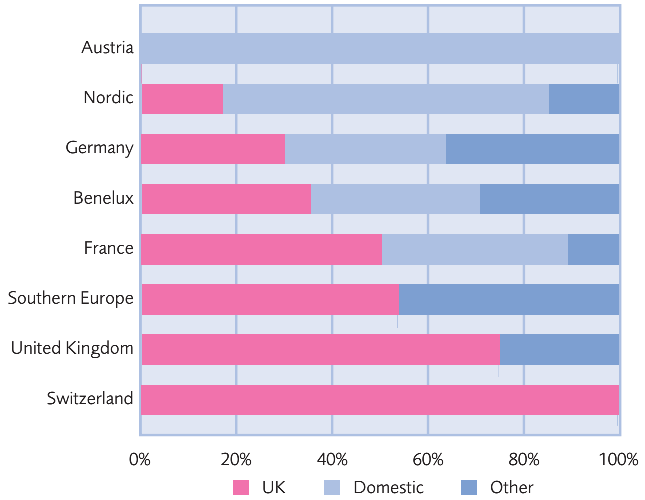
3.4 Mezzanine provision

In terms of the provision of subordinated debt, the picture is similar. UK-based providers of mezzanine finance to private equity-backed LBOs[6] participated in around three-quarters of the transactions including a mezzanine strip in the domestic market in the period from 2001 to 2005. Outside the UK, these groups were also among the most active, participating in around a quarter of German private equity deals with mezzanine, 40% of those in Southern Europe and Benelux and half of those transactions recorded in France (see Figure 3a).

[6] Includes most active mezzanine investors only: those which have participated in two or more transactions over the period 2001-2005.

Figure 3a
Market share of most active mezzanine investors

By number of deals per region



Source Unquote (2005)

Note Chart focuses on 'most active investors' only: includes those mezzanine providers which have participated in two or more transactions over the period 2001-2005.

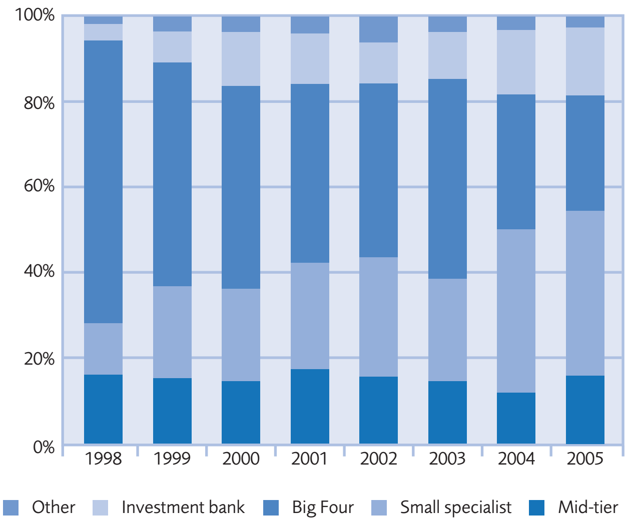
3.5 The advisory community

The UK has been characterised by the rapid development of a mature network of advisory firms (see Figure 3b). The overall market is not dominated by one type of organisation. There are in fact four established channels to market which have been a consistent feature of the market over time: Big Four accountancy firms, mid-tier accountancy practices, investment banks, and small, specialist corporate finance houses vie for business.

In particular, the rise of the small, specialist firms has been a marked trend over recent years in the UK, notably on smaller and mid-market deals. This process helps ensure that smaller regional businesses have access to funding. In addition, these smaller, specialist houses are characterised as being particularly focused on originating transactions, boosting dealflow for private equity houses operating at the more opaque end of the market. While the Big Four individually remain the most active groups in terms of the number of transactions on which they work, their combined market share has slipped as the market has become increasingly intermediated and populated by a wider range of groups. With transaction fees tending to account for around 5% of the deal value, the estimated fee income generated on UK transactions in 2005 therefore stood at over £1bn.

Figure 3b
Market share of corporate financiers

Proportion of the number of UK transactions by corporate financier advisor type



Source Unquote (2005)

4. The supply of capital

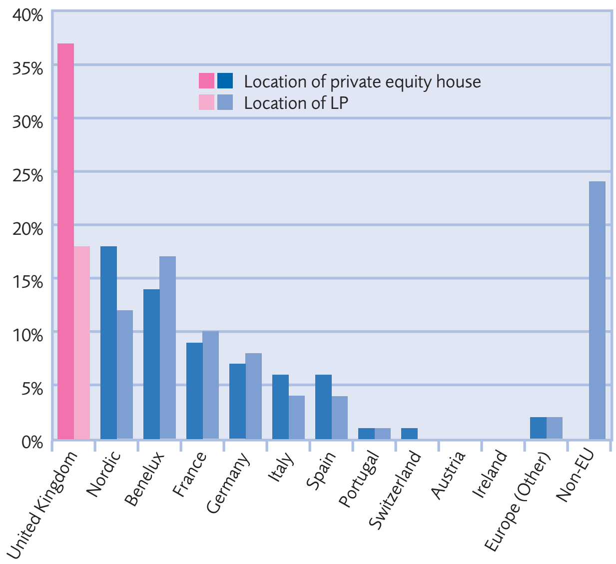
- The proportion of non-domestic money managed is higher in the UK than any other country. This reflects the demand for UK-based GPs by non-UK LPs.
- The demand for UK-based GPs, assisted by the development of the UK limited partnership, has led to more funds of funds and intermediary organisations locating in the UK.

4.1 Introduction

As well as being the headquarters for the largest number of private equity fund managers, the UK also represents the largest European market in terms of limited partners actively investing in private equity (see Figure 4a).

Figure 4a
Location of limited partner versus location of private equity house

Proportion of total capital raised by location of limited partner and fund manager in 2004



Source EVCA/Thomson Venture Economics/PricewaterhouseCoopers (2005)

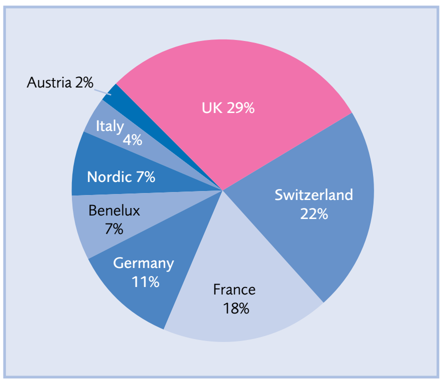
However, the success achieved by UK private equity houses in raising funds from a diverse range of geographical sources is highlighted by the fact that a far larger proportion of European private equity capital is managed in the UK than is raised from UK-based limited partners. Only the Nordic region reveals a similar, although less marked, trend highlighting a significant commitment to managers in that region from non-domestic LPs. UK GPs enjoy the support of global limited partners, with two-thirds of capital raised in the UK over recent years sourced from non-domestic LPs (BVCA, 2005). Around 45% of this money is sourced from institutions outside Europe, with North America being the dominant contributor, as opposed to 21% for continental Europe as a whole (BVCA, 2005).

4.2 Funds of funds

The dominance of both UK-based LPs and private equity fund managers in terms of the number of active European organisations means that other supporting and intermediary organisations are also disproportionately located in the area. For example, almost a third of funds of funds are UK-based, compared to 22% being located in Switzerland, 18% in France and 11% in Germany (see Figure 4b).

Figure 4b
Fund of funds managers

Number of managers by region



Source Initiative Europe (2002)

4.3 The limited partnership

The development of the limited partnership vehicle has been of assistance in attracting these organisations to the UK (see 7.3).

5. A gateway to Europe

- Over the past decade, an increasing proportion of UK GPs' investments has been in continental Europe.
- Historically, North American organisations have tended to establish their European operations in the UK.

5.1 Introduction

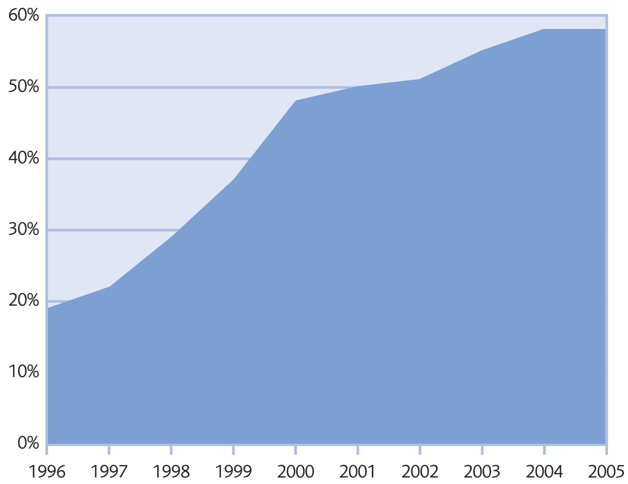
UK private equity houses have provided an important gateway to Europe for LPs. Possibly helped by close trading and cultural ties between the UK and the USA, the UK has tended to be where North American organisations have established their operations in Europe. Likewise, the high number of UK-based limited partners and private equity houses has attracted many associated private equity investment managers, such as funds of funds and secondary fund managers.

5.2 Investing outside the UK

The shift up the deal value spectrum has been a relatively steady one in the UK. With larger funds comes the need and ability to target larger businesses, and the associated need and ability to look further afield; continental European transactions have therefore become a more common feature of UK private equity fund managers' investment activity. Just under half of all pan-regional European private equity houses active over the five years since 2001 are UK-based organisations[7]. It is these organisations which have been accounting for an increasing proportion of European investment over recent years (see Figure 5a).

Figure 5a
UK-based GPs outside the UK

The proportion of investments completed by UK-based pan-regional GPs outside the UK



Source Unquote (2005)
Note Investors which have completed deals in three or more regions since 1996

5.3 Local GPs

Figures published by EVCA (2005) reiterate this trend, suggesting that UK GPs invest just over 50% of their funds outside the UK. This indicates a net outflow of capital from the UK into continental Europe-based businesses. It also contrasts with the other major markets on the Continent, where there is a net inflow of capital (see Figure 5b).

While the data suggests that UK-based GPs are active outside the UK, continental European GPs are less active in the UK market. Approximately 16% of non-UK deals over the last five years involve a UK-based private equity house, while just 9.8% of UK deals involve an organisation based outside the UK.

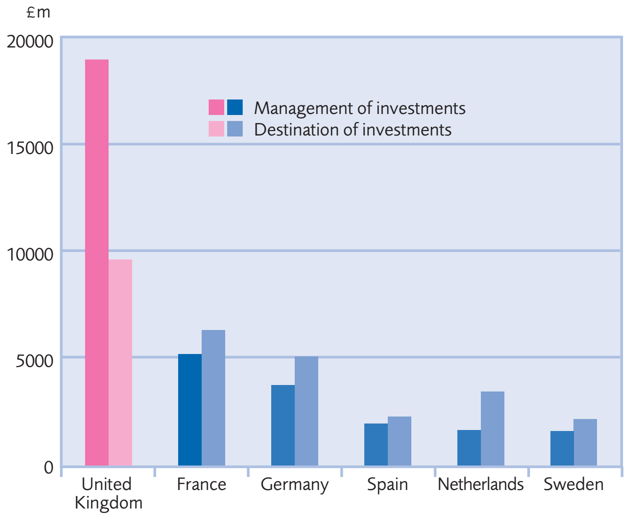
[7] Pan-regional investment houses are defined here as private equity houses which have completed deals in three or more separate countries over the period 1996-2005.

5. A gateway to Europe – continued

Figure 5b

Net flows of private equity capital

Geographical destination and country of management of investments in 2004



Source EVCA/Thomson Venture Economics/PricewaterhouseCoopers (2005)

The smaller markets (by volume of deals) often do not have a large local private equity community. Non-domestic GPs therefore represent a more significant proportion of the market. Across continental Europe as a whole, around a quarter of deals are completed by organisations not based in the region where the deal is transacted. The proportion of overall continental European investment accounted for by UK-based organisations is 16%.

6. Availability of investment opportunities

- In terms of the pool of potential investment targets, the UK has a large stock of companies, balanced between small, medium-sized and large businesses.
- In 2004, the UK accounted for the largest proportion of European seed and start-up investment.
- The UK also has a higher proportion of larger businesses than any other country in the wider European market, ensuring continued investment in the mid-market and larger deals ranges.

6.1 Introduction

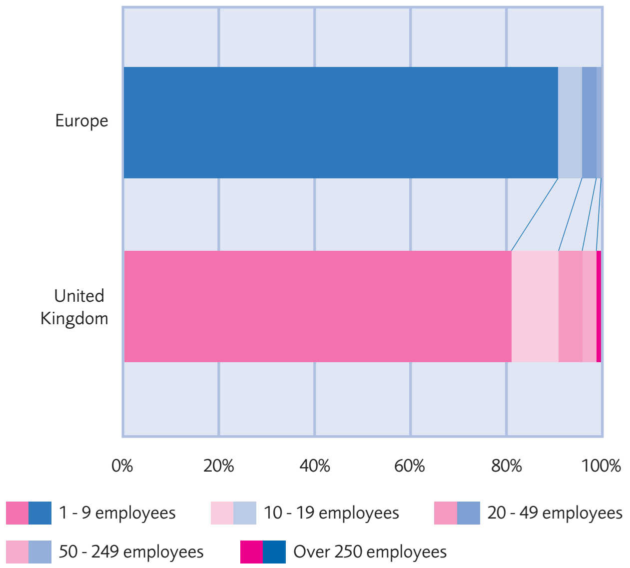
The pool of potential investment opportunities in the UK is one of the largest of any single region within Europe. The European Commission estimates that the UK accounts for around 17% of European businesses employing ten or more people (Eurostat, 2005) and 18% of those employing 50 or more.

6.2 The corporate structure

The UK's corporate structure is more heavily weighted towards larger businesses than many of its European counterparts. Nearly 9% of UK businesses employ more than 20 people. Only Ireland has a slightly greater proportion (9%), although this is against a smaller overall actual number of businesses.

The broad nature of the UK corporate structure is reflected in the diversity of the GP community, which serves a similarly wide range of business. The investor base includes groups backing businesses from seed and start-up through high growth to later stage mid-market and large buy-out transactions.

Figure 6a
European versus UK corporate structure



	UK	Europe
1-9 employees	82%	91%
10-19 employees	10%	5%
20-49 employees	5%	3%
50-249 employees	3%	1%
Over 250 employees	1%	0%

Source Eurostat (2005)

6.3 Venture hubs

The UK accounts for the largest proportion of European seed and start-up investment. Figures for 2004 suggest that the value of UK deals at these stages represented 34% of that seen across Europe as whole (EVCA, 2005).

The venture industry remains one which is characterised as highly dependent on networks of entrepreneurs, scientists, academics and financiers. This has therefore led to a variety of geographical areas rising in prominence, notably including the so-called Silicon Fen around Cambridge and the M4 Corridor/Thames Valley.

A recent independent report conducted on behalf of the BVCA (2005) also highlights the quality of UK research and technology and the rising significance of university spin-out companies. The number of spin-outs rose to a peak of 89 new firms in 2001, with the overall total reaching 435 by 2004; these businesses were formed as the result of activity in 36 separate universities around the UK.

Funding for these companies comes from a diverse range of sources including R&D grants, University Challenge Funds, the universities and licensing deals among others. However, respondents to the research highlighted funding from formalised venture capital GPs and business angels as being among the three most important sources of investment, with venture capital identified as the most important for post seed stage spin-outs.

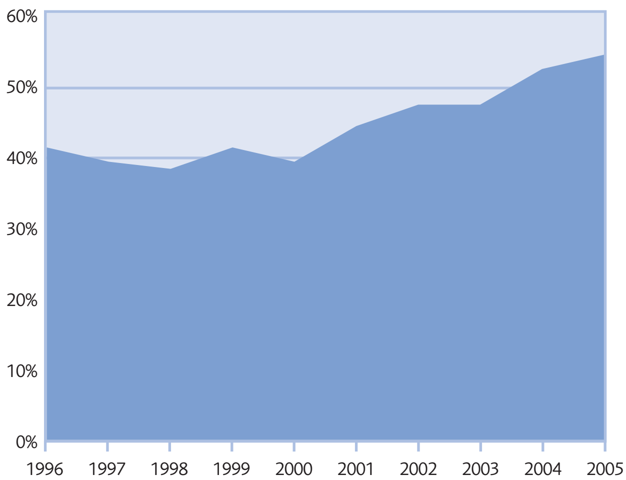
6.4 The mid-market

In the UK, businesses employing between ten and 249 people (largely the domain of the mid-market GP community) account for an estimated 18% of all UK businesses, the largest proportion recorded in any region. The situation in Germany is broadly comparable, with companies in this size bracket accounting for 17% of the business stock.

Figure 6b

UK mid-market

Deals with a total value of £5m-150m (excluding early stage) as a proportion of all deals, by year



Source Unquote (2005)

The mid-market (here defined as non-early stage deals with a total value of £5m-150m) is arguably the bedrock of the UK private equity industry, consistently accounting for over 35% of investment activity in the UK each year. It remains a highly diversified market both in terms of the regional and sectoral composition of businesses backed and remains the most active within Europe (see Figure 6b).

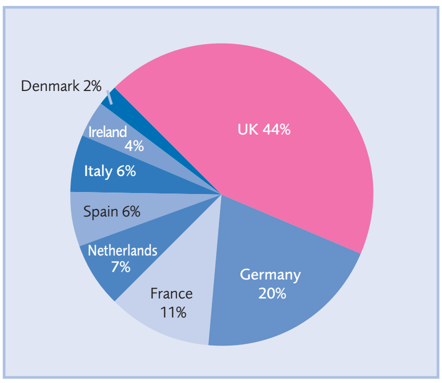
6.5 Large buy-outs

The UK's position, and that of London in particular, as not only a national, but also a global centre is reflected in the fact that the region is home to a significant proportion of Europe's larger businesses. The UK hosts around 20% of these businesses (those employing 250+ people), second only to Germany.

The presence of a healthy pool of large investment targets, coupled with a domestic GP community which includes many of the pan-regional groups with access to the greatest firepower, is reflected in the UK's 44% share of larger deal activity (see Figure 6c). Furthermore, 54% of £1bn+ European transactions included the participation of a UK-based private equity house.

Figure 6c

European £1bn+ deals by region



Source Unquote (2005)

7. Regulatory, legal and fiscal framework

- UK governments have continued to promote entrepreneurship and build a business-friendly environment via the introduction of tax breaks and simplifying legislation.
- In the recent past, several initiatives aimed at encouraging investment in the sub-£2m segment of the market have been launched including Venture Capital Trusts, Regional Venture Capital Funds and Enterprise Investment Schemes, while new proposals such as Enterprise Capital Funds are in the offing.
- The user-friendly nature of the UK limited partnership has been particularly helpful.

7.1 Introduction

UK government initiatives have been a vital stimulus. Regulatory, legal and fiscal frameworks in place in the UK are recognised as being broadly favourable for private equity activity. Likewise, the Government continues to introduce measures designed to promote entrepreneurship. Furthermore, there are signs that attitudes towards business and entrepreneurship continue to move closer to a 'US-style' view of entrepreneurial activity.

7.2 The Government and private equity

The UK Government has played a positive role in ensuring the business landscape continues to be conducive to private equity activity. Key initiatives of direct relevance to private equity have included the addressing of a perceived equity gap at the lower end of the deal value spectrum via the launch of Venture Capital Trusts (VCTs), Regional Venture Capital Funds (RVCFs), Enterprise Capital Funds (ECFs) and the Enterprise Investment Scheme (EIS).

VCTs are quoted limited companies that invest shareholders' funds in smaller unquoted trading companies and AIM-listed stocks. A VCT must invest at least 70% of its funds in 'qualifying holdings'. These holdings must be in unquoted companies that will carry on a 'qualifying trade' wholly or mainly in the UK. The VCT cannot invest in any company whose gross assets exceed £15m immediately before the investment in it or £16m afterwards. Most VCTs are run by investment managers and raise their funds from private investors.

RVCFs are an England-wide programme to provide finance of up to £500,000 to small and medium-sized enterprises. The funds are managed by venture capital professionals and are commercially focused, making commercial returns.

The concept of ECFs is a proposed new UK government initiative following a consultation process instigated at the 2003 Budget. This aims to improve access to growth capital for small and medium-sized enterprises by applying a modified US Small Business Investment Company model to the UK. ECFs will be privately managed through a limited partnership model and invest up to £2m of equity into an enterprise.

The EIS, which was set up to replace the Business Expansion Scheme, is a series of tax reliefs designed to encourage investments in small UK-based unquoted companies. The EIS offers both income tax and capital gains tax (CGT) reliefs to investors who subscribe for shares in qualifying companies.

7.3 Legislative environment

The Government's broader legislative environment and recent changes, which are considered to have had a positive impact on the private equity industry in the UK, include changes to key financial institutions, the tax regime and company law.

Tax regime

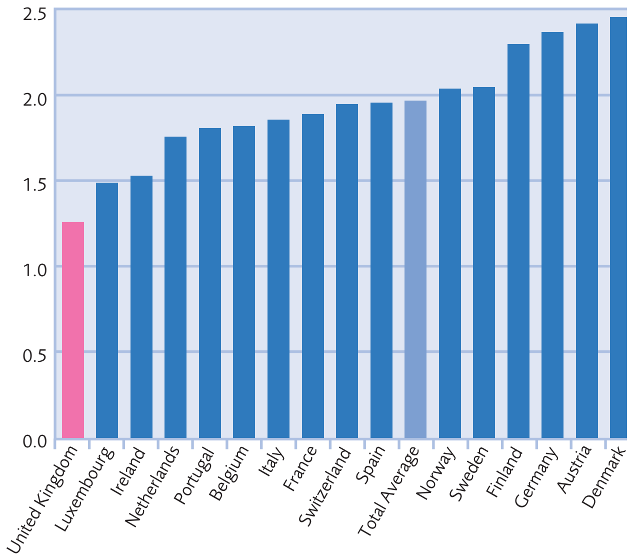
Particular elements in the favourability of the UK over other regimes within Europe identified in a recent EVCA (2004) report include the company tax rate, personal income tax rate, and individual CGT rate, as well as the existence of tax breaks and incentives to encourage investment in private equity (including for retail customers via VCTs, for example). The introduction of 'taper relief' in 1998 and the subsequent changes made to it, for example, are seen to have been of significant benefit (AltAssets, 2005).

7. Regulatory, legal and fiscal framework – continued

Figure 7a

Favourability of tax and legal environments

Scores – 1: More favourable; 3: Less favourable



Source EVCA (2004)

Legal environment

Overall, the EVCA (2004) benchmarking report (see Appendix 2) rated the UK tax and legal environment to be the most favourable to private equity of those in place across Europe (see Figure 7a). Key elements cited were:

- UK limited partnership fund structure (see below)
- merger regulation
- ability of pension funds and insurance companies to invest in private equity
- company tax rate
- personal income tax rate – below European average
- CGT rate for individuals
- tax incentives for private individuals to invest in private equity
- entrepreneurial environment
- R&D incentives
- bankruptcy and insolvency practices and processes.

UK limited partnership

The UK limited partnership offers advantages over other fund structure forms. EVCA's 2004 benchmarking report identified a number of key features of the UK limited partnership structure which made it an attractive vehicle for private equity houses:

- Tax transparency for domestic investors – of significance given the fact that UK investors account for the largest proportion of European institutional investors active within private equity.
- International investors need no local permanent establishment in the UK – of significance given the proportion of funds raised by UK managers from non-domestic institutional investors.
- Tax efficient capital investment or incentive for fund managers can be incorporated (note: legislation means certain conditions must be met to achieve CGT treatment for carried interest).
- Management charges and carried interest are not liable to VAT, subject to structuring so that the GP and manager are in the same VAT group.
- There are no undue restrictions on the types of investments that can be undertaken.

While some of these characteristics are common to other fund structures in use around Europe, EVCA's report concluded that no other country's structure (with the exception of Ireland) included all these key features (see Figure 7b). The UK limited partnership structure has also continued to evolve, with the removal of the 20-partner limit, abolished in December 2002, being a recent innovation intended to retain the attractiveness and effectiveness of the structure (SJ Berwin, 2003).

Figure 7b
European fund structure characteristics by region

	Austria	Belgium	Denmark	Finland	France	Germany	Ireland	Italy	Luxembourg	Netherlands	Norway	Portugal	Spain	Sweden	Switzerland	United Kingdom
Tax transparency for domestic investors	No	Yes	n/a	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	Yes	n/a	Yes
Ability of international investors to avoid a permanent establishment	Yes	Yes	n/a	No	Yes	Yes	Yes	Yes	Yes	No	No	Yes	Yes	No	n/a	Yes
Ability to incorporate a tax efficient capital investment/incentive for fund managers	Yes	Yes	n/a	No	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	n/a	Yes
Ability to avoid paying VAT on management charges	No	Yes	n/a	Yes	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	n/a	Yes
Ability to avoid paying VAT on carried interest	No	Yes	n/a	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	n/a	Yes
Freedom from undue restrictions on investments	No	No	n/a	Yes	No	Yes	Yes	No	No	Yes	Yes	No	No	Yes	n/a	Yes

Source EVCA (2001)

Company law

In May 2005, the Government reaffirmed its commitment to continuing to improve the business environment by restating a pledge to modernise company law. Particular areas to be addressed include:

- The administration of private companies
  Including making it easier to run a company by having no compulsion to appoint a company secretary or have annual meetings and implementing more sensible notice periods for meetings.
- The forming of companies
  Including making it easier to issue new shares/reduce share capital and making it possible to pass resolutions more quickly and easily in writing with only the majority having to sign.
- Abolition of prohibition on financial assistance for private companies
- Restating of director's duties in statutory code to make clearer and more accessible.

(SJ Berwin, 2005)

EVCA (2004) notes that the process of establishing a business in the UK is a relatively less bureaucratic process than in many other parts of Europe. In particular, the process is often quicker and cheaper, taking around 5-7 days to establish a new company and usually just £20-80 to set up a private limited company (see Figure 7c).

Figure 7c
Founding a business in the UK

Factors	Private Limited Company	Public Limited Company
Form	Ltd (Limited)	Plc (Public Limited Company)
Time to set up	5-7 business days/'same day' basis	5-7 business days/'same day' basis
Typical admin cost for set up	£20-80 for direct filings; £150-300 using incorporation agent	£20-80 for direct filings; £500-550 using incorporation agent
	£1 (no legal minimum)	

Source EVCA (2004)

7. Regulatory, legal and fiscal framework – continued

Regulatory

The private equity industry in the UK has been regulated by the FSA (Financial Services Authority) since 2000. The UK private equity industry is one of only two regulated private equity and venture capital industries in the world. The BVCA has liaised extensively with the FSA for the burden of regulation to be appropriate for the industry. It is keen to ensure that the negative impact of additional regulation does not adversely affect the competitive and successful nature of the UK industry.

8. Entrepreneurial culture

- The development of an entrepreneurial culture is being pursued both via education and through the establishment and maintenance of structures and procedures encouraging entrepreneurial and economic activity.
- The Lisbon Agenda has set an EU target to become the most entrepreneurial region by 2010.

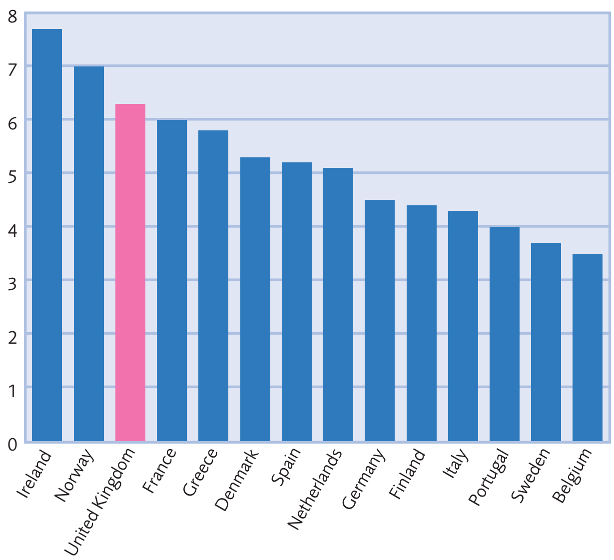
8.1 Introduction

An important part of ensuring the long-term success of the corporate environment is the fostering of a culture of entrepreneurship. There is evidence to suggest that the fostering of the type of entrepreneurial spirit more commonly associated with North America has achieved success in the UK.

8.2 Attitudes to entrepreneurship

The UK is considered to be one of the most entrepreneurial European countries. The latest Global Entrepreneurship Monitor (GEM, 2004) ranked the UK third, behind only Ireland and Norway (see Figure 8a) and highlighted strong cultural attitudes towards entrepreneurship in the region.

Figure 8a
European entrepreneurship index



Source Global Entrepreneurship Monitor (2004)

In addition to highlighting the favourable attitudes to entrepreneurship in the UK, GEM has recorded views becoming increasingly positive over recent years (GEM, 2004). Indeed, the study highlights the UK's strong position not only in comparison to other European countries, but from a global perspective.

The opinions of survey respondents highlight a cultural shift within the UK towards an increasing awareness of, and predisposition towards, entrepreneurship. Over half of UK participants in the UK GEM survey said they thought they had the skills to start a business, with under a third saying the fear of failure would put them off pursuing that goal (see Figure 8b). Likewise, over a quarter of respondents said they knew an entrepreneur, with over a third noting that they saw good opportunities for entrepreneurial activity in their locale.

Figure 8b
Attitudes to entrepreneurship

Percentages of respondents by country who have the listed attributes	United Kingdom	United States	France	Italy	Germany	Japan	Canada
Know an entrepreneur	27.7	35.8	41.0	34.9	37.9	29.7	34.1
See good opportunities for entrepreneurship locally	35.9	33.6	21.1	25.4	13.5	14.0	44.8
Have skills to start a business	51.7	54.3	33.1	32.6	36.2	13.5	54.9
Fear failure	32.9	21.2	50.0	40.2	47.7	22.6	28.8

Source Global Entrepreneurship Monitor (2004)

8.3 Entrepreneurial education

Part of the process of creating an entrepreneurially-aware and progressive society is the promotion of entrepreneurship via education. A recent report undertaken by the European Commission (2005) highlights the range of measures already being undertaken within the UK at secondary school level to promote entrepreneurship education. The UK is rated ahead of its European peers having already addressed areas such as ensuring entrepreneurship is part of the education curriculum, that support is provided to teachers and schools, that different government departments co-operate to promote the area and that the success of these strategies is monitored (see Figure 8c).

Figure 8c
Promoting entrepreneurship via school education

Overview of measures undertaken by public authorities to promote entrepreneurship education, especially in secondary schools (selected regions only)	United Kingdom	France	Germany	Norway
Co-operation between government departments	Y	Y	Y	Y
Entrepreneurship in curriculum	Y	N	Y	Y
Supporting measures to schools	Y	N	Y	Y
Training of teachers	Y	N	Y	(Y)
Support to mini-companies	Y	(Y)	Y	Y
Collection of data	Y	Y	N	(Y)
Targets	Y	N	N	(Y)
	7	2+1	5	4+3

Y Measures exist
(Y) Measures are planned / Available partly
N No measures exist

Source European Commission (2005)

Since 2002, the UK has seen a number of initiatives launched and governmental support provided to entrepreneurship education. The Davies Review in 2002 highlighted the need for a clear articulation of strategy and commitment to enterprise education from the Government. This led to the allocation of over £70m over a number of years to support the cause as well as a £10m commitment to Enterprise Insight. The Chancellor has also restated a commitment to the Young Enterprise Scheme aimed at providing school children with experience in establishing and running their own business. In 2004, the National Council on Graduate Entrepreneurship was launched to act as a central source of information for graduates and undergraduates in raising the profile of entrepreneurship. In 2005, the BVCA launched the Enterprise Report in conjunction with Enterprise Insight, with the aim to create a more enterprising culture among young people in the UK.

8.4 Encouraging entrepreneurship

The Lisbon Agenda has set an EU-wide timetable to become the most entrepreneurial global economic region by 2010. It seems that Europe will have to make significant strides over the coming years to achieve this goal. The World Bank (2005) ranks only two European countries (the UK and Denmark) in the top ten in terms of global business friendliness. The UK's position reflects both the existence of a government that has created a regulatory environment conducive to the operation of business and also the relatively low burden (in terms of time and costs) of complying with business regulation.

Appendix 1. Methodology

Project aims

The BVCA commissioned IE Consulting to produce a report compiling evidence highlighting the relative attractiveness of UK-based private equity managers and the broader UK private equity industry. The report is based exclusively on desk research, drawing together private equity industry specific data, together with broader economic and business statistics on the UK and Europe.

The survey parameters include a focus on both the private equity houses and the environment in which they operate. Particular emphasis is placed on the following key areas:

- Private equity activity levels
- Development of the UK private equity industry
- Investment opportunities
- The macro-economic context
- The regulatory environment

Key definitions

In the UK, continental Europe and much of the rest of the world, 'private equity' means the equity financing of unquoted companies at many stages in the life of a company from start-up to expansion, or even mangement buy-outs or buy-ins of established companies. 'Venture cpaital' is a subset of private equity, covering the seed to expansion stages of investment. Where this report uses the term 'private equity' it is taken to include 'venture capital'.

- Abbreviations used in this report:
  GP: General partner (private equity manager)
  LP: Limited partner (institutional investor)
  MBI: Management buy-in
  MBO: Management buy-out
- **Start-up:** Financing provided to companies for use in product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not yet sold their product commercially.
- **Other early stage:** Financing provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They may not yet be generating profits.
- **Expansion:** Sometimes known as 'development', capital provided for the growth and expansion of an established company. Funds may be used to finance increased production capacity, product development, provide additional working capital, and/or for marketing.
- **Management buy-out (MBO):** Funds provided to enable current operating management and GPs to acquire an existing product line or business. Institutional buy-outs (IBOs), leveraged buy-outs (LBOs) and other types of similar financings are included under MBOs for the purposes of this report.
- **Management buy-in (MBI):** Funds provided to enable an external manager or group of managers to buy into a company.
- **Value:** Where deal values are referred to in this report, the total deal value (including both equity and debt elements) is being included.

Information sources

A variety of information sources have been used within this report. Private equity industry information has primarily been sourced from Unquote, the BVCA and the EVCA (European Private Equity and Venture Capital Association). Economic data has been primarily sourced from official national government statistics and the European Union.

A full list of sources of information cited within this report can be found in Appendix 2.

Appendix 2. Information sources

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BVCA

Founded in 1983, the BVCA (British Venture Capital Association) represents private equity and venture capital in the UK. We are devoted to promoting the private equity industry and improving the performance and professional standards of member firms and the individuals within those firms. Its members include UK-based private equity firms and those companies actively involved in the industry, including advisers, accountants and lawyers. The BVCA provides publications to potential private equity users, their advisers and other interested parties, and carries out a wide range of private equity research.

3 Clements Inn
London WC2A 2AZ
United Kingdom

Tel: +44 (0)20-7025 2950
Fax: +44 (0)20-7025 2951
bvca@bvca.co.uk
www.bvca.co.uk

IE Consulting

IE Consulting is an affiliate company of Incisive Media's Alternative Assets Division (formerly Initiative Europe), which has been researching Europe's private equity industry for 16 years. Our consultants undertake high impact bespoke consultancy work across the entire private equity cycle for Europe's leading General Partners, Limited Partners and Specialist Advisers.

Projects undertaken include providing materials to be used in the fundraising process and in PPM documents and detailed market and data studies to aid strategic decision-making in areas such as market positioning, deal origination, investor communication and management company structure.

Please contact Matt Craig-Greene for more information:

Haymarket House
28-29 Haymarket
London SW1 4RX
United Kingdom

Tel: +44 (0)20-7004 7461
Fax: +44 (0)20-7004 7545
matt@ieconsulting.co.uk
www.ieconsulting.co.uk

BVCA *investing in enterprise*

3 Clements Inn
London WC2A 2AZ

T 020-7025 2950
F 020-7025 2951
bvca@bvca.co.uk
www.bvca.co.uk

Jeffrey Pellin Consultancy Ltd 01603 666822 W3479 02/06