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More than just looking for profit

Four insiders tell Carmela Mendoza how the private equity industry in France has shifted amid political and fiscal changes and why sustainability has become a much bigger play

On 15 April, three days before *Private Equity International* gathered four French private equity veterans together in Paris for a discussion on the market, a massive blaze hit the 850-year-old Notre Dame Cathedral, destroying its iconic spire and a large part of the roof. Thousands of Parisians watched in horror as flames engulfed the gothic masterpiece.

When we met on a warm spring afternoon a few days later, Notre Dame and its imminent restoration was on everyone's minds. While there is no industry-wide effort to aid the renovation of the cathedral, roundtable participants said firms and individuals were making their own contributions. KKR co-founder Henry Kravis, for example, has pledged $10 million. However, consensus around the table was that President Macron's goal to get the cathedral rebuilt in five years was not possible.

Another point they have in agreement: France private equity is on a tear. 2018 was a record year for fundraising and deal activity. French private equity firms landed €18.7 billion of investor commitments last year, a 13 percent jump from the previous year's €16.5 billion and the highest ever since industry association France Invest began tracking data in 1996, according to its *Activity of French Private Equity in 2018* report.

The industry is also delivering: French private equity has generated a net internal rate of return of 10 percent-plus over 10 years, data from France Invest show.

Eddie Misrahi, president and chief executive of mid-market firm Apax Partners, says the upward trajectory of French private equity is the result of the natural evolution of the industry, partly helped by Brexit, which has reduced the number of deals available in the UK, Europe's largest market.

"It's also a result of a much more investor-friendly environment," he says. "The election of Macron as president in 2017 has totally changed the attitude of foreign investors toward France – from the measures to attract talent into technology or venture companies, to the end of the wealth tax."

13%

Rise in investor commitments to French private equity firms from 2017 to 2018

Many funds did not want to touch France from 2010 to 2016, he says, with most London-based pan-European funds looking almost exclusively at northern Europe. "Brexit first happened, then Macron was elected nine months later and suddenly everybody wanted to be in France."

François Jerphagnon, managing director and head of expansion at Ardian, adds: "The question five years ago in terms of asset allocation especially for large institutions from the US or Asia, was, 'Why should we allocate to Europe? And why France?' That changed clearly two years ago."

Here's why: the first several months of Macron's presidency were defined by his pro-business economic programme, transforming France's wealth tax and easing taxes on companies.

Sabina Comis, a partner at international law firm Dechert, says existing carried interest held by managers moving to

PHOTOGRAPHY: **ANDREW WHEELER**

François Jerphagnon

Managing director and head of expansion at Ardian

François Jerphagnon joined Ardian in 2001. He began his career in 1994 at Caisse des Dépôts et Consignations, where he implemented a new portfolio management model. In 1996, he joined insurance company MACIF where he became head of asset allocation and stock management.

Sabina Comis

Partner at Dechert

Sabina Comis is partner at international law firm Dechert. She advises French and international companies on domestic and international tax structuring that arises from complex corporate transactions, restructurings and refinancings, often involving multiple sponsors. She also has a wealth of experience in creating and structuring private investment funds, including joint ventures and private equity vehicles.

Eddie Misrahi

President and chief executive at Apax Partners

Eddie Misrahi joined Apax Partners in 1991 as a partner, responsible for investments in the TMT sector and carrying out investments in growth financing and buyouts. He became managing director of Apax Partners in 2007 and chairman and CEO in 2010. He started at McKinsey & Company in Paris, before working in the USA for a telecommunications firm. Misrahi was chairman of Association Française des Investisseurs en Capital (now France Invest) from 2007-08.

Marc Frappier

Managing partner and head of Eurazeo Capital

Marc Frappier joined the Eurazeo investment team in 2006. At Eurazeo, he has participated in the investment or in the oversight of Accor/Edenred, Elis, Fintrax, Foncia, IMSquare and Rexel investments. He began his career in 1996 as a financial auditor with Deloitte & Touche in Paris and New York. From 1999 to 2006, he worked for The Boston Consulting Group in Paris and Singapore and worked on strategy and operational effectiveness assignments in various sectors.

Responding to cyber-crime

The industry is totally underestimating the impact of cybersecurity and it has been targeted because of the huge flows of capital, says Apax Partners president and CEO Eddie Misrahi.

In recent years, a couple of its companies as well as its LPs have been attacked. "For example, you make a capital call for €100 million and LPs get an email saying the bank account has changed and it's now in Hong Kong. We had that happen. It's a major threat to the industry," he says.

Ardian and Eurazeo have also been hit by cybercrime. Marc Frappier, managing partner and head of Eurazeo Capital, says the firm works two ways to bulk up cybersecurity firm-wide and in its companies. Eurazeo subscribed to Cyber Angel, which monitors the dark web for all its portfolio companies to see if they can find any information leakage. It also has an on-demand cybersecurity company, which its companies can call if an issue arises. "We've also had the same issue with funds flow – the level of sophistication of these players is surprising," Frappier says.

Misrahi notes combatting cybercrime involves a trade-off between cost and protection. The answer, he says, is not so much in the intensity of investments in cybersecurity, but in the firm's processes such as double-checking phone calls and wire transfers for capital calls and distributions.

France from abroad can now benefit from more favourable tax treatment. Tax reforms have also further improved the onshoring regime which may allow reduction in the overall income tax rate of a manager moving to France to less than 30 percent for a period of up to eight years. "These measures when added to the reduction of the corporate income tax rate make France a rather favourable environment for managers and management companies to settle in."

Investment activity has also been rising in recent years, although it only saw a slight uplift last year to €14.8 billion from €14.3 billion in 2017. Nearly two-thirds of private equity-backed transactions were in small and medium-sized enterprises, and were also largely domestic, with 84 percent of the deals recorded in French companies.

France private equity has always been characterised by small-cap transactions, says Marc Frappier, managing partner and head of Eurazeo Capital. The upper mid-market

"Wealth concentration and its distribution mechanism has been a long-term issue of the industry, not just in France but also globally"

MARC FRAPPIER
Eurazeo Capital

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>
> **EDDIE MISRAHI**
> **Apax Partners**

sees about 30 to 40 deals a year, while the large-cap buyout space is a finite market.

"It has been one of the largest markets globally for a long period now and that's why you also see big firms emerging. You have firms that have built on this large market, but it's still relatively small compared to the North American market," he says. "You see more and more funds going outside of France to look for opportunities."

Eurazeo focused historically on investing in France but has in recent years strengthened its presence across Europe, North America and Asia. In early April, the Paris-listed investment firm picked up a minority stake in Madrid-based MCH Private Equity as part of its internationalisation plans. A month before, China Investment Corporation, the world's second-largest sovereign wealth fund, selected Eurazeo to manage a growth fund of up to €1.5 billion for French and European companies that want to expand in China.

2018 saw an increase for the third consecutive year in the number of companies backed to 2,218, growing 34 percent last year against the average for 2006-17, ccording to data from France Invest.

Tickets of less than €5 million accounted for nearly 80 percent of companies backed and 14 percent of overall capital invested.

Not that easy

GP activity in France – from domestic to pan-European and global firms – has been vibrant, but entering the market as a new manager is a challenge, partly due to competition. An increase in the number of buyers has accelerated pressure on pricing, which has consequently led to a rise in pre-emptive processes.

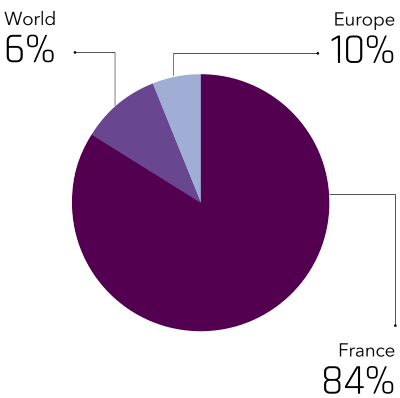
For established managers, this is a positive, says Jerphagnon: "It reinforces the winner-take-all concept, or at least the high barrier to entry. If you don't have the network, if you're a newcomer, it's much more difficult to make new investments."

Regulation is also a deterrent: it's becoming increasingly difficult for small firms to be compliant, Misrahi says. Participants agree France's private equity regulatory framework is tougher than a decade ago.

Comis, who advises French and international companies on domestic and international tax structures, says tax changes impact the industry on each one of its levels: fund structuring, management company, deals and carried interest level.

"All of these pull against each other. We are facing on one side favourable tax treatment for managers relocating to France, reduced corporate income tax rate, and new tools to share capital gains with employees. On the other side is the need to

84% of companies backed in 2018 are based in France (% of invested companies)



comply with the new tax rules on interest deductibility limitations."

On the latter, France has gone further than the directive required, choosing to keep some of the existing limitations and add them to those in the directive, Comis says. Thus, it is more challenging now to efficiently structure a private equity deal in France.

More dealflow

While the industry is feeling the effects of fiscal reform, it also expects that the end of the wealth tax will have a positive impact on dealflow.

Called *Impôt de solidarité sur la fortune*, the wealth tax was first introduced by the Socialist Party in the 1980s and levied on individuals with assets above €1.3 million. In 2017, the French parliament scrapped the wealth levy on everything except property taxes, while a 30 percent flat tax rate was introduced on capital gains, dividends and interests.

Family businesses used to be immune to the wealth tax as long as they kept hold of the business, Misrahi says. His firm, Paris-based Apax Partners, is deploying its 2016-vintage €1.03 billion Apax France IX, targeting investments in small and mid-size companies in Europe that focus on TMT, consumer, healthcare and services sectors.

In his view, the end of the wealth tax means, in theory, there should be a lot more dealflow. "Families can now sell and diversify their asset base because for the past 10 years they were stuck. If you sold before, you would lose a lot of money. For example, 1.5 percent per year in 10 years is a big chunk of your wealth."

Its recency means there has been little effect thus far.

"The *gilets jaunes*, or yellow vest movement, with a lot of people saying we should reinstate the wealth tax, is also creating an uncertainty which not a lot of people are willing to bet on," Misrahi says.

Spreading the wealth

The yellow vest movement has arisen amid Macron's pro-business reforms. It began in November last year initially as a fuel tax protest, which has now morphed into a wider anti-government movement against tax reforms. Its main complaint: lower- and middle-income France is taxed unfairly in favour of the rich.

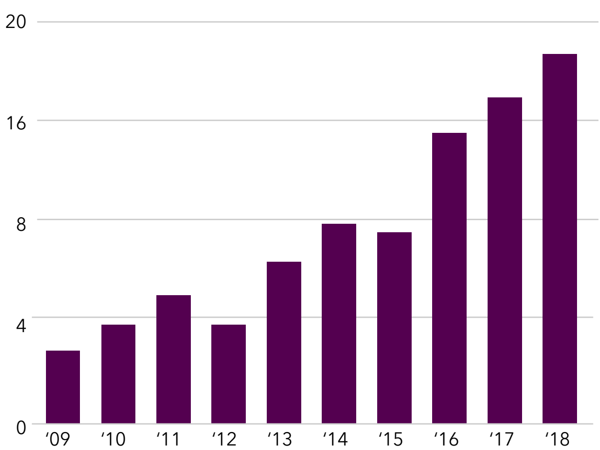
Private equity's role in wealth concentration and distribution is front of mind for the roundtable participants.

Jerphagnon says: "One topic we see now is how could we align as much as possible the interest of the funds and the employees, not just the fund manager and the top management of the company."

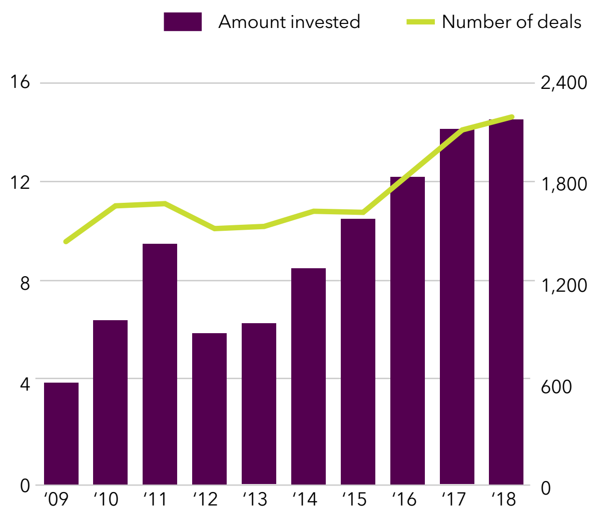
Ardian pioneered in France the practice of sharing a portion of the capital gains on successful exits with every employee of the companies involved and has done this since 2008.

Although Jerphagnon declines to explain on how this is done, he says the firm

A record €18.7bn was raised, nearly 50% from foreign LPs (capital raised, €bn)



PE invested €14.7bn in 2,218 start-ups, SMEs and mid-caps in 2018 (amount invested, €bn and number of deals)



Source: France Invest and Grant Thornton

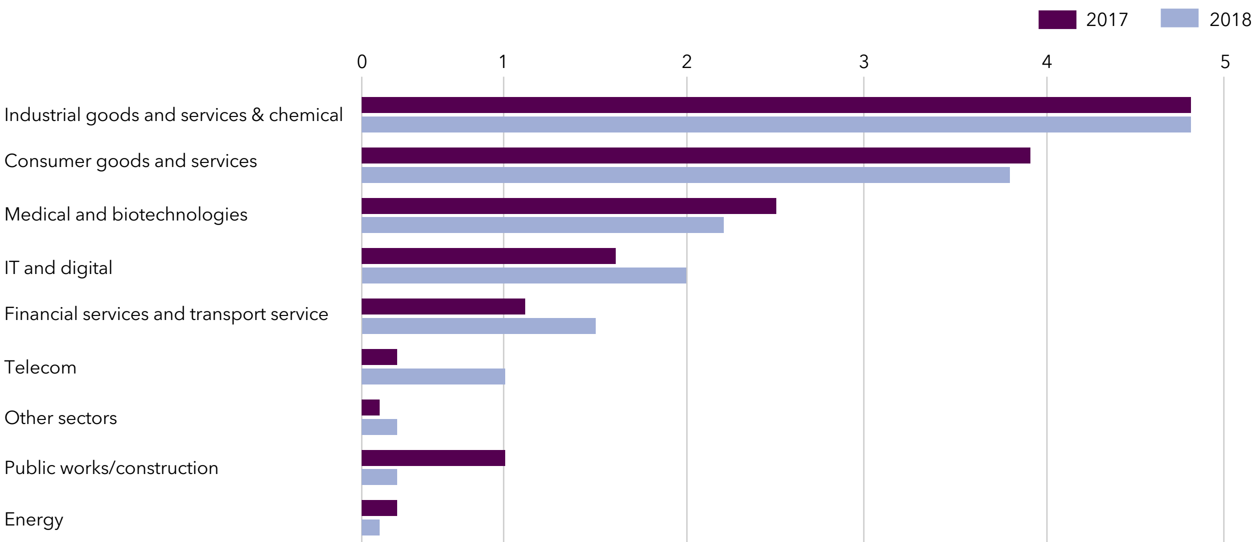
> *"We have to invest responsibly to create lasting value for all stakeholders. Our responsibility goes far beyond creating financial value"*
>
> **FRANÇOIS JERPHAGNON**
> **Ardian**

believes there is no way it can turn its back on having a sustainable private equity business. "We have to invest responsibly to create lasting value for all stakeholders. Our responsibility goes far beyond creating financial value."

Wealth concentration and distribution has been a long-term issue for the industry globally, notes Frappier. While he believes the private equity associations are doing a good job of showing wealth is being created for the employees and for job creation, there's more to be done. *Raison d'être* – having purpose beyond making money – has always been a big debate in France and a part of the PACTE law proposed last year, he adds.

The *Plan d'Action pour la Croissance et la Transformation des Entreprises* or Plan for Business Growth and Transformation law was proposed in June last year, to make companies fairer, better funded and less overburdened with obligations. One of its aims is to make companies do more than simply seek to make a profit. It will also abolish the employer's contribution on profit-sharing plans for businesses with

2018 saw strong growth in investments in digital technology (amount invested, €bn)



Source: France Invest

"These measures when added to the reduction of the corporate income tax rate make France a rather favourable environment for managers and management companies to settle in"

SABINA COMIS
Dechert

How to unlock €10bn more for PE

France has a limited investor base, with only a small number of pension funds and the remainder wealth management platforms, banks or insurers.

Data from France Invest show foreign capital commitments have increased. Nearly half of the €18.7 billion raised in 2018 was gathered abroad, versus 39 percent on an annual average between 2008 and 2017. Misrahi says life insurance offers huge potential: "We have close to €2 trillion in life insurance contracts that are sitting, generating zero interest, and which aren't allowed by French regulation to get into private equity. This is a huge potential capital source. If you can unleash €10 billion a year, it adds 50 percent to our market."

François Jerphagnon, managing director and head of expansion at Ardian, says the question is whether private equity and retail can work together: the LP market in France is mainly institutional and linked to insurance companies. "With retail investors, the numbers can be much larger. But that raises a lot of questions. Who do you do it with? What's your communication policy?"

One issue with retail investors will be the need for separate vehicles, says Sabina Comis, a partner at Dechert. Reconciling the tax and legal needs for individual investors and the fund can be a headache: "There are a lot of legitimate expectations on the revised conditions for the *apport-cession* or capital contributions. However, we still find it difficult to see how we can make it work for classic private equity funds. Private equity funds have their own ratio to fulfil from a regulatory and tax perspective."

fewer than 250 employees. Comis sees some promising items in PACTE for a more sustainable private equity industry, such as the ability for a shareholder to give up, tax free, a portion of their capital gain on the sale of shares of a target to the benefit of employees of the latter; the employees would in turn be exempt from income tax on the amount received.

But the application of PACTE, which is subject to several conditions, may be technically tricky to implement as-is.

"The takeaway here is that the legislator is actively looking for measures which can reconcile the investors and the investing teams with the employees of the targets," she adds. "It's a form of alignment of interest well known to the French players and generally fiercely negotiated on both sides."

Misrahi adds: "Younger generations will work with companies that want to give them a sense to what their job is and how it will contribute to society. To attract the future talent, we will have to think about what kind of sense we can give them. It's a real issue today." ■