Private finance markets

Francisco Javier González Pueyo
María José Pérez-Santamarina Atiénzar

Working paper No. 88

Private finance markets

Francisco Javier González Pueyo (*)
María José Pérez-Santamarina Atiénzar

Working paper No. 88

February 2025

(*) Francisco Javier González Pueyo and María José Pérez-Santamarina Atiénzar belong to the Research and Statistics Department of the Strategic Policy and International Affairs Directorate-General. This document is the sole responsibility of its authors and does not necessarily reflect the opinion of the CNMV. The authors would like to thank Eudald Canadell Casanova, Alejandro Marroquín González and Alberto Segurado García for their comments.

Comisión Nacional del Mercado de Valores
Edison, 4
28006 Madrid

Bolivia, 56
080018 Barcelona

Heros, 3
48009 Bilbao

The CNMV discloses its reports and publications online at www.cnmv.es.

ISSN (digital edition): 1989-8711

Layout: Cálamo y Cran

Index

Abstract

This document analyses the current state and recent developments of private equity and credit markets.

In recent years, supported by low interest rates, private equity and credit markets have experienced steady growth, reaching a total asset volume exceeding $14 trillion.

This paper explores the key cyclical and structural factors driving this growth, highlighting the significance of the interconnection between public and private markets. It examines the specifics of private market funding mechanisms, their primary vehicles, operating characteristics, asset segmentation, and the flexibility and advantages private markets can offer to companies in emerging economic sectors.

Public and private markets have always been interconnected, rather than being isolated or disconnected segments. Regulated markets provide liquidity to private equity investments, with the largest managers listed on stock exchanges.

One of the most significant connections is the role of initial public offerings (IPOs) as a means of divesting capital contributions to start-ups and leveraged buyouts. However, in recent years, this has been adversely impacted by a global shortage of IPOs. In fact, stock exchanges have recently established or strengthened trading segments dedicated to companies known as scale-ups, which have proven business models and sustained revenue growth. This development allows private equity to divest and free up funds for new investments in early-stage companies.

The interconnection between public and private equity markets also becomes apparent during stock market corrections. In such situations, institutional investors tend to reduce their contributions to private equity, making it more challenging to divest through IPOs and sales to third parties. This can hinder new investments in start-ups and extend the investment horizon for companies.

From the perspective of the entities that finance the economy, these interconnections are integral to corporate strategy. They stem from alliances and collaborations between private equity and credit managers, banks, insurance companies, and investment funds, which go beyond merely distributing private assets. The ongoing growth in funds raised by private credit managers has allowed them to fully finance loans originated by banks, whose role in many transactions is often limited to leveraging their network of clients in need of financing. Investments from private equity in insurance companies are also common, as they drive changes in investment policies by increasing exposure to private assets. While these assets

may align with longer investment horizons, they also expose insurers to heightened liquidity and valuation risks.

Structural factors have significantly contributed to the growth of private equity and credit markets. Key among these is the regulatory shift initiated after the major financial crisis of 2008, which raised capital costs for banks, particularly for loans to unrated entities. This change has discouraged traditional lending in favour of transferring leveraged lending activities from banks to private credit managers. Furthermore, the increased availability of private funds has facilitated larger financing rounds and allowed investors to maintain their capital in companies until they achieve greater maturity. This approach enables them to capture a substantial share of value creation while taking on more risk during the initial development stages of these companies. Private equity firms also play an active role in managing businesses, bringing in highly experienced executives and maintaining a longer investment horizon. This longer timeframe allows them to support projects that require extended maturation periods before they can become viable.

Another significant structural factor, particularly from the perspective of firms needing capital and funding is the reluctance of new economy companies to endure the continuous scrutiny of their company's valuation on the stock exchanges and to regularly disclose information about their business models, which often contain substantial intellectual property. Moreover, as highlighted in a report by Mario Draghi, traditional banking finance is not well-suited to support innovation, as it requires greater risk tolerance and longer time horizons.

Focusing on artificial intelligence companies, which received 50% of venture capital investment in 2024 according to the latest data, raises important questions for future research. It is crucial to assess whether the influx of private funds has contributed to inflated valuations and the financing of non-viable business models or lower returns compared to more efficient alternatives.

This paper also identifies key issues for supervisory authorities to analyse and monitor, particularly concerning potential systemic risk and the distribution of private investments to retail investors, who have largely been off from these markets thus far. In both instances, increasing transparency is essential, covering both the activities and entities operating in these market segments, as well as the procedures for asset valuation. It is crucial to enhance the information requirements for the activities and participants within this expanding area of financial activity, while also ensuring that supervisory authorities have access to this information and can share it effectively. For retail investors, strengthening investor education is necessary, along with a thorough assessment of the suitability of the investment vehicles offered, given the unique challenges of investing in private assets, such as their lower liquidity and less transparent valuations.

The paper also includes a brief analysis of private equity in Spain, comparing it with other European countries. Both the levels of private equity investment relative to GDP, as well as the types and sectors of investment – predominantly in technology and healthcare – are quite similar to the rest of the European Union (EU), with the exception of a higher involvement in the hospitality and leisure sectors. Like elsewhere in Europe, 80% of investments originate from non-EU managers, who focus primarily on large transactions (€100 million) and middle market deals (€5–10 million). In contrast, Spanish private equity managers direct 90% of their investments towards small and medium-sized enterprises (SMEs).

Finally, the paper includes a section on sustainable investment in private markets, concluding with a summary of the main findings.

1 Private equity and private finance markets: recent developments

There is no universally accepted definition of private markets; however, literature typically describes them as markets where alternative investment managers channel funds from predominantly institutional investors to various capital seekers, using debt or equity instruments that are not traded on regulated markets or alternative trading systems.

In general, private markets can be segmented based on the types of assets managed,[1] including private equity (PE), venture capital (VC), private credit (PC), and real estate (RE). Many classifications also recognise infrastructure and natural resources as distinct categories due to their specific characteristics.

Sections 4 and 5 of this document examine notable aspects of the fund-raising process, the vehicles used, and the various segments within private markets.

The key differences between private and public capital markets revolve around several aspects:

i) In private markets, the primary investment vehicle is closed-end funds. These funds typically have a defined lifespan of 10 to 15 years in which they need to raise, invest, mature, and return capital. During this period, investors are required to commit their capital without the option to redeem their shares.[2]

   As a result, investing in private markets is inherently illiquid. This characteristic is crucial for assessing whether these private investment alternatives suit retail investors, who have largely stayed out of these markets until now.

   Moreover, the minimum investment period restricts liquidity transformation because the time horizons of the assets in the portfolios align with the investors' contributions. This is different from traditional investment funds offered to retail investors by commercial banks or conventional fund managers, where significant fund outflows are more likely.

1 Aramonte & Avalos (2021).

2 In the United States and Canada, some open-ended structures have been introduced that allow the fund to remain operational as long as the portfolio investments are not liquidated. These funds feature liquidity windows that enable investors to exit at the net asset value (NAV).

ii) Investments in private equity and debt are not traded on organised markets. Typically, the companies targeted by private equity and venture capital funds are unlisted, except for certain leveraged buyout (LBO) transactions, in which publicly listed companies are acquired and subsequently delisted through public-to-private takeovers.

iii) Unlisted companies backed by private equity do not have to adhere to periodic financial reporting requirements beyond those mandated by commercial law and any conditions specified by investors during their initial investment.

iv) Because of the investment horizons involved, private equity investees are not marked to market, which can make it challenging to monitor investments and assess their potential returns. However, this approach helps managers and capital providers mitigate volatility during periods of economic instability.

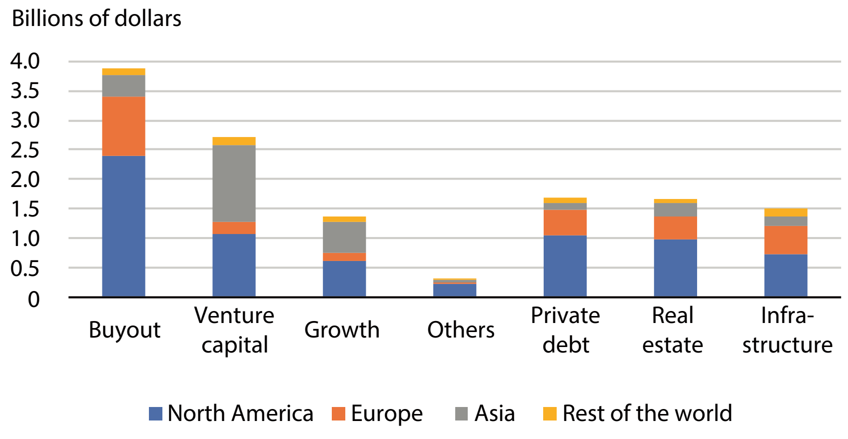
v) In many jurisdictions, private equity managers typically face less stringent supervision than investment fund managers. In Spain, the CNMV oversees the financial status of investment vehicles and ensures compliance with investment ratios and legal public disclosure requirements.

vi) Traditionally, private market investors have been large institutional players with robust analytical capabilities and access to extensive information. These professional investors are well-equipped to assess the risk-return profile of such investments, and they allocate a portion of their portfolios to them for diversification purposes. However, until very recently, retail investors had little involvement in these markets, as investments were generally restricted to amounts exceeding €100,000. As a result, financial regulators need to focus on retail participation in private markets. Although these investments offer clear diversification benefits, their unique characteristics, such as illiquidity and limited transparency, may make them unsuitable for all types of investors.

Size and recent developments in assets managed in private markets

Figure 1 illustrates the assets under management across various geographical regions for the main categories of private markets, including private equity, venture capital, private credit, real estate, and infrastructure. This data is sourced from the McKinsey *Global Private Markets Review 2024* report.

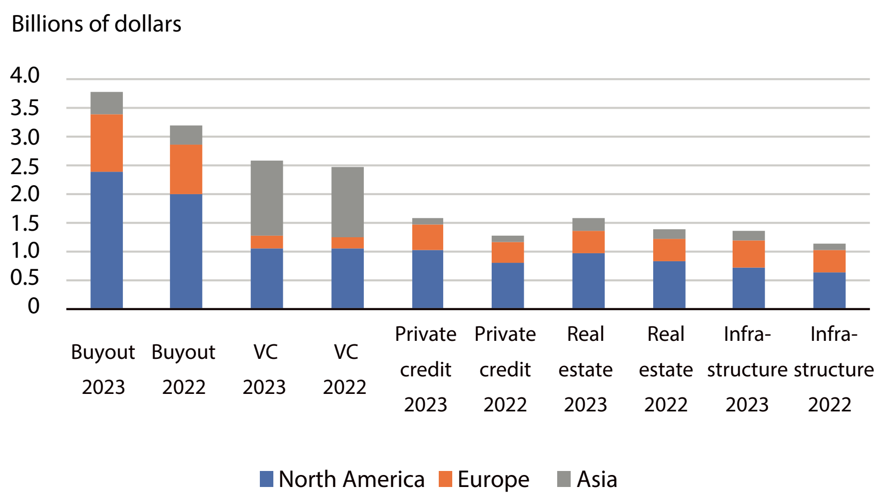
Assets under management (AuM). 2023 FIGURE 1



Source: Mckinsey.

The following figure illustrates the change in assets under management for the main categories of private markets in 2022 and 2023, based on data from McKinsey's last two annual reports. With the exception of venture capital, all other categories saw an increase in assets under management, despite a decline in fundraising compared to previous years. In the case of private credit, both fundraising and assets under management rose.

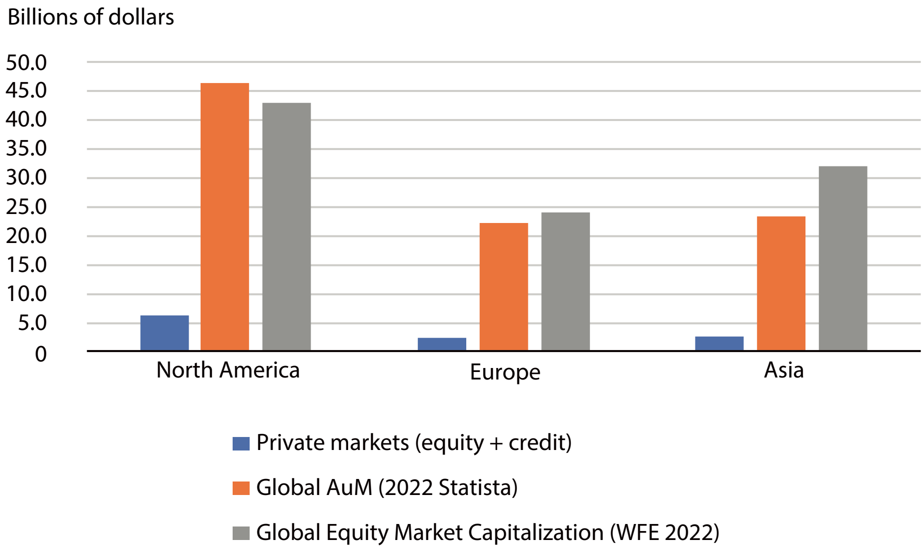
Assets under management. 2022–2023 FIGURE 2



Source: Mckinsey.

Figure 3 measures the volume of assets under management (AuM) of the private equity and debt markets and compares them by geographical areas with global assets under management (which include investment funds and management discretionary mandates) and with market capitalisation.

Assets under management (AuM) FIGURE 3



Source: McKinsey, Statista and World Federation of Exchanges (WFE).

Despite the significant growth achieved in recent years, the size of private markets, which exceeds $14 trillion, does not currently pose an imminent systemic threat when considered within the broader context of the financial system. However, financial supervisors should maintain vigilance and enhance their monitoring and analysis, particularly concerning the following areas:

i) Market activity volumes, particularly in fundraising, investments, divestments, and committed but unutilised capital – commonly referred to as "dry powder" – which reached $3.7 trillion in mid-2023, equating to 1.6 years of potential investments. This also includes the trends in assets under management.

ii) The type of trade, with a focus on LBOs and with special emphasis on:

   a. The financing mechanisms and vehicles involved, such as collateralised loan obligations (CLOs) and syndicated loans.

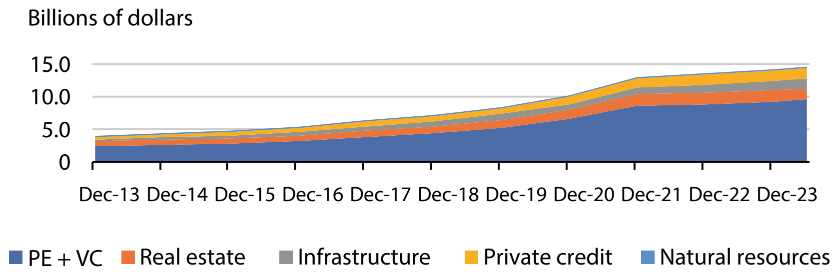
   b. The entities that provide this financing, specifically examining the exposure of credit institutions, both directly through loans and indirectly by financing the acquired companies via CLO purchases.

iii) The relationships between credit institutions, with an emphasis on their credit exposure to the private equity and credit sectors, as highlighted by the ongoing assessments from the European Central Bank (ECB).

iv) The marketing of private equity and credit products to retail investors.

Figure 4 illustrates the significant and sustained growth in private equity and credit markets over recent years, especially since late 2016.

Assets under management (AuM). Global FIGURE 4



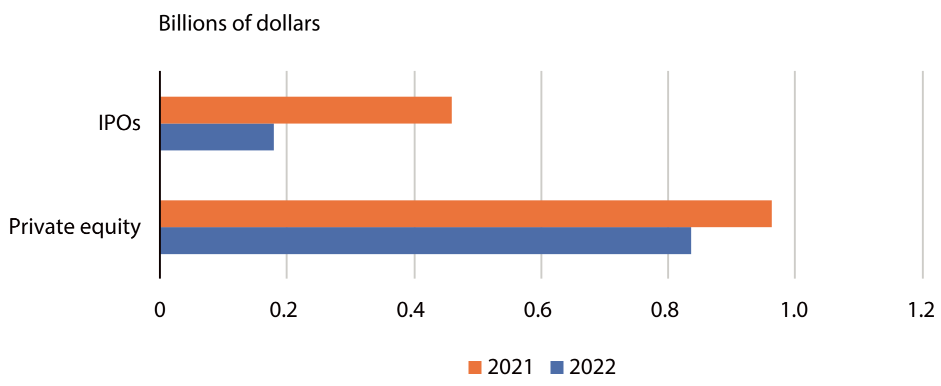
Source: Prequin.

In terms of volume, private equity and venture capital are prominent, with assets under management increasing from $500 billion in 2000 to $8.3 trillion in 2023. Within the private equity segment, which exceeds $5 trillion as shown in Figure 1, buyouts represent $3.85 trillion in assets under management, accounting for 47% of the total for the segment, down from 55% in 2018. A significant portion of these acquisitions is leveraged; these are the LBOs, which are examined in greater detail in Section 5 of this document. The latest data from Prequin, published in March 2024, indicates figures very similar to those reported at the end of 2023.

At the same time, a report by EY[3] indicates that in 2022, IPOs of companies previously funded solely by private equity and venture capital hit their lowest level in 20 years, representing only 5% of total IPOs that year.

Notably, according to the Organisation for Economic Co-operation and Development (OECD), more than 30,000 companies have delisted from public markets since 2005.

Funds raised. Global FIGURE 5



Source: Prequin and EY.

3 EY (2022).

According to Prequin data, 2022 experienced a significant decline in fundraising, particularly in Europe, which saw a drop of 28.2%. Until that point, Europe had recorded 11 consecutive years of annual growth. Despite this decline, 2022 marked the third-best year for global fundraising on record, achieving $1.2 trillion compared to the previous year's record of $1.4 trillion. In Spain, fundraising reached €2.62 billion in 2022, reflecting an 11% decrease from 2021. In 2023, fundraising figures from SpainCap were very similar to those in 2022, amounting to €2.61 billion.

In the first half of 2023, fundraising issues persisted, with $517 billion raised – that is, 35% less than in the same period the previous year – according to a Bain report published in June 2024. By the end of 2023, total fundraising reached its lowest level since 2017 at $1 trillion, marking a 22% decline from the prior year, although there were signs of recovery in the latter half of the year.

Several factors contributed to this slowdown in fundraising.

i) Macroeconomic uncertainties and increased volatility led investors to favour lower-risk assets.

ii) Additionally, the tightening of monetary policy by the US Federal Reserve starting in June 2022, in line with the ECB and other monetary authorities, alongside these economic uncertainties, prompted banks to withdraw from financing leveraged transactions. A high interest rate environment reduces transaction activity and complicates divestments – especially through IPOs – while making it harder to raise new funds, as investors turn to alternative assets offering higher returns.

iii) The so-called "denominator effect", stemming from the interconnection between public and private markets, suggests that price declines in public markets throughout 2022, which were only partially corrected in 2023, would affect private markets with a delay during 2023. This effect is discussed in more detail in Section 3 of this document.

In 2023, the pressures on fundraising, investment, and returns that began in 2022 continued due to inflation rates. While these rates have improved compared to 2022, they remain elevated relative to previous years. High interest rates also continue to raise the cost of financing, negatively impacting the profitability of operations.

Effect of interest rates TABLE 1

	Interest rates
Fundraising	Lower with high rates More attractive alternative assets
Transactions	Lower due to: i) Higher cost of borrowing ii) Portfolio valuation corrections
Divestments	Lower due to: i) Difficulty in market flotations ii) Lower portfolio valuations which are advisable to maintain so as not to materialise losses
Private credit	Higher volumes due to higher margins and restrictions on bank financing

In any case, the figures for assets under management in private equity and credit markets, as reported by entities like Preqin, represent net amounts – excluding any external financing. Therefore, the precise level of leverage used in private markets remains unclear.

2 Structural factors explaining growth in private market activity

The sustained growth of private markets cannot be attributed solely to the abnormally low interest rates experienced since the global financial crisis up until 2022. It is true that both the viability and profitability of transactions are highly sensitive to fluctuations in interest rates, and that a prolonged period of low rates encourages private equity activity. Moreover, leveraged buyouts (LBOs) are even more affected by interest rate levels and applicable risk premiums due to their high levels of debt. This connection means that activity in this segment of private equity is particularly responsive to changes in the interest rate environment.

While the significant growth in private market activity has been supported by a favourable environment of low interest rates, there are indications that this represents a structural trend. This trend is based on changes in various aspects of the financial system and its participants, which have created sustainable and self-reinforcing conditions for the sector. These advantages stem from the flexibility offered by private equity and credit financing, as well as the inherent business model of private investment, which will be explored in further detail below.

Buying to sell vs. buying to hold

One of the most commonly cited factors in academic literature that contributes to the success of private equity management is the alignment of interests between the owners and the management team. Often, the managers of the investment firm invest a portion of their own capital (typically 1-5%) alongside the firm's investments. In 1989, Michael Jensen[4] anticipated the "eclipse" of publicly listed companies, arguing that unlisted companies addressed the weaknesses stemming from conflicts of interest between owners and managers.

Another factor contributing to the high returns on private equity investments is the "aggressive" use of debt, which enhances the return on equity used for acquisitions. This effect is further supported by tax incentives for interest expenses in many jurisdictions where private equity is most active. However, the significance of leverage in creating value within private equity has diminished over the past few decades, dropping from 50% in the 1980s to 17% in the 2010s, according to data from Goldman Sachs, BCG, and IESE.[5] This shift reflects a greater focus on operational improvements within companies, such as revenue growth – either organic or through acquisitions – and enhanced profit margins.

4 Jensen (1989).

5 Moonfare (2023).

According to Barber and Goold,[6] the primary reason lies in the different strategies adopted by private equity compared to listed companies. Private equity tends to favour a "buy to sell" approach, whereas listed companies typically follow a "buy to hold" strategy.

Their theory is that private equity firms usually acquire companies to manage and guide them through a transitional phase aimed at enhancing performance, ultimately enabling them to sell these companies for a profit later on. This approach merges effective company management with investment portfolio oversight, which the authors believe contributes significantly to the success of private equity. Private equity purchase targets can include anything from subsidiaries of listed companies to entire listed firms.

In the United States, private equity has a tax advantage when selling acquired companies: it is not subject to capital gains tax due to its status as a private partnership. In contrast, listed companies must pay corporation tax when they sell a unit or subsidiary. A recent study by Phalippou (2024) estimates that private equity firms have generated $1 trillion in management fees since 2000 through a method known as carried interest. This method is taxed as long-term capital gains rather than as annual income, which reduces their overall tax burden.

The increase in available private funds

The rise in funds raised by private equity managers, driven by a prolonged period of low interest rates, has enabled larger financing rounds and delayed the IPOs of companies which are the object of investment. This trend offers companies continuous financing throughout their value creation cycle, adhering to consistent criteria within an ecosystem that is acutely aware of the nuances of different business models.

For instance, Uber successfully raised $25 billion from 2009 to 2019, while Facebook managed to secure *only* $2.2 billion from 2005 until its IPO in 2011.

In the United States, the result has been a decline in the number of IPOs; however, the companies that have gone public tend to have higher valuations, as they are typically well-established with less potential for significant value growth.

For years, private equity managers have pooled resources and collaborated to gain access to larger transactions through club deals, which function similarly to loan syndications. Activity in club deals peaked before the major financial crisis, but subsequently declined significantly, reaching record lows in 2013. As interest rates remained low, club deals made a resurgence, facilitating larger acquisitions. According to Bain & Company, this trend has led to an increase in both the number of large transactions and their average size, surpassing $1 billion.

6 Barber & Goold (2007).

Demanders from emerging sectors in new areas of the economy

Credit and capital seekers in the technology sectors, where private equity plays a significant role, tend to favour this financing alternative due to its flexibility. These companies feature a high degree of innovation, resulting in considerable volatility and uncertainty regarding their revenue and expected profitability. This situation complicates access to highly regulated bank financing, which often penalises the use of internal resources in such operations. Consequently, innovation, along with other well-known factors such as clusters associated with top-tier universities, is typically financed through market-based routes, including bond issues – challenging to undertake without a credit rating history – and through private equity and, more recently, private credit.

Brau & Fawcett (2006) note that the primary reason company executives choose not to pursue an IPO is to retain decision-making power and ownership of the company. When it comes to debt financing, companies prefer customised solutions, certainty in loan approval – since they do not rely on a larger number of participants typical of syndicated loans – and the formation of long-term relationships with lenders.

This perspective was highlighted during a meeting of the Advisory Committee on Small and Emerging Companies at the Securities and Exchange Commission (SEC) in 2017. It was noted that founders of new companies prioritise the control and flexibility offered by private financing, along with the opportunity to take risks in their business models without facing constant scrutiny from stock market investors.

The reduced activity of banks in financing SMEs (discussed in the following section) has shifted some of this business to private markets, which have been able to provide the necessary funds for companies in the new economy. As noted by BlackRock,[7] public markets are undergoing a structural change, focusing more on large financing deals and leaving medium-sized enterprises out of the picture. This is evident in the case of syndicated loans, which have experienced growth since the financial crisis driven by larger transactions (with an average deal size of $400 million in the United States). Such a focus has created a barrier to entry for SMEs, highlighted by the stagnation of syndicated loans under $50 million since 2008.

In a climate of rising interest rates, banks may further reduce their lending activities for risky investments in these ctypes of companies, which could also contribute to the continued growth of private financing.

Regulatory changes in banking

The regulatory changes implemented after the major financial crisis have restricted the use of banks' own funds in traditional lending, particularly to companies without a credit rating. These increased regulatory capital costs have

7 BlackRock (2023).

diminished banks' activities in the SME sector, paving the way for private credit to fill the gap.

The report *The Future of European Competitiveness* (2024), led by Mario Draghi, acknowledges that while bank financing still represents the majority of business funding in Europe, it is not the most effective means of fostering innovation. According to the report, innovation requires investors who are "patient and risk-tolerant", in contrast to banks, which operate under heavy prudential regulation.

In the private credit segment, the Ares report[8] highlights that growth in the United States can be attributed to changes in both the competitive landscape of the banking sector and the relevant regulatory environment. Since the mid-1990s, banking consolidation has led to the emergence of larger banks that predominantly focus their lending on large corporations, often at the expense of SMEs. Moreover, regulatory changes following the major financial crisis have discouraged the financing of illiquid assets and hastened the transition from a traditional "buy-to-hold" model – where banks used deposits for long-term lending – to an "originate-to-distribute" model. In this latter approach, banks act as intermediaries between borrowers and lenders, facilitating this intermediation through the issuance of structured and packaged financial assets.

For US banks, the share of industrial and commercial loans in their portfolios has steadily declined from over 26% to around the current 15%, with significant drops occurring after the implementation of the Dodd-Frank Act in 2010 and Basel III in 2014.

Reporting requirements for listed companies

Regulatory changes have impacted not only solvency requirements but also the reporting obligations for listed companies. These reporting requirements, essential for informed investment decisions, impose significant costs in terms of time and resources on these companies. In particular, many technology firms are hesitant to disclose details of their business models during the early stages of development.

In the United States, the National Securities Markets Improvement Act (NSMIA) of 1996, as noted by Ewens & Farre-Mensa (2019),[9] allowed start-ups and private equity funds to raise larger amounts of capital by broadening the pool of investors and the states they could access.

Activist investors in public markets may interfere in the management of companies whose innovative business models require stability and confidentiality until their viability is confirmed. This creates an additional incentive for firms to seek funding from private markets instead of public ones.

8 Ares (2020).

9 Ewens & Farre-Mensa (2019).

Like all segments of the capital markets, mark-to-market valuations that deviate significantly from fair values based on fundamentals pose a potential risk and can significantly hinder sustainable growth, especially if investors exit suddenly.

Private equity managers openly prefer to take the listed companies they acquire off regulated markets, allowing them to focus on their management strategies without being influenced by daily price fluctuations. A pertinent example[10] is the takeover bid by Manzana Spain Bidco, which is wholly owned by Apollo funds, for the Applus Group, as detailed in the purpose of the transaction (see section 4.1 of the prospectus).

Some authors have noted that companies with a significant proportion of intangible assets, particularly intellectual property, are often hesitant to meet periodic reporting obligations. They view their business models as particularly sensitive and prefer to keep them shielded from third-party scrutiny. Firms valued at tens or even hundreds of millions of dollars, such as ByteDance (a content platform), OpenAI (artificial intelligence), Stripe (payments), and SpaceX (aerospace), have yet to go public.

Value creation in private markets. Decline in IPOs

The ongoing global decline in IPOs in recent years has made it more challenging for private equity firms to divest their holdings. According to PitchBook data, private equity firms in the United States and Europe held onto their investments for an average of six and a half years in 2022, compared to just over four years in 2000.

The latest Global Private Equity Report 2024 by Bain & Company estimates that private equity managers currently have 28,000 companies in their portfolios that remain unsold, totalling about $3.2 trillion. Notably, 40% of these companies have been operating for more than four years, bringing them closer to potential exits through IPOs or sales to other funds.

As a result of the expansion of private shareholdings and the time frames for value creation in companies, private equity retains a significant portion of the increase in value from a company's inception to its consolidation and potential IPO. This aligns with the value creation curve for newly established companies, where the most substantial increases in value typically occur in the early years, following an inverted S shape. During this initial phase, the risk of failure is highest, which means that private equity assumes a considerable level of risk. For this reason, many asset managers acknowledge the importance of participating in private equity to capture the peak value creation opportunities presented by emerging

10 "… the Offeror believes it is beneficial for the Applus Group and its management team to delist the company at this stage. This will enable them to concentrate on implementing long-term initiatives without the distractions of fluctuations in listed share prices and the need to meet short-term expectations from capital markets. Consequently, the Offeror will advocate for the delisting of Applus shares from the stock exchanges".

companies. For instance, in November 2023, Norges Bank, Norway's central bank and manager of the sovereign wealth fund with assets exceeding $1.4 trillion, sent a letter to the Minister of Finance requesting authorisation to invest regularly in private equity funds, while remaining mindful of the fund's volatility limits.

Overall, structural changes are occurring in both private and public capital markets, with each influencing the other. Some key aspects of this interconnection are discussed in Section 3 of this document.

3 Interconnections between public and private markets

Old economy vs. new economy

Stock exchanges emerged in Amsterdam in the 17th century, serving as vital venues for financing companies through IPOs and capital increases. Their role was particularly significant in supporting companies from the "old" economy that emerged in the early 20th century, giving rise to large corporations with substantial capital investment requirements essential for manufacturing, storing, and distributing goods. According to Jensen,[11] stock markets played a crucial role in reducing excess capacity in certain sectors and facilitating business consolidation in the 1980s through LBOs and hostile takeover bids. Notably, 1988 witnessed the largest hostile takeover bid recorded at that time, valued at $25 billion, when private equity firm KKR acquired RJR Nabisco.

The companies from the "new" economy, which emerged in the early 2000s, are driving the transition to the internet, online activities, and the so-called "fourth industrial revolution". Compared to their old economy counterparts, these new economy companies generally incur much lower sales costs due to their business models, which involve reduced operating expenses. They do not require production facilities and extensive distribution networks, and they also offer more scalable products. The widespread adoption of cloud services has enabled these new companies to avoid significant investments in equipment and systems.

This shift has resulted in a substantial change in capital requirements, with new companies primarily allocating funds to R&D rather than permanent investments. It is important to highlight that, regarding capital-intensive industrial activities, both Europe and the Unites States initiated a process of globalising their supply and production chains. This involved relocating a significant portion of their manufacturing operations to Asia while retaining highly concentrated activities in their home countries that focus on human capital and intangible assets, which require less capital investment.

However, several business models rely on achieving significant network externalities, which necessitate substantial investments – not just in production facilities, but also in advanced software. For instance, Uber has invested heavily in owning a fleet of vehicles and has allocated $1 billion towards R&D for autonomous cars. Through successive financing rounds, they have managed to meet their expansion needs in private markets before going public, a strategy that previously would have involved seeking funds in public markets. A similar

11 Jensen (1993).

situation occurred with Amazon. To expand its business model and international presence, Amazon needed significant investments in logistics warehouses and went public just two years after its launch, in search of capital that was unavailable in private markets at the time. Earlier, in 1995, shortly after its founding, Amazon secured $8 million in a Series A funding round from Kleiner Perkins Caufield & Byers. This investment yielded a 55,000% return for the private equity firm by 1999, after Amazon's IPO.

Start-ups focused on generative AI, including large language models (LLMs) like ChatGPT, require substantial resources due to their increasing demands for computing power and data. Ethan Mollick from Wharton estimates that future versions will need around $1 billion, a significant increase from the $10 million required in 2022.

The recent launch of the artificial intelligence chatbot DeepSeek in January 2025 made a significant global impact, even challenging the highly capital-intensive development models of artificial intelligence in the United States, which captured 50% of global venture capital investments in the final quarter of 2024. This opens up an intriguing area for future research: whether the influx of private equity into the artificial intelligence sector has contributed to a bubble in valuations and in potentially unviable projects that offer lower returns compared to more efficient alternatives, all bolstered by the abundant availability of private funds. Private equity and venture capital firms are investing throughout the entire artificial intelligence value chain, including data centres and cloud services. In a business model like artificial intelligence, which was seen as having escalating development costs until DeepSeek's arrival, reliance on private equity could pose a significant challenge if funding were to decline.

Representation of the new economy in stock market indices

Many prominent global stock market indices consist primarily of companies from traditional sectors such as banking, insurance, and energy. For instance, the Ibex 35 has a large weighting in financial services (28%) and oil and energy (23%), along with technology and telecommunications (15%). This concentration may restrict asset allocation options for investment managers seeking exposure to new economy sectors. Additionally, the FTSE 100 index features a substantial number of companies from the old economy, particularly in mining and energy.

The stock market as a vehicle for divestment and private equity investment

Private capital markets would struggle to sustain their level of financing without the presence and interconnection of public markets (stock exchanges). Together with sales to other entities and the secondary market, these avenues provide the natural exit routes for investments.

For most private equity-backed companies, the primary objective has typically been to go public (across different segments based on their potential capitalisation) or to be acquired by a larger listed company. However, in recent years, the growth of the secondary market and the influx of private equity funds seeking returns have allowed new companies to remain private for longer periods.

One of the most notable trends in the last decade concerning the relationship between private and public capital markets is the increasing time it takes for technology companies to go public. According to McKinsey,[12] before 1999, software companies typically launched an IPO within four years of their founding. However, since 2014, technology firms have averaged around 11 years before debuting in regulated markets. Furthermore, more companies are achieving a valuation of $1 billion (often referred to as "unicorns") prior to their IPO.

The delay in going public in the United States has resulted from two main factors: first, the regulatory change introduced by the 2012 JOBS Act, which increased the number of investors in a company requiring it to go public from 500 to 2,000; and second, a consistent rise in available private funding. Additionally, staying in private markets allows technology companies to concentrate on their long-term business strategies without the pressure of public scrutiny over short-term performance. This environment also lets them avoid disclosing critical elements of their operations that contribute significantly to their competitive edge, helping them fend off hostile takeover bids and the intrusion of activist investors.

However, this delay in IPOs has occurred alongside rising company valuations, which has hindered the subsequent success of these offerings, as they have often been priced with limited potential for growth. It is important to note that the dot-com bubble of 2000 had a more significant effect on companies listed on regulated telecommunications markets than on those in the internet sector. Currently, high valuations are seen in the private market, and as previously mentioned, these valuations not only undermine the success of IPOs, risking the discouragement of future investors, but also render recent rounds of private equity fundraising less appealing due to lower potential returns.

From a critical standpoint, the absence of IPOs for technology companies on the Spanish stock market stems from the caution exercised by private funds in light of the bleak outlook for public offerings. This is particularly true for those investing in later stages, as they are the ones expected to take companies public. The decline in divestments (exits) due to this lack of IPOs delays investment in subsequent funding rounds, creating a ripple effect that underscores the connections between public and private markets. In recent years, the highest number of IPO withdrawals has occurred in the technology and health sciences sectors, highlighting the lack of alignment between the valuations of potential candidates and the expectations of investors.

In private equity, stock exchanges provide a significant number of companies targeted for LBOs, which often lead to delisting. In the context of the Spanish stock market, a recent example illustrating the interconnection between private equity and regulated markets is the takeover bid launched on 30 June 2023 by the US

12 Erdogan et al. (2016).

private equity firm Apollo for 100% of Applus+, valued at €1.23 billion. In recent years, BlackRock acquired Hispania and delisted it in 2014. In 2015, Brookfield purchased Saeta Yield. A consortium that included the EQT fund took over and delisted both Parques Reunidos and Solarpack. KKR acquired Telepizza in 2018 and subsequently delisted it in 2020.

The appeal of US stock markets

Another important factor to consider is the increasing attractiveness of the Nasdaq and NYSE as listing venues, particularly for European companies of significant size. Many of these firms are backed by US private equity firms that prefer the post-IPO environment offered by these exchanges, which are close to sources of liquidity. In 2024 alone, the London Stock Exchange lost 88 listed companies, some of which were acquired by private equity firms, while others began trading in the United States.

A recent example is the IPO of the British chip manufacturer ARM on the NYSE, which was oversubscribed five times.

The denominator effect

A key consequence of the interconnection between public and private markets is the “denominator effect”. To grasp this concept, it is important to recognise that institutional investors allocate a specified percentage of their portfolios to alternative investments and unlisted assets, while another portion is assigned to assets in regulated markets. This diversification strategy aims to maintain a consistent balance over time.

Significant corrections in the prices of assets traded on public markets lead to a decrease in their percentage allocation relative to private assets. This results in an overexposure to private assets. Due to their illiquidity, private asset prices adjust with a delay (or lag) compared to the immediate revaluations (mark to market) seen in public markets, which benefit from greater liquidity.

Throughout 2022, public market prices fell more sharply than those in private markets. This disparity caused an overweighting of private markets in relation to public markets. Given the challenges of selling private holdings, investors had to adjust their portfolios to restore target investment percentages between the two markets. Consequently, they slowed down new contributions of private funds during 2023 until they achieved a better balance in their investment allocations between public and private markets.

Scale-up markets in regulated environments

Scale-ups are companies with proven business models that achieve annual growth of 20% over the last three years. These companies must have a minimum turnover of €1 million or have received at least that amount in investment. Once a scale-up’s valuation exceeds $1 billion, it is classified as a "unicorn". These companies play a crucial role in driving innovation and creating jobs.

There are an estimated 1,200 unicorns worldwide, with 700 based in the United States, where 344 were created in 2021 alone. However, in 2023, the rate of new unicorn creation has slowed, reaching its lowest level in six years, with only 45 new unicorns formed in the United States. Notably, there has been a significant concentration of these new companies in the artificial intelligence sector over the past few months. The challenging environment resulting from higher financing costs is also reflected in companies' valuations, which have fallen compared to previous funding rounds. According to *The Spanish Tech Ecosystem Report – 2024*, Spain ranks seventh in Europe with 18 unicorns.

"Centaur" companies, valued between $100 million and $1 billion, represent a stage of development below unicorns. These companies have raised Series B funding, typically securing between €20 million and €30 million, and have usually completed two to three prior funding rounds. Between 2020 and 2023, approximately 50 companies in Spain are estimated to have received financing rounds exceeding €20 million, positioning them as centaurs.

Mario Draghi's 2024 report on European competitiveness reveals that many European companies prefer to seek funding from US venture capital funds and investors to access the US market. Between 2008 and 2021, 30% of European unicorns relocated their headquarters to the United States.

According to the Start-ups Observatory of the Bankinter Innovation Foundation, Spain has around 450 scale-ups, nine of which are valued at over $1 billion (unicorns, including Jobtalent, Devo, Fever, Cabify, Travelperk, Domestika, Recover, Copago, and Factorial). Among the three former unicorns, Idealista was acquired by EQT in 2020 for €1.3 billion and sold to Cinven in June 2024 for €2.9 billion. Glovo was purchased by Delivery Hero in 2023 for €780 million, while Wallbox was the latest unicorn to go public. Other significant transactions include Ardian's acquisition of Adamo, an internet and fibre optic company, for €800 million, and Red Ventures' purchase of Rastreator in 2020 for €560 million.

Approximately 34,000 companies in the United Kingdom qualify as scale-ups, contributing nearly as much to GDP as 6 million smaller SMEs. These scale-ups face the decision of whether to remain private or go public, although they are doing so later than in the past. Their choice is influenced by their growth cycle, the types of investors they wish to attract, and their development plans.

Several initiatives from regulated markets aim to support the transition from private to public for these companies.

In Spain, one such initiative is BME Scale, a market operating as a multilateral trading facility (MTF) designed to help scale-ups that cannot access the BME Growth market to list on an MTF instead.

Similarly, the London Stock Exchange (LSE) has introduced an intermittent trading venue, allowing scale-ups to stay unlisted while providing liquidity windows for their shareholders at specific times through the LSE's trading systems, complete with price and volume limits. During these liquidity periods, only professional investors would have access to information and protections similar to those in regulated markets, without requiring company managers to commit to a specific timetable for an IPO. These liquidity windows allow initial investors – such as shareholders and private equity or venture capital funds – to exit their investments while also enabling new investors to come in. However, this system would not serve as a primary market for raising new funds.

In 2014, the Nasdaq Private Market was introduced, providing a MTF where investors can buy and sell shares in unlisted companies.

Private equity firms going public and potential consolidation moves

Several of the largest private equity firms are now publicly traded. These include Blackstone Group Inc. (BX), valued at $138 billion; Apollo Global Management (APO), valued at $52 billion; KKR & Co. Inc. (KKR), valued at $68 billion; and Carlyle Group Inc. (CG), valued at $13 billion. In Europe, CVC Partners announced on 15 April 2024 that it plans to launch an IPO on Euronext Amsterdam, aiming to raise approximately €1.25 billion.

In a climate of higher interest rates, raising new funds and seeking new company acquisitions become more challenging. This situation may concentrate activity in the largest or most successful management firms, possibly leading to a consolidation process aimed at achieving economies of scale.

Evidence of this potential consolidation is emerging in Europe. In the first half of 2023, private equity managers in Europe raised €49 billion, down from €68 billion in the entire year of 2022. Notably, on 20 July 2023, CVC Partners secured €26 billion, marking the largest amount ever raised by a buyout fund. In the same month, Blackstone surpassed $1 trillion in assets under management for the first time. However, fundraising is increasingly concentrated in so-called "mega funds" – those that raise over €5 billion – particularly in two firms: Permira, which raised €16.7 billion, and CVC Capital Partners, which secured €26 billion. This trend towards concentration among the largest managers began in 2022 and persisted into 2023, when the 25 largest firms accounted for 41% of total funds raised, according to data from McKinsey & Company.

4 Key aspects of the private market investment process

Creation of the investment vehicle

Investors have two options for participating in private markets:

i) Investment through funds: this involves entering via funds managed by general partners (GPs), which adopt a fee structure similar to hedge funds, typically comprising a 2% management fee plus 20% of carried interest.[13]

ii) Co-investment: in this approach, investors participate directly with the managers, thus avoiding management fees.

Funds managed by general partners (GPs)

Unlike open-ended investment funds, contributions to private equity funds come with clauses that specify a timeframe, usually spanning 10 to 15 years. During this period, the manager (general partner or GP) identifies, manages, and ultimately liquidates investment opportunities on secondary markets, to other investors, or through IPOs, while also accounting for any potential losses. The initial 5 to 6 years represent the fund's investment period, during which managers may call upon the capital committed by investors that has not yet been disbursed (known as a "capital call" or "drawdown"). The term "dry powder" refers to the capital that investors (limited partners) have committed but that managers (general partners) have not yet allocated.

After this initial investment period, managers typically do not request additional capital, except for covering fees or expenses and monitoring existing investments. Once investments are realised – whether through sale or IPO – the capital and any profits generated are distributed to investors. Therefore, in this process, both the contributions of committed capital and the returns upon liquidation are entirely controlled by the managers, leaving investors unable to influence the timing of investment or divestment.

The fundraising process in private markets, particularly within private equity and venture capital segments, typically unfolds as follows. Initially, a period of 12 to

13 In Spain, the Start-up Law classifies carried interest as income from work. Taxpayers must include 50% of this income in their personal income tax (IRPF), while the other half is exempt from taxation. In the United States, carried interest is taxed as capital gains rather than ordinary income, meaning that 20% of the commission on investment returns benefits from a lower tax rate.

18 months is dedicated to raising funds. During this time, the investor or allocator[14] commits to a closed-end fund, agreeing to contribute a specific amount of capital (commitment) that will only be disbursed once the management entity identifies investment opportunities. This capital commitment designates the investor as a limited partner (LP) through the signing of a limited partnership agreement, while the asset manager takes on the role of general partner (GP). It is common for managers to invest in the fund as well, usually around 1%; this proportion has increased to 2–3% in recent years, aligning the interests of both investors and managers.

Co-investment

Co-investment allows investors to directly join managers in various projects, bypassing established funds. This approach primarily attracts family offices, enabling them to access projects individually and exercise greater control over their allocated funds.

However, this option remains quite limited, with only $10 billion raised in 2022 compared to over $800 billion for the private equity sector as a whole.

Staged investment (rounds)

A defining characteristic of private equity markets is investment in stages or through successive financing rounds. Instead of providing all the committed capital at once, contributions are made gradually to companies, particularly start-ups, as their projects evolve and develop. This approach allows managers to gather information, monitor the company's progress, and retain the option to withdraw if the management team fails to meet expectations or if the business model becomes invalid due to issues with the product, service, or technology offered by the start-up. The staged investment model serves as a robust control system, enabling periodic analysis of the company's profits and prospects, with more frequent evaluations occurring when the intervals between financing rounds are shorter.

In Spain, the initial funding rounds, called "pre-seed", are small in volume and can reach up to €200,000. In these rounds, business angels who specialise in the early stages of start-up development invest their own capital in small portfolios of fewer than five companies. The next round, known as "seed", typically raises between €700,000 and €1 million, with participation from business angels, family offices, and venture capital funds. Following this is the "late round" or pre-series A, which raises between €2 million and €3 million. Once the early financing stage is complete, the need for capital increases, leading to larger funding rounds known as Series A, B, etc. These later rounds average around €10 million each and heavily rely on large international funds, particularly from the United States, as few national funds manage over €1 billion in assets.

---

14 An agent looking to invest funds is typically a pension fund, sovereign wealth fund, family office, or university endowment fund.

One of the best examples of financing through rounds is Uber, the mobility services company that harnessed the potential of mobile phones to create an alternative business model to traditional taxis. Since its launch in 2009, Uber has completed 28 financing rounds, raising $25 billion before its IPO in 2019. In each successive round, it secured more capital than in the previous one, allowing it to cover the high costs of establishing its network of cars and drivers across various countries. Uber reported its first positive results in the second quarter of 2023.

Given the characteristics of each stage of a start-up's development, private equity managers often specialise in specific rounds of financing, which involve increasing amounts based on development needs. In recent years, the most competitive segment has been late-stage financing[15] (pre-IPO), attracting a growing number of investors. Traditionally, this round was reserved for companies nearing the public offering process. However, due to the recent scarcity of IPOs, there has been a shift towards raising larger funds.

Investor relations

Managers rely on establishing long-term relationships with a select group of institutional investors,[16] who have a strong history of allocating alternative assets to their portfolios and share aligned interests, as both parties invest in the same projects. In the United States, the primary private equity investors are pension funds, which account for an estimated 40% of the capital contributed. Other significant players include sovereign wealth funds, which are increasing their participation, family offices, and private university endowments. Over the past decade, institutional investors have raised their allocation to private markets to 27% of their portfolios, which is 10 percentage points higher than the average exposure since 2013. Institutional investors are acutely aware of the unique aspects of investing in private equity and credit markets, particularly their illiquidity and associated risks. As a result, they set maximum allocation limits for these assets. This awareness has reduced the need to develop distribution channels similar to those found in the investment fund industry.

A key characteristic of institutional investors in private markets is not only their ability to assess risks but also their proactive approach when they believe that managers' actions could lead to potential issues for them. For example, as noted in Section 7, they played a significant role in the substantial reduction of lending against asset values to pay dividends in the second half of 2023.

Since the latter half of 2022, difficulties in raising funds have prompted private equity managers to provide incentives to institutional investors, including sovereign wealth funds and pension funds.[17] These incentives consist of reduced management fees and, in some cases, larger co-investment stakes. Reflecting this

15 Gurley (2015).

16 Bain & Company (2023).

17 Financial Times (2023b).

trend, as discussed in Section 7, private equity managers are also acquiring stakes in insurance companies to gain access to their long-term asset management.

In the current climate of limited access to new funds, another approach being adopted by managers is deal-by-deal fundraising. This strategy allows institutional investors to select where to allocate their funds on a company-by-company basis, enabling a more tailored assessment of risks and the benefit of lower management fees.

Due to the challenges of IPOs and sales to third parties in recent years, combined with a higher interest rate environment, private equity managers have adopted debt financing as a strategy to return contributions to investors according to their planned schedules. This involves using the investment portfolio as collateral, a practice known as "net asset value financing". Such an approach introduces an additional "layer" of debt to the business, alongside the initial debt typically seen in leveraged buyouts (LBOs).

Historically, the private equity industry has provided distributions – returns of capital to investors through exits from portfolio companies – averaging around 25% per annum of the fund's value. However, in 2023, investment bank Raymond James reported that this distribution rate fell to 11%, the lowest level since 2009. This decline stems from the difficulties discussed earlier in exiting portfolio investments, either through IPOs or sales to other firms within the sector. This low distribution rate is reminiscent of the figures seen during the dot-com crash in 2000 and the major financial crisis of 2007.

During that period investors could not, in theory, recover their capital. This is one of the primary reasons why private equity investors typically adopt a long-term investment horizon, as seen with pension funds, insurance companies, and university endowment funds.

In Europe, the Draghi report indicates that in 2022, pension fund assets amounted to 32% of GDP. In contrast, the figure for the United States is 142%, with public pension funds investing 13% of their assets in private equity. This figure does not account for additional investments from private pension funds, sovereign wealth funds, and university endowments, which are significantly higher than the allocations made by these same investors in Europe. This disparity in institutional fundraising capabilities may help explain, alongside the prevailing financial culture and the start-up ecosystem, the differing levels of development and maturity of private equity markets in Europe and the United States.

In Spain, investment in private equity by national insurance companies and pension funds is notably lower than in comparable economies, according to a report by the Boston Consulting Group.[18] A significant portion of this investment is directed towards managers based outside Spain, which contrasts with the trends seen in other European countries and developed economies. This tendency for a greater international allocation of alternative assets aligns with the practices of

18 Boston Consulting Group (2021).

private banking and family offices and highlights a potential growth area for Spanish private equity.

As retail investors show increasing interest in private equity, managers need to clarify several aspects:

i) The specific retail segments they aim to target.

ii) The products they will offer.

iii) The strategies and distribution channels they plan to implement, potentially through partnerships with investment firms or banks.

Exit alternatives before maturity

There are two mechanisms that provide liquidity for investors looking to exit their private equity and credit investments: secondary funds and continuation funds.

Secondary funds

Both investors and managers can use secondary funds to sell their holdings in companies or assets. These funds represent a valuable investment tool in private equity. In fact, in 2023, the total amount raised for new secondary funds reached $76 billion, marking a 92% increase compared to 2022.

Private equity (PE) boasts the most active secondary market, with real estate, private credit (PC), and infrastructure gaining importance. According to data from Lazard, the secondary capital market in 2023 set a record, achieving a historic volume of secondary fund transactions totalling $112 billion. In September 2023, Goldman Sachs successfully raised $15 billion for a secondary fund named Vintage IX, following its predecessor, which garnered $10 billion in 2020.

Exiting private equity funds early incurs costs, as the exit price typically includes a discount to the net asset value (NAV). Research by Nadauld et al. (2016)[19] indicates that secondary market prices relative to NAV ranged from 86.2% to 85.6% for a sample of 2,226 transactions conducted between 2006 and 2014. The authors note that discounts tend to be larger when economic prospects are poor and when funds are smaller. This period included part of the major financial crisis, which likely contributed to the increased discounts.

In 2019, amidst heightened competition and a more favourable economic environment, the average price achieved in secondary market transactions rose to 93% of NAV, according to Unigestion.[20] Discounts on NAV are particularly pronounced in venture capital and growth capital, often ranging from 35% to 45%.

---

19 Nadauld, Sensoy & Weisbach (2016).

20 https://www.unigestion.com/insight/the-upside-of-a-downturn-secondaries-in-2023/

Continuation funds

In continuation funds, managers transfer one or more assets into the fund. These assets typically belong to companies that show potential but require more time to mature. The managers establish a new fund with these assets and offer investors (limited partner or LPs) either a price for exiting or the chance to invest in the new fund.

A continuation fund generally includes between one and five assets in its portfolio, making it less diversified than the original fund and concentrating risk on a small number of companies. One example in Spain is Miura Partners. Since becoming a shareholder in Martinavarro in 2016, they facilitated its integration with Rio Tinto to create Citric&Co in 2017 through a buy-and-build strategy, where a company purchases another to expand its size by acquiring competitors. In 2019, Miura continued its investment in Citric&Co through a continuation fund and pursued the acquisition of additional citrus companies in 2021 and 2022.

Europastry, which suspended its planned IPO in October 2024, is backed by the MCH Continuation Fund, the successor to MCH Iberian Capital Fund II, which had held an initial stake in Europastry since 2010.

5 Relevant aspects of private market segments

Private equity (PE) vs. venture capital (VC)

Private equity (PE) and venture capital (VC) are two categories of investment within the broader segmentation of private market activities, which also includes private credit and infrastructure. While PE and VC share some similarities, their distinct characteristics allow for separate categorisation.[21]

Private equity:

- Private equity managers typically acquire majority stakes in companies, focusing on mature businesses that operate in traditional sectors. This majority ownership enables them to enter the management of the target company, to which they bring their own qualified and experienced management teams.

- PE also seeks investment opportunities in established companies facing challenges due to operational inefficiencies. By addressing these inefficiencies, managers aim to restore these companies to profitability. In recent years, private equity has increasingly targeted technology firms that have received venture capital funding. These investments aim for returns through operational improvements, organic growth, and company expansion, alongside the application of financial engineering.

- Investments are made using capital from the fund or management, as well as through debt financing.

- The four largest private equity firms – Apollo Global Management, Blackstone Group, Carlyle Group, and KKR & Co – are actively traded on regulated markets.

Venture capital:

- Venture capital focuses on start-ups, primarily high-growth companies in the technology and healthcare sectors, where it typically acquires minority stakes.

- Investors seek returns by increasing the value of these target companies, which can be realised through sales to larger firms or via IPOs.

- Transactions in venture capital tend to be smaller in scale compared to those in private equity.

21 Pitchbook (2023b).

- Funding for these investments comes from cash contributions.

- Over the past decade in the United States, 74% of exits for venture-backed companies have occurred through sales to larger companies, according to Pitchbook data featured in an article in *The Economist*.

Private equity investment vehicles TABLE 2

VENTURE CAPITAL

Venture capital involves providing funding to companies in their initial or early stages of development. Investments typically target technology firms, businesses in the healthcare sector, or those with a strong innovative focus.

Seed capital

Seed capital is used to invest in business ideas or newly established companies that have yet to launch their products or services in the market and, therefore, generate no sales. This represents the first round of institutional financing and is the smallest in terms of volume. The funds are allocated for product or service development, market research, or creating a business plan. Investors in seed capital generally receive convertible notes, equity, or preference shares in return. The investment carries a high level of risk, as many of these companies struggle to establish a viable business model and may fail before achieving economic sustainability.

Start-up capital

Investment for establishing a company, covering expenses such as registration, website creation, and office setup. This funding is crucial for initiating operations, especially when a company may be generating sales but has a negative EBITDA. The amount of capital provided is typically greater than what is allocated in seed capital investments.

Early stage – Late stage venture

In the early stage, the company is in development, necessitating larger financing to support its operations once the viability of its product or service has been verified. Funding is provided in rounds known as A and B, which correspond to this early growth phase. Rounds A and B correspond to the early stage phase.

As a start-up advances, it may secure more substantial funding rounds, referred to as other early stage financing.

Growth-late stage: This stage applies to companies that are already generating sales and may have a positive EBITDA. Funding rounds during this phase are labelled C, D, E, F, G, and can continue to K, depending on how many times the company has sought new investments.

By this point, target companies typically have business models that demonstrate viability.

To summarise in very simple terms, a company starts with a Series A funding round, consolidates its business with a Series B, and, in a maturation phase, a Series C funding round brings the company close to acquisition by third parties or to an IPO.

Risks: High valuations in the later funding rounds can jeopardise IPOs and the overall profitability of the investment.

PRIVATE EQUITY

Growth capital

Growth capital finances the expansion of profitable companies. The funds are typically allocated for the acquisition of fixed assets, increasing working capital for developing new products, or entering new markets. These investments are generally larger and carry less uncertainty, supported by historical performance data.

Growth capital: Financing profitable companies makes growth capital relatively lower in risk. However, ensuring appropriate valuations remains crucial.

Replacement capital

In replacement capital, the private equity firm takes over part of the existing shareholding. This often happens in family businesses and during succession planning. It may also occur when large companies sell non-strategic assets or business units, where managers or external parties seek financial backing from private equity as part of a spin-off and subsequent independent development initiative.

Leveraged buyouts (LBOs)

A leveraged buyout involves acquiring companies where a significant portion of the purchase price is financed through external funds, partly secured by the assets of the acquired company, and partly through capital contributed by the investors, who then become the owners. Typically, the target company has consistent and stable cash flows that are sufficiently robust to cover interest payments and the repayment of the principal debt. Some features of this type of operation are described in the next section.

Restructuring or turnaround capital

This refers to investment in companies facing prolonged difficulties that require financial resources to implement significant transformations essential for survival. It often entails an operational restructuring that encompasses all aspects of the business, including facilities, personnel, and products.

Source: SpainCap and CNMV.

Buyouts and leveraged buyouts (LBOs) financed through debt issuance

According to global data on assets under management (AuM) from Prequin and McKinsey, which is detailed in Section 1 of this study, company buyouts represent $3.85 trillion in the PE segment. This accounts for 47% of the total private equity assets under management, which amount to $8.2 trillion. Buyouts not only represent the largest area of activity within private equity, but they have also experienced significant growth in recent years, alongside the private credit segment. Over the past decade, these transactions have set continuous records in both the number of deals and company valuations, largely due to low interest rates.

The proportion of buyouts within total private equity assets under management varies by geographical region. Europe (at 74% of the total) and the United States (at 55%) account for the largest share of the total. In contrast, LBOs are less common in Asia, where they account for only 17% of the market, while venture capital dominates at 58%. In Spain, buyouts made up 54% of total private equity and venture capital investment in 2023.

A significant portion of buyout transactions are LBOs,[22] which involve using debt to finance more than 70–80% of the transaction value, with equity making up a maximum of 20–30%. Of this equity, managers typically contribute between 1–5% of the total transaction value. Consequently, a large segment of private equity relies on debt as a key operational tool. These transactions are generally financed with around 50% senior debt, 20–30% mezzanine debt, and the remaining 20–30% from fund capital. However, LBOs have seen a consistent decline in the level of debt employed. This reduction stems from a period of low interest rates, which has increased the availability of private equity, as well as decreased lending activity from banks in this type of transaction.

The shift to a restrictive monetary policy has resulted in significant reductions in bank financing for LBOs during 2022 and 2023. This has led to a 50% decline in volume, particularly impacting larger transactions, along with a decrease in the valuations of target companies. However, in the first half of 2024, LBOs increased by 28% compared to the same period in 2023, reaching $471 billion, according to data from the London Stock Exchange Group (LSEG). According to the *Financial Times*, in response to rising interest rates, managers are shifting their focus towards private credit, and infrastructure and asset managers such as Apollo and BlackRock now have a greater volume of assets under management in credit than in equity. These managers are not only acquiring existing private credit assets but are also originating new ones by directly providing credit to companies.

In LBO transactions, managers and traditional financiers, particularly banks, are moving away from the conventional model. Banks have become increasingly cautious about their exposure to these deals. Managers are now relying less on leverage as a tool for value creation, instead prioritising operational improvements and multiple expansions, alongside a heightened focus on the credit segment.

22 The first LBO in history is considered to have been the purchase of Ford by Henry Ford and his son.

In the late 1980s, leveraged buyouts aimed for profitability primarily through debt, with up to 50% of the value created coming from leverage financed largely by high-yield bonds that emerged in the 1970s. However, the role of leverage in private equity value creation has substantially declined over the 21st century, dropping from 50% in the 1980s to just 17% in the 2010s. This shift, based on data from Goldman Sachs, BCG, and IESE,[23] reflects a greater emphasis on operational improvements within companies, which include increasing revenues – either organically or through acquisitions – and enhancing margins.

The lengthening of holding periods for companies represents another shift in LBOs. In the 1990s and 2000s, a private equity firm typically sold its stake within three to four years of acquiring a company. By 2023, data from Pitchbook across a sample of 1,121 transactions reveals that private equity managers held companies for an average of 6.4 years. This extended investment horizon reinforces the previous thesis about value creation, which now relies not only on leverage and cost-cutting but also on improvements in management practices. Factors such as continuation funds, discussed earlier in this study, are contributing to this trend of longer holding periods.

While target companies are often well-established, the increase in leverage and the prices being offered play a crucial role in determining the profitability of these transactions. Particularly, debt-to-EBITDA ratios are highly sensitive to fluctuations in interest rates and overall economic activity. According to Pitchbook data[24] for the US market, LBO transactions financed through the syndicated loan market in the second half of 2022 recorded a debt/EBITDA ratio of 6.1x, the highest level since 2007 (compared to 5.8x in 2021).

Private equity managers often engage in a strategy known as "leveraged recapitalisation dividends", where the target company pays dividends to managers and investors using borrowed funds. This approach increases the company's debt, while allowing private equity professionals and investors to enhance their internal rate of return (IRR) through the company's leveraging. In Spain, a report by Simmons & Simmons[25] highlights several rulings from the Supreme Court (STS 1088/2020, STS 3199/2022, and STS 3200/2022) that confirm the deductibility of financial expenses related to recapitalisation dividends from corporation tax.

A notable example of a challenging LBO in the market was Apax Partners' acquisition of Panrico in 2005 for €900 million, which came with a price-to-earnings ratio exceeding 45x. The goal was to enhance management and eventually float the company on the stock market. Apax Partners financed the majority of the purchase by issuing €650 million in debt (comprising 72% debt and 28% equity), which was subsequently transferred to Panrico. After several management decisions that did not yield positive results, creditor banks took control of Panrico in 2010. A year later, the Oaktree fund acquired 80% of the company's shares.

23 Moonfare (2023).

24 Lukatsky (2022).

25 Simmons & Simmons (2022).

Traditionally, credit institutions financed the debt component of LBOs through syndicated loans. However, the classification of these loans as leveraged transactions has led to a decline in banks' involvement in this segment. In response, new financing vehicles have emerged, notably through the issuance of collateralised loan obligations (CLOs). These CLOs are secured by a portfolio of loans that support mergers and acquisitions conducted by private equity. Their structure closely resembles that of collateralised debt obligations (CDOs), which played a significant role in the 2008 subprime crisis.

Another alternative funding route involves private credit managers who utilise their platforms and vehicles, effectively displacing banks. As a result, private markets –including capital (20–30%), private credit funds, and CLO issuance – have become increasingly prominent in financing LBOs.

LBO activity employs debt as a means of generating profitability, with some studies in the United States estimating that one-third of returns stem from debt and its associated tax benefits. As a result, this approach is highly sensitive to interest rates and investors' appetite for credit risk.

In 2023, the number and volume of large acquisitions continued to decline, giving way to what are termed "add-ons" (or "build-ups"). These involve acquiring smaller companies within the same line of business, typically with lower transaction values. Private equity funds are increasingly purchasing these smaller firms without relying on debt, aiming to enhance their portfolios by expanding their products and business lines. According to PitchBook, add-on transactions accounted for 55% of all private equity purchases in Europe during the first quarter of 2023, with an even higher percentage in the United States.

Estimates of private equity returns

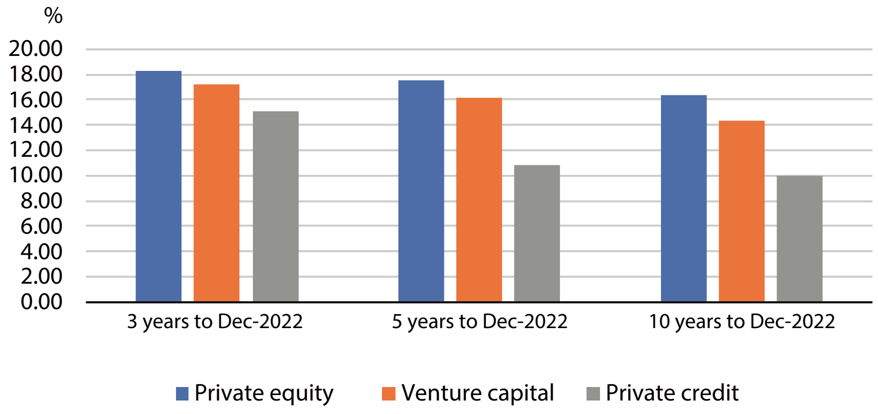
One of the main challenges in monitoring investments in private equity markets is estimating investment returns, as there is no secondary market for the companies involved.

Figure 5 presents returns measured by the internal rate of return (IRR) calculated by Prequin for various categories of private equity and credit across different reference periods. We were unable to replicate these calculations due to the difficulty in obtaining the necessary information, a common issue in the private equity and credit sector. Key data points include the initial year when the investor contributes funds (vintage), capital contributions (capital calls), and capital distributions (what the investor receives net of fees). Although the periods are not directly comparable, a study on the profitability of private equity funds in Spain published by EY[26] in 2021 indicates that the net IRR for the period from 2006 to 2021 averaged 11.2%. This study was based on data from 40 Spanish fund managers, representing 45% of all active fund managers during this period. A more recent study, released in December 2023, expands the number of fund

26 https://www.spaincap.org/downloads/estudio-de-rentabilidad-2022.pdf

managers to 47 (48% of the total) and slightly adjusts the return for the 2006–2022 period to 11.3%.

Percentage of IRR based on year of investment (vintage) FIGURE 6



Source: Prequin and EY.

One of the first academic studies to challenge the profitability of private equity was conducted by Kaplan & Schoar (2005), who concluded that private equity returns were comparable to those of public stock markets after accounting for management fees. Later, Kaplan, Harris & Jenkinson (2012) published new research based on data from various private equity funds, demonstrating that returns exceeded those of public markets by over 3% across an extended period. Specifically, they analysed 1,400 LBO and venture capital funds and found that their returns averaged between 20% and 27% higher than the S&P 500 during the life of the funds, translating to more than 3% per year. Venture capital funds outperformed public markets in the 1990s but fell short in the 2000s.

When comparing private equity returns to benchmark indices, it is important to consider size bias; private equity portfolio companies tend to be smaller than those in leading benchmark indices. Additionally, there is a geographical bias within fund portfolios, with a predominance of the United States.

Another factor to consider when analysing private equity returns, as with hedge funds, is the growing number of participants. This increasing competition complicates the selection of suitable assets, as many funds pursue the same companies and strategies.

Private credit markets

According to aggregate global data from Prequin and McKinsey, the private credit markets held approximately $1.6 trillion in assets under management at the end of 2023, a 27% increase from 2022. This figure has doubled since 2018. In Europe, around €460 billion is invested in private credit, although specific information on the Spanish market is not available. For context, data from the Bank for International

Settlements (BIS)[27] as of June 2023 reveals that the outstanding balance of negotiable debt for non-financial companies worldwide was $4.8 trillion, with Spanish non-financial companies holding an outstanding balance of $130 billion. Notably, $16.6 trillion of this total pertains to the outstanding balance of issued bonds. In certain segments, such as real estate, private financing is increasingly replacing traditional bank financing. In the United States, private credit now accounts for 40% of new loans to the sector, while in Europe, this figure remains below 10%.

The private credit segment known as direct lending has experienced the most significant growth, expanding at an annual rate of 30% over the last decade, according to McKinsey data. As reported by the *Financial Times* on 4 May 2024, Apollo estimated it would originate $200 billion in new private loans during 2024, an increase of $50 billion compared to 2023.

In Europe, data from the *EU Non-bank Financial Intermediation Risk Monitor 2024 No. 9* reveals that Luxembourg and Ireland host the majority of private credit funds. Unlike capital funds, credit funds permit early redemptions during monthly liquidity windows, which is facilitated by the principal and interest payment structure of the loans in their portfolios.

Companies seeking financing in the private credit markets[28] are typically SMEs with EBITDA ranging from $3 million to $100 million. The private credit market can be divided into two main segments: the middle market, which comprises companies with an EBITDA of over €50 million, and the lower middle market, where average EBITDA ranges from €15 million to €25 million. Most of these companies lack a credit rating. However, S&P Global Ratings does provide credit rating estimates for around 1,400 active companies in private credit markets, predominantly in the technology and healthcare sectors, which are also significant in the rated syndicated loan market. Over 90% of issuers in private credit markets are backed by private equity firms. According to McKinsey & Co, 80% of & Co,[29] middle market transactions conducted by private equity have been funded through private loans.

In contrast to the syndicated loan segment, which typically involves multiple lenders, private financing transactions are usually bilateral, occurring directly between the lender and the company. This approach streamlines the process, reducing the timeframe from initial contact to financing approval to approximately two months. It also allows for flexible loans that include variable components tied to the company's performance, as demonstrated by Oquendo Capital's 2022 transaction with Congelados Navarra, which will support the implementation of its business plan for the coming years.

27 BIS (n.d.).

28 Gunter, Latour & Maguire (2021).

29 McKinsey (2023).

According to BlackRock,[30] direct lending is generally provided at a variable interest rate and is secured by the borrower's assets. Unlike syndicated loans, these loans are not transferred to third parties; the lender retains them on its balance sheet until maturity. For instance, BlackRock granted a venture debt loan of €354 million to the Spanish unicorn Jobtalent. This loan includes covenants linked to gross margins and liquidity levels, with a variable interest rate of Libor + 8.5%.

In syndicated loans, two tranches are commonly present: senior and subordinated. In contrast, private loans typically consist of a single tranche (unitranche) that combines senior and subordinated debt. This unitranche carries an interest rate that is 50 to 100 basis points higher than the senior rate, reflecting the differing risk-return characteristics of the two tranches. In debt involving different tranches, each tranche has its own credit terms, guarantees, covenants, and conditions governing how creditors of the subordinated tranche might recover the collateral securing the loan. In unitranche transactions, however, all creditors have identical rights.

The main participants in this market are alternative asset managers who operate through lending platforms. These platforms source financing from various avenues, including: i) private credit funds, ii) collateralised loan obligations for medium-sized companies (middle-market CLOs), iii) investment funds, and iv) business development companies (BDCs). In recent years, low interest rates have directed significant funds towards credit funds seeking higher returns. This trend, along with advancements in financing structures and vehicles, has enabled the provision of larger loans and transactions, similar to developments seen in the PE segment.

One key characteristic of private credit investors is their long-term horizon. These buy-and-hold investments are made by pension funds, insurance companies, university endowments, and foundations, which aim to align interest income from loans with their payment obligations.

BDCs[31] are closed-end funds that must invest more than 70% of their assets in equity or debt of companies not traded on regulated markets, and they are required to distribute 90% of their income as dividends. Established in the United States through legislation in 1980, BDCs aim to provide financing to SMEs and are exempt from corporate income tax. In the United States BDCs can be publicly listed, allowing retail investors to buy and sell shares on the stock market. In contrast, investments in other vehicles and unlisted BDCs are typically held until the underlying debt matures. BlackRock was a pioneer in establishing perpetually non-traded BDCs, designed for high-income investors and not listed on regulated markets or MTFs.

It is estimated that around a quarter of private credit assets under management are held in vehicles structured as BDCs. A typical operational model involves the BDC

30 BlackRock (2023).

31 As of April 2023, there were 130 BDCs in the United States. According to Standard & Poor's, these firms could have invested approximately $270 billion, with around a dozen BDCs accounting for nearly 50% of the total.

originating loans on its platform and distributing them to private credit funds or CLOs managed by the same entity. Managers can invest a portion of their capital both in the BDC itself and in the funds or instruments through which it distributes the loans. According to Moody's, 80% of financing transactions involving BDCs are with companies backed by private equity.

One alternative to paying interest on private loans is the presence of clauses that allow for payment in kind, enabling debtors to make loan repayments in new debt or shares during the initial years.

Six major firms – Apollo Asset Management Inc., Ares Management Corp., Blackstone Inc., Brookfield Asset Management Inc., The Carlyle Group, and KKR & Co. – control a significant portion of private lending activity, with assets exceeding $1 trillion.

In the United States, partnerships between alternative managers and insurance companies are common, providing a very long-term funding source for lending platforms and ensuring financial stability throughout the life of the loan.

Lack of liquidity in credit instruments and vehicles

Illiquidity poses a significant risk in private financing, as the credit instruments involved are not traded on secondary markets. While they may include assignment or sub-participation clauses that allow for the sale or transfer to third parties, there is no public price formation process. Consequently, investors must evaluate the risk-return profile of their investments based on the limited information available to them. Investors need to be prepared to hold the debt until maturity, which makes long-term investors, such as insurance companies, the primary buyers. Vehicles that facilitate early exits for investors may face liquidity challenges, potentially forcing managers to conduct disorderly asset sales during periods of market stress.

Lower credit quality

Firms seeking private financing are often smaller and have lower credit ratings. Although solvency standards in this sector were traditionally more stringent than those for syndicated loans, the growth of private credit in recent years has led to relaxed requirements and a decrease in the number of covenants, which are typically reduced to just one. In contrast, around 90% of syndicated loans, according to Standard & Poor's,[32] are covenant-lite. Similarly, there has been an increase in EBITDA add-backs in both private and syndicated loans.

The following table summarises the main differences between syndicated loans and private financing.

32 Latour (2021).

Differences between syndicated loans and private financing TABLE 3

	Préstamos sindicados	Mercados privados de crédito
Lenders	An agent bank and several insurers. Growing participation of non-banks (18% according to BIS)[33]	1 or club deals with a maximum of 6 investors (non-banks)
Size of transactions	\$200 million–\$5 billion	\$20 million–\$2 billion. Middle market (companies with EBITDA > 50 million) and lower market
Interest rates		Higher than syndicated loans. Variable rate plus a spread over Euribor, Libor, etc.
Covenants	Most (> 91%) are covenant-lite	Most loans have a covenant. More than one covenant is unusual
Credit rating	BB, B+	Most are unrated
Liquidity in the secondary market	Possible, except in stress situations	Lower liquidity. Held to maturity
Leverage recommendations	6x EBITDA. May be higher upon negotiation	Negotiable
Grant	Two months from inception	With a single lender, 30–75 days

Source: S&P Financial Services and CNMV.

The following table lists the primary types of vehicles in private credit markets:

Private credit investment vehicles TABLE 4

Direct lending

The private credit fund directly finances SMEs through credit lines or senior and subordinated loans. This financing primarily targets SMEs and accounts for approximately half of the assets under management in private credit.

Risk: similar to that of senior or subordinated debt.

Distressed debt

The fund acquires senior debt from companies that are bankrupt or on the verge of bankruptcy, purchasing it at a significant discount. Target companies are solely those facing financial difficulties. In this case, no new debt is created.

Risk: high.

Mezzanine

This type of investment combines elements of both debt and equity. It includes subordinated debt, senior debt, and hybrid debt, often featuring clauses that allow conversion into shares for lenders in the event of default. Mezzanine financing is commonly used in leveraged buyout (LBO) transactions.

33 Aldasoro, Doerr & Zhou (2022).

Special situation

Investments in the debt of financially distressed companies aim to take or gain control. These investments may encompass the purchase of existing debt and shares or the origination of new debt. They can also target companies expected to undergo business unit spin-offs, mergers, acquisitions, or takeover bids.

Venture credit

Venture credit refers to short- and medium-term loans granted to start-ups. This type of financing offers the advantage of not diluting ownership, although lenders sometimes include share purchase options to lower overall costs.

Venture credit is typically divided into two categories: early-stage and late-stage. Early-stage financing supports the initial phases of start-ups, during which banking activity is often minimal due to the high associated risks. One notable player in this space was Silicon Valley Bank (SVB), which was a significant participant until its bankruptcy in 2023. Late-stage financing, on the other hand, is aimed at supporting the growth phases of companies.

The risk involved in venture credit is similar to that of venture capital, as it pertains to early-stage businesses.

Funds of funds

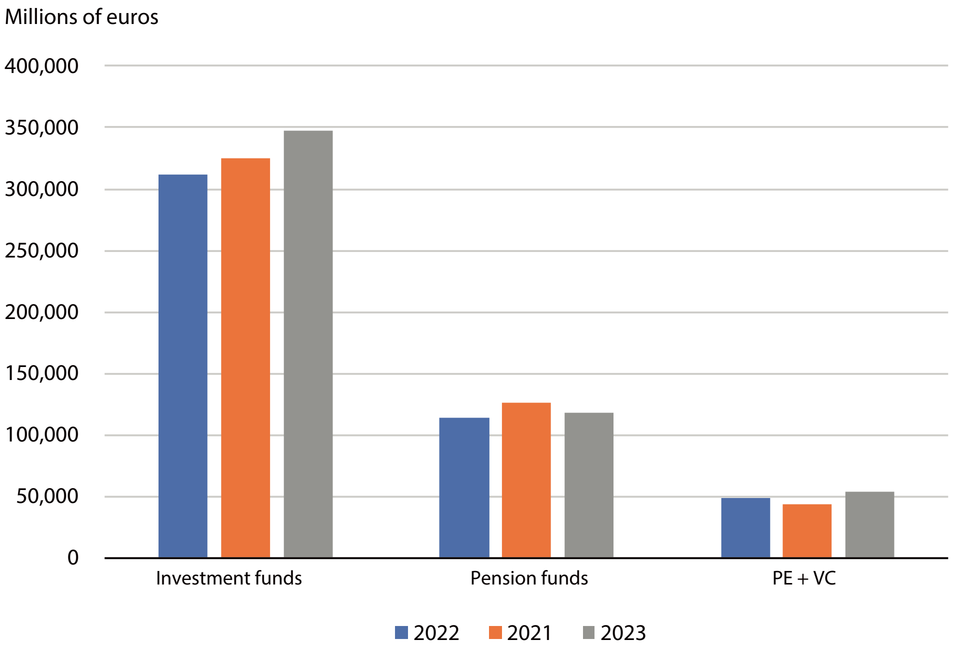
Funds of funds invest capital in various private equity or venture capital funds that are managed by other entities.

6 Main characteristics of private equity in Spain

The half-yearly and annual activity reports published by SpainCap[34] provide a detailed analysis of the private equity and venture capital sectors. These reports offer a wealth of granular data, revealing the distribution of investments by sector and autonomous community, as well as figures on fundraising and divestments. At the European level, this analysis can be supplemented by the information released annually by Invest Europe. In contrast, the private credit segment in Spain lacks the same level of detail and quality of information.

The following figure summarises the size of Spain's private equity investment portfolio, which reached €43.74 billion at the end of 2023. Of this total, €33.37 billion was managed by international firms. The report also compares this figure with the assets under management (AuM) of Spanish investment and pension funds, based on data from Inverco for the last two financial years.

Assets under management in Spain FIGURE 7



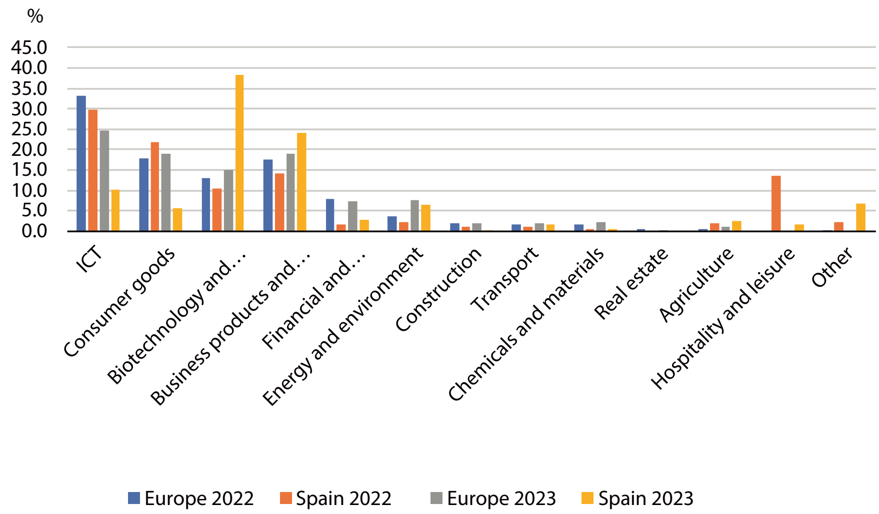
Source: SpainCap, CNMV and Inverco.

34 SpainCap (ASCRI until May 2022) is the association of private equity and venture capital in Spain, as well as its investors.

The sectors that have historically attracted the highest volumes of investment are ICT (information and communication technology), consumer goods, and biotechnology and health.

Sector-specific analysis of private equity investments in Spain reveals some similarities with trends in the rest of Europe, with one notable exception: the hospitality and leisure sector, which is not included in the statistics published by Invest Europe. This oversight likely reflects the significant role of the hospitality sector in Spain compared to other European countries, a factor that is also evident in private equity investment activity. The heavy concentration of private equity investment in the technology sector makes it more sensitive to market fluctuations, similar to certain stock market indices dominated by tech companies, such as the Nasdaq-100.

Percentage of private equity investment by sector FIGURE 8



Source: SpainCap and Invest Europe.

Examining the development stage of private equity and venture capital investment in Spain alongside the European average for 2023, the following figure illustrates a consistent trend. Most investment activity is concentrated in LBOs, accounting for 54% of the total in Spain and 62% in Europe. This is followed by growth financing (private equity and venture capital) and both start-up and late-stage venture investments, each representing similar percentages of the total (6–7%).

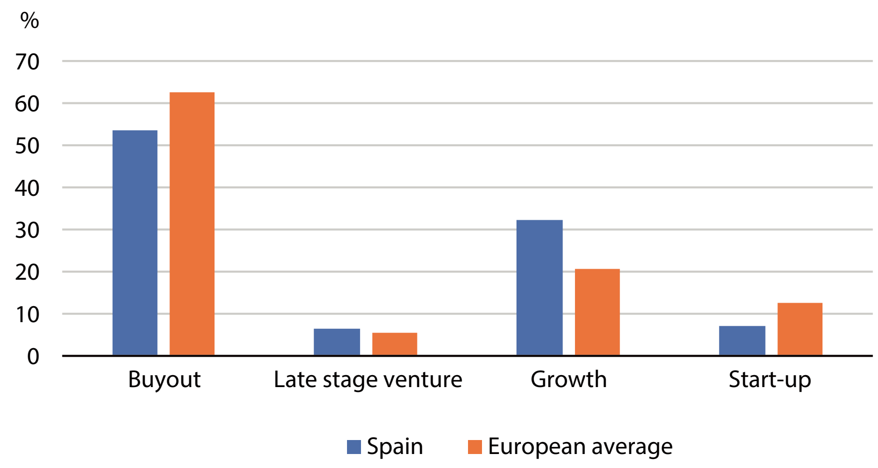
Regarding the financing of LBOs, data from the investment bank Houlihan Lokey, published on 4 July 2024 by *Expansión*,[35] reveals that Banco Santander and Banco Sabadell together accounted for 51% of transactions, with BBVA and Caixabank following behind. Banco Santander's dominant position results from its financing of transactions exceeding €20 million for international funds,

35 BBVA and Banco Sabadell would jointly control venture capital financing.

facilitated through both its traditional banking operations and its direct investment fund, Tresmares.

Banco Sabadell has a much more recent presence in the private equity market, with its activities being far less significant until 2023. Commercial banks hold an information advantage over direct lending funds regarding private equity investees, thanks to their traditional role in financing unrated companies.

Major investments in 2023 by stage (% of total) FIGURE 9



Source: SpainCap and Invest Europe.

A distinctive aspect of private equity investment in Spanish companies is that international managers account for between 75% and 80% of total investments, a figure that has remained stable in recent years. This level of participation by international managers contrasts sharply with the rest of Europe, where most investments are made by domestic managers and about a third by EU entities operating in other Member States. Typically, international funds focus on large transactions (over €100 million, known as megadeals), middle market transactions (between €5 million and €10 million), and leveraged transactions. However, in 2023, both large and middle market transactions lost momentum, resulting in a decrease in the average investment amount from €9.6 million to €7.9 million. In 2023, private equity invested an average of €11.8 million in each of the 569 companies it supported.

According to data from SpainCap, 90% of this investment went to SMEs, which is slightly higher than the European average of 85%. In terms of regional distribution, Madrid received the largest share of investment at 34%, followed by the Valencian Community with 24%, Catalonia at 21%, and Murcia at 5%. The average age of the companies in the portfolios of Spanish private equity firms is 4.5 years.

When looking at private equity investment as a percentage of GDP, Spain's figure stands at 0.32%, which is slightly below the European average of 0.4462% but still higher than that of Germany, Italy, Belgium, and Portugal.

The Spanish Tech Ecosystem Report 2024 reveals that the value of Spanish start-ups surpassed €100 billion for the first time in 2023. This figure exceeds the valuations of countries like Norway, Italy, and Portugal, which have yet to reach it. Germany (€450 billion), Sweden (€250 billion), France (€330 billion), and Denmark (€130 billion) have the highest valuations for their start-ups in Europe.

Dealroom lists 12,000 start-ups in Spain, with around 500 poised to reach scale-up status and 18 expected to achieve unicorn status. Between 2017 and 2023, these start-ups raised €13.70 billion, with 2021 marking their best year, bringing in €4.31 billion. Since 2020, there has been a noticeable slowdown in funding rounds for start-ups. That year, 135 rounds raised between €1 million and €5 million, with only nine rounds exceeding €50 million, according to the Bankinter Observatory. In 2023, start-ups managed to secure €2 billion across more than 850 funding rounds according to *The Spanish Tech Ecosystem Report 2024*.

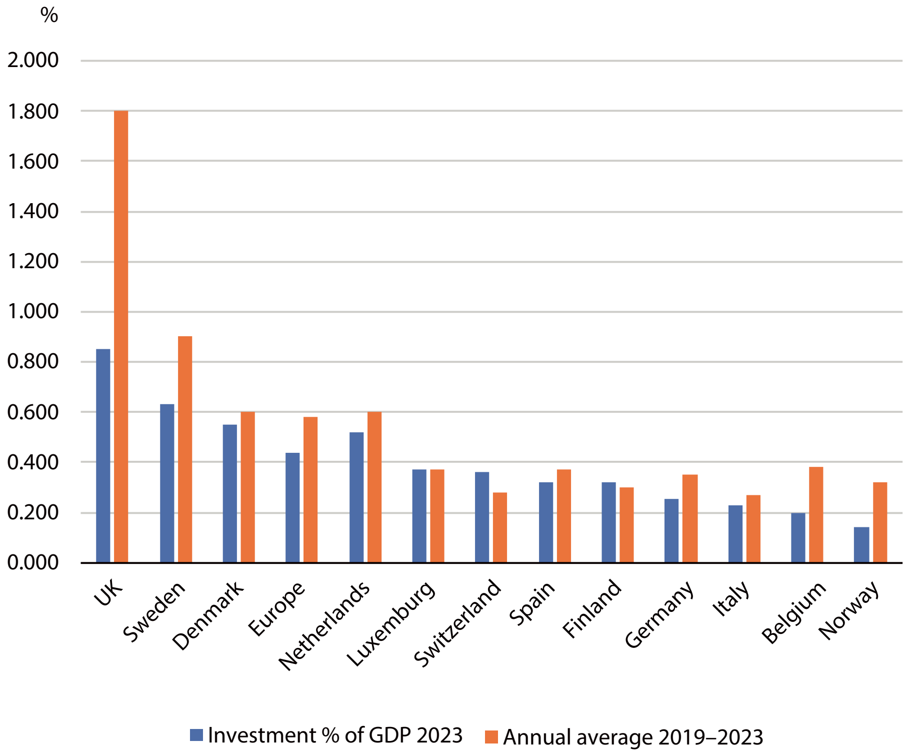
Spain has two prominent start-up hubs: Barcelona, which attracted €6.35 billion, and Madrid, with €5.78 billion. Together, they raised €12.14 billion between 2018 and 2023, nearly six times the amount secured by other regions in Spain, with Valencia trailing as a distant third at €494 million. During the 2020–2023 period, the sectors that garnered the most investment included: mobility and logistics (€1.64 billion), productivity and business (€1.55 billion), FinTech and InsurTech (€1.29 billion), PropTech (€1.05 billion), TravelTech (€842 million), health (€758 million), software (€522 million), and cybersecurity (€510 million).

In May 2024, Spain finalised the launch of its largest venture capital fund, managed by Mundi Ventures, which aims to invest in scale-ups and start-ups. This fund has a target size of €1 billion and will involve the participation of the European Investment Bank.

Spanish private equity funds, both public and private, play a crucial role in financing start-ups during their early stages, such as seed and start-up phases. However, as funding needs grow, international funds typically dominate later-stage investments.

The following figure, based on data from Invest Europe, illustrates that the percentage of private equity investment as a share of GDP declined in 2023 across nearly all European countries compared to previous years. Overall, private equity investment in Europe fell by 25% in 2023 and by 11% relative to the average over the last five years.

Private equity investment as a percentage of GDP. 2023 FIGURE 10



Source: SpainCap and Invest Europe.

Spanish investors provided 80% of the €2.70 billion raised by private equity and venture capital in 2023. Family offices in Spain have increased their involvement in private equity due to changes in the taxation of open-ended collective investment companies (SICAVs), prompting some to transition into private equity firms. In 2023, these family offices accounted for 33% of the total amount raised (€2.70 billion). This year marked the second-best performance for fundraising in history.

An analysis of the European market, based on data from Invest Europe and organised by region, reveals that France, the Netherlands, and Belgium combined account for 22.2% of total private equity funds, with the United Kingdom at 10.2%. Spain, Portugal, Italy, and Greece collectively contribute 5.2% of private equity funds in Europe. Most of the funds raised by private equity in Europe came from North America (23.4%) and Australia and Asia (19.9%).

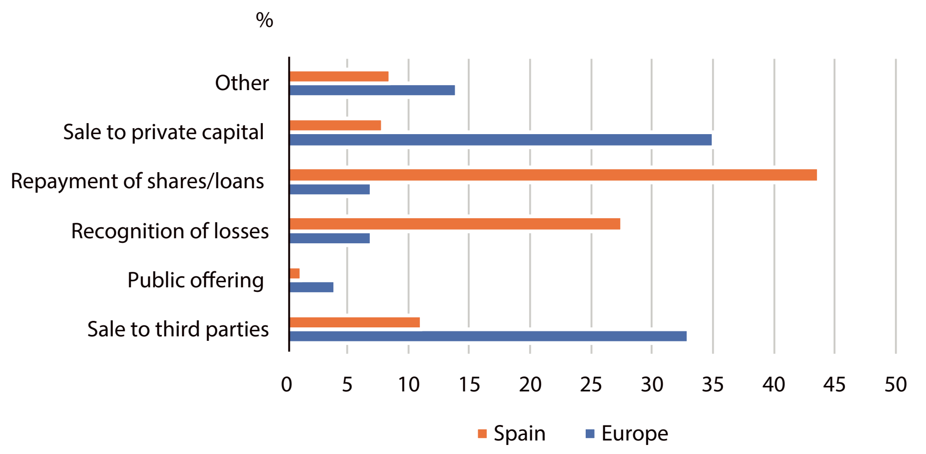
According to the Pitchbook report,[36] 2022 saw the highest number of transactions in Europe, although they tended to be smaller in scale. Only 36 transactions surpassed €1 billion, marking the lowest figure in nine years, with none occurring in the fourth quarter. There has been an increase in the number of add-on purchases. The decline in larger transactions can be attributed to managers exercising greater caution due to economic uncertainty. The volume and number of exits also reached their lowest point in nine years. In Spain, only 1.6% of transactions exceeded €200 million, with most investments falling within the €2.5 million to €5 million

36 Pitchbook (2022).

range and in the lower middle market (investments between €5 million and €10 million).

When it comes to divestment alternatives in Spain, loan redemptions have been the most prevalent option in recent years, while IPOs remain the least utilised alternative, accounting for less than 7% of divested capital in Europe. Figure 11 illustrates the types of private equity divestment in Europe and Spain as a percentage of the total for 2023. In Spain, the recognition of capital losses on investments has also become quite notable.

Divestment alternatives. Total 2023 FIGURE 11



Source: SpainCap and Invest Europe.

7 Key considerations for supervisors

In most jurisdictions, securities market supervisors have two primary mandates: to protect investors and ensure the orderly functioning of markets. Macroprudential supervisors focus on maintaining the stability of the financial system.

Traditionally, private markets, including both capital and credit, were largely inaccessible to retail investors. However, recent regulatory changes now permit small savers to invest in private equity funds with a minimum initial investment of €10,000, down from the previous requirement of €100,000.

The following sections detail the key aspects that supervisors should consider regarding private financing activity.

Macroprudential supervision

One of the main challenges in supervision, particularly in identifying, monitoring, and containing systemic risk, is the limited regulation of information and transparency requirements across many relevant jurisdictions. This issue is compounded by the heterogeneity of regulations and the lack of or minimal requirements for information sharing among participants in private markets and the supervisors of the regulated financial system. This challenge is critical in the areas outlined below, as the interrelationship and interconnection between private finance and the regulated financial sector are significant. Weaknesses in information sharing can pose a major obstacle to supervisors in their efforts to contain systemic risk.

Leverage

According to the BIS,[37] there are three sources of leverage in private equity transactions: i) the initial debt of the investee company prior to the transaction; ii) the additional debt that private equity managers (GPs) incur when financing the acquisition of the target company through loans or bond issues – the ECB reports that private equity-backed companies in Europe account for 80% of leveraged loans on the continent and 50% in the United States – and iii) subscription credit lines (SCLs), which are loans secured by the committed capital of investors (LPs). Managers use these lines to seek greater flexibility and to reduce the frequency of capital calls from investors. Over the past decade, a new form of leverage has gained traction as managers struggle to raise new funds in a higher interest rate

37 Aldasoro, Doerr & Zhou (2022).

environment. Some managers have started taking out loans secured by the NAV of their fund portfolios, instead of borrowing directly from individual companies. According to the Fund Finance Association, the NAV financing market is expected to grow from $100 billion in 2023 to $600 billion by 2029. In the second half of 2023, however, the demand for NAV loans dropped by 90% due to the concerns and reservations institutional investors have about this practice. This decline in leverage highlights the influence of institutional investors over private managers. Their keen awareness of risk enables them to enforce a level of self-regulation among these managers concerning NAV loans, which have frequently been used to pay dividends to investors even in cases where the fund's assets had not been divested.

The Financial Stability Board[38] (FSB) highlights synthetic leverage, generated through derivative instruments, as currently not being a concern within private equity and debt, in contrast to hedge funds, which the FSB has flagged as a potential source of financial instability. This synthetic leverage contributed significantly to the propagation and acceleration of the major financial crisis in 2008.

Following the crisis, the role of banks in financing has shifted towards non-bank lenders, as seen in other segments of the market. Recently, several private equity firms have turned to secured loans to pay dividends to pension fund and sovereign investors and to finance acquisitions of companies.

LBOs warrant special attention from supervisors for several reasons:

i) The potential increase in debt for target companies, which could jeopardise their viability.

ii) The role of banks in financing these transactions.

iii) The use of tax engineering to facilitate dividend payments to management through the indebtedness of the acquired company (leveraged recapitalisation dividend).

In its 2017 guide to leveraged transactions, the ECB[39] states that credit institutions should classify as leveraged any transaction that meets at least one of the following criteria: i) loans and credits to borrowers with a total debt to EBITDA ratio exceeding 4; and ii) all loans or credit exposures where the lender is owned by one or more financial sponsors, defined by the ECB as investment firms engaged in private equity or leveraged lending.

This definition may have contributed to some of these loans transferring from banks to private credit managers. In 2022, the global market saw a significant 50% decline in the issuance of leveraged loans due to macroeconomic uncertainty, alongside private credit financing accounting for over 59% of

38 Financial Stability Board (2023).

39 European Central Bank (2017).

transactions. However, as Moody's points out,[40] there is a risk that increasing competition between the syndicated loan segment and private credit could lower the lending standards for LBOs when this activity resumes. Data from the ECB's *Q4 2023 European Credit Markets Quarterly Wrap* report indicates that in 2023, 81% of European LBO transactions were financed by private credit, up from 56% in 2021.

In October 2024, Apollo and Citigroup announced an agreement to originate $25 billion for financing company acquisitions. Under this arrangement, Apollo would supply the funds while Citigroup would focus on identifying transactions, marking a significant shift in traditional roles where investment banks have become mere facilitators, leaving the financing to Apollo.

An EU directive will impose limits on the leverage of private credit funds. For credit funds that permit redemptions, the leverage limit relative to the fund's net value will be set at 175%, while for those that do not allow redemptions before the loans' maturity date, the limit will be 300%. If the value of the loans in the portfolio declines, as witnessed during the 2008 crisis, these funds may exceed the established limits and will need to liquidate a portion of their loans.

Along with leverage, prudential supervisors should also focus on leverage and the relationships and level of activity that credit institutions maintain with private equity and credit managers, as they currently do.

An ECB[41] article from 2007 highlighted the risks associated with financing LBOs for credit institutions. Authors like Kaplan & Strömberg[42] (2009), who critique private equity practices, argue that LBOs impose significant debt burdens on target companies, which in turn increases credit risk for the banking sector. This can reduce the future profitability of a company by tying up its earnings in interest payments, even if it shows a positive EBITDA.

Procyclical activity

Authors such as Bernstein, Lerner & Mezzanotti (2019)[43] and Aramonte & Avalos from the BIS[44] point out that private equity activity tends to be procyclical and positively correlated with stock market indices.

The low interest rates observed until 2022 led to substantial growth in private credit operations. In the current environment of higher interest rates, the strength of the credit market needs to be assessed, particularly for those transactions completed in 2021 when rates were near zero and involved very small companies.

---

40 Financial Times (2023).

41 European Central Bank (2007).

42 Kaplan & Strömberg (2009).

43 Bernstein, Lerner & Mezzanotti (2019).

44 Aramonte & Avalos (2021).

Since 2022, the landscape has changed significantly, with rising interest rates and declining growth prospects potentially impacting the ability to repay loans. Moreover, the noted lack of IPOs complicates divestment and hinders the influx of new investors and investment projects.

While interest rates remain closely linked to private capital markets, several factors may mitigate their procyclical tendency:

i) The substantial amount of dry powder held by asset managers, which exceeded $3.7 trillion in mid-2023.

ii) The lack of mark-to-market valuations, which reduces the impact of volatility on portfolios and allows for adjustments to valuations over longer periods, enabling a potential "return to normality".

iii) The closed structure of funds, which prevents forced sales of portfolio assets during periods of market stress.

iv) The comprehensive information that managers have about the companies in which they invest and actively participate in managing. Strong bilateral relationships between lenders and borrowers in private credit markets, which enhance credit information and facilitate loan renegotiations.

Some private equity managers[45] are currently buying back the debt of the companies they invested in to finance their acquisitions, often at a discount to par. In light of the decline in merger and acquisition activities and the liquidity at their disposal, these discounted debt buybacks present a viable strategy for enhancing the profitability of existing vintage transactions.

Reliance of certain sectors/industries on private financing

Private equity activity is highly concentrated in specific sectors such as technology and healthcare, while SMEs primarily rely on private credit for their financing needs. A slowdown in private finance markets could hinder the availability of funding during the growth and maturation phases of many innovative companies that play a crucial role in job creation.

Counterparties

Private equity and private credit involve a diverse range of investors across the various vehicles used, unlike the derivatives markets, which typically feature single counterparties. While this diversity can increase potential issues, it also helps to limit exposure and mitigate individual losses.

45 Bloomberg (2023).

Purchases of bank loan portfolios by private credit

In March 2024, Apollo announced an agreement to acquire $8 billion in senior debt from UBS, building on its earlier 2022 agreement to purchase UBS's structured lending unit.

Growing interdependence between managers and insurance companies

According to *The Economist*,[46] private equity and credit managers are acquiring stakes and forming partnerships with insurance companies to gain better access to long-term assets that insurers manage, which are well-suited for less liquid private equity and debt investments. In the credit segment, the National Association of Insurance Commissioners (NAIC) reported that in 2022, 29% of bonds held by private equity-owned insurers were structured, compared to an average of 11% for other insurers. Fitch found that, within a sample of private equity-owned insurers, Level 3 assets –those lacking precise market values – accounted for 19% of their balance sheets, four times higher than in other insurance companies.

Investor protection and market integrity

Retail investor participation in private finance markets

Until recently, retail investors faced significant barriers to investing in private equity and credit markets due to three main factors:

i) Regulatory restrictions that barred them from accessing these types of assets.

ii) High minimum investment thresholds set by asset managers.

iii) A lack of distribution channels tailored for retail investors.

Institutional investors remain, by a considerable margin, the primary providers of funds in private finance markets. However, recent regulatory changes in both the United States and Europe, along with technological advancements – particularly blockchain technology enabling the tokenisation of fund shares – and the introduction of new open-ended fund structures, have created opportunities for retail investors to access private financing. Currently, there is no evidence of synthetic exposures being sold through derivative instruments in private equity and credit markets. However, should such practices emerge, the risks for retail investors would increase, particularly due to the credit risk associated with derivative counterparties. From a financial stability perspective, this could lead to significant levels of exposure, reminiscent of the subprime crisis involving the underlying real estate assets of structured instruments.

---

46 The Economist (2024).

Regarding regulatory changes, in the United States, the Department of Labor issued a statement in 2020 that allowed certain pension plans in the 401(k)[47] category to include private equity as eligible investment assets. That same year, the SEC revised the criteria for accredited investors to encompass those with sufficient knowledge and experience, rather than focusing solely on their net worth. In August 2023, the SEC updated its regulations to enhance transparency for private equity fund advisors. From that point, fund advisors must provide investors with quarterly updates on fees, expenses, and fund performance. In addition, they are required to share the audited financial statements of each recommended fund with unitholders annually, along with an opinion on the valuation when suggesting a secondary market transaction.

In the European Union, the European Parliament approved amendments in 2023 to the regulations governing European long-term investment funds (ELTIFs). These changes aim to channel long-term capital towards financing digital and sustainability transitions, which are crucial for supporting SMEs and long-term projects in sectors such as transport, infrastructure, and sustainable energy generation and distribution. In Spain, Law 18/2022, of 28 September, on the creation and growth of companies (the Create and Grow Law) allows retail investors to acquire shares with a minimum investment reduced to €10,000, down from the previous €100,000 (Article 74 bis). Furthermore, customers must receive a recommendation from an authorised entity providing advisory services, and the investment should not exceed 10% of the portfolio if financial assets are under €500,000.

The FinTech ecosystem is starting to develop various initiatives aimed at establishing a direct channel between fund managers and retail investors. These initiatives focus on digitising most of the investment process, which includes evaluating potential clients, ensuring compliance with MiFID requirements, adhering to money laundering regulations, and facilitating investment once all necessary criteria are met. Some of these initiatives provide platforms dedicated to educating investors about the risks and specific characteristics of this type of investment. Platforms like Moonfare, based in Berlin, and iCapital in New York offer retail investors access to private equity funds by pooling their investments. These platforms are also exploring the creation of secondary markets[48] to enhance liquidity for retail investors. For instance, Moonfare provides two liquidity windows each year for selling fund units and collaborates with Lexington Partners under certain conditions to facilitate liquidity.

Lack of liquidity and transparency

Due to the specific characteristics of private equity and credit investments, the potential inclusion of retail investors must occur within a tailored framework that addresses at least two key distinguishing features: restricted liquidity during predefined periods and lower transparency compared to public markets. The

47 Pension plans that companies offer to their employees and whose contributions are tax-deductible.

48 Bain & Company (2023).

gradual shift of activity from public to private markets will significantly impact supervisory capacity, as it limits the information available and transfers risks to the private sector.

These characteristics directly affect a crucial aspect of investment decision-making: accurately valuing fund units. The absence of daily secondary markets for portfolio assets, combined with the restriction on selling units to predetermined windows, complicates this process. The Financial Conduct Authority (FCA), the UK regulator, plans to examine the responsibilities for valuations carried out by managers, how these valuations are communicated to the management committee and Board, and the corporate governance practices in place. This information is based on a report published by the *Financial Times* on 27 September 2024.

International private equity and credit firms, including pioneers like Blackstone and Goldman Sachs, are introducing open-ended funds (also known as semi-liquid or interval funds) that offer more flexible options for divestment to attract retail investors. These open-ended funds will have liquidity windows based on NAV. However, the lack of a secondary market and inherent illiquidity means that managers will retain control over the valuation of capital redemptions. While these arrangements aim to alleviate some of the illiquidity issues faced by retail investors during specific timeframes, they do not simplify the complexities involved in valuing the underlying portfolios.

Fund managers and distributors must enhance the guarantees and safeguards when marketing private equity and credit units to retail investors, as many entities have already begun to do. While investor education is crucial, it requires a sustained effort over time for optimal effectiveness. Therefore, the industry itself must prioritise effective distribution to diversify its sources of financing and mitigate potential issues stemming from inadequate marketing practices.

In the United States, private equity firms are increasingly acquiring stakes in audit companies, with reports suggesting that up to 10 of the 30 largest US audit firms could soon come under private ownership. This trend has raised concerns among regulators, who emphasise the need to preserve the independence of audit activities and prevent conflicts of interest related to the valuation of portfolio companies held by private equity firms.

Valuation challenges and information asymmetries

The entry of retail investors poses risks primarily due to the complexities involved in valuations. These complexities arise from several factors: i) the illiquidity and uniqueness of the various investment portfolios managed by private equity firms, ii) the frequent absence of comparable companies, iii) insufficient transparency, and iv) the high valuations typically seen during the final stages before an IPO or sale to another company. Potential investors often encounter information asymmetries when determining the issue price, while business owners possess confidential information about their ventures.

Each private equity fund's portfolio is unique and cannot be replicated, since the companies or projects they invest in are usually owned by a single fund and do not trade on secondary markets. This uniqueness significantly complicates the valuation process for retail investors due to both a lack of information and the inherent challenges of valuation models, which rely heavily on future business expectations to determine reference prices. Many of these companies are also disruptive within their sectors, further complicating their valuations as they operate in industries characterised by significant network effects, where the first entrant often dominates the market ("winner takes it all").

As noted earlier, start-ups typically go through several rounds of capital raising from their inception before pursuing an IPO or selling to a third party. Investment in late-stage ventures, which include companies with positive sales and EBITDA and are considered pre-IPO, is particularly common in this phase. Start-ups often see substantial increases in valuation that align with the anticipated success of their business plans. The rise in company valuations prior to an IPO carries several risks, including the possibility of inflated valuations that could undermine the success of the IPO and diminish returns for shareholders and investors in the final pre-IPO rounds, potentially including retail investors drawn in by these high valuations. Valuations of start-ups peaked during the COVID-19 pandemic, as the potential of business models involving significant digital components was often overestimated. With the pandemic receding, expectations for digital business have been revalued, leading to a downward adjustment in valuations. This correction is particularly evident in companies at more advanced stages, as many closed funding rounds between 2020 and 2022 at multiples that are now misaligned with the current market conditions. Some companies, once hailed as unicorns with valuations exceeding $1 billion, have lost their prestigious status and are struggling to achieve viable EBITDA figures, earning them the label of "zombicorns". During new funding rounds, these unicorns often reassess their business models, which can lead to declining valuations as their growth prospects come into question.

While late-stage financing has become synonymous with pre-IPO preparations – evidenced by the substantial amounts raised and the lofty valuations – there is a risk of insufficient scrutiny akin to the thorough evaluations typically mandated for IPOs. This lack of rigorous analysis by regulators, auditors, and investment banks can leave vital financial details and future outlooks unchecked. Moreover, inflated pre-IPO valuations can result in unsuccessful public offerings if the initial share price is set too high, discouraging potential investors in subsequent IPOs.

Data from the CNMV concerning the behaviour and characteristics of retail investors in financial markets in 2022 highlights the significant interest in growing companies. Retail investors accounted for over 35% of transactions in the Ibex Growth Market 15, compared to just 6% in the Ibex 35.

Due to the limited access to information in private markets, providers like MSCI and rating agencies such as Standard & Poor's create and publish various private market indices. In 2007, S&P Dow Jones introduced the S&P Listed Private Equity Index, which includes over 50 constituent managers and aims to represent the performance of these managers. Meanwhile, MSCI's indices encompass more than 20,000 private equity and credit funds, reflecting the returns of different private equity and credit investments.

In June 2024, the New Orleans Court of Appeals ruled in favour of six private equity groups, overturning a transparency rule enacted by the SEC in 2023. This rule required managers to publish quarterly performance and fee reports, conduct annual audits, and end preferential treatment for certain investors regarding redemptions and special access to portfolio assets.

Potential conflicts of interest between different investors

One potential conflict of interest that managers may encounter arises from the extended execution periods for investments made by their vehicles. This situation occurs as investors enter at different valuations during the investment period, while there is a single exit point for all unitholders. Such conflicts can emerge because managers sometimes make investments before finalising the investment vehicles. During the subsequent fundraising period, which typically has a longer horizon than traditional investment funds, the situation becomes more complicated. When investments are liquidated, all investors receive the same exit price, regardless of when they entered the vehicle. During this placement period, the value of the investments often fluctuates based on the viability expectations for each project, and there is no reference market value available for comparison. Consequently, investors may pay different prices depending on when they entered, leaving particularly retail investors unable to assess the suitability of their investment. To address this issue, the CNMV has recommended introducing anti-dilution measures to reduce potential conflicts of interest.

The CNMV has also implemented a maximum 24-month limit for attracting investors and established equalisation premiums to ensure fair treatment across the board.

Market integrity: contagion from private to public markets

Private equity and credit managers are not required to liquidate positions during periods of market turbulence driven by investor redemptions. Closed-ended private market vehicles invest in unlisted assets, and their valuations typically reflect declines in public markets with a delay of two to three quarters. As a result, it is unlikely that private markets will exert pressure on public markets in terms of price fluctuations. However, significant corrections in public markets can lead to a slowdown in fundraising for private markets and complicate the divestment process through IPOs.

Losses in private markets can impact the overall returns and portfolio values of institutional investors, potentially jeopardising their obligations and limiting their capacity to invest in other segments. This may also necessitate the liquidation of assets in organised markets. Therefore, supervisors need to monitor their exposure and concentration in private markets closely.

IOSCO's work in private markets

The CNMV participated in the IOSCO task force that produced the report *Thematic Analysis: Emerging Risks in Private Finance*, published in September 2023. This report examines the development of private finance markets and highlights key issues for supervisors, focusing on the main potential risks identified.

8 Private markets and sustainable investment

According to Eccles et al. (2022),[49] the private equity industry has primarily focused on achieving results without prioritising long-term sustainability or considering its societal impact. However, the authors argue that the private equity model offers significant advantages over publicly traded companies for implementing a sustainability agenda.

Private equity managers control the ownership and corporate governance of their portfolio companies, have access to financial and sustainability information, and can even replace CEOs who fail to meet established objectives. Moreover, companies owned by private equity typically operate with a longer time horizon than listed firms, allowing them more time to pursue sustainable investments without the pressure of quarterly performance evaluations.

According to Eccles et al. (2022), managers will be unlikely to integrate a strategy based on environmental, social, and governance (ESG) principles if they do not believe it will be profitable in the long term. In fact, by August 2022, nine of the ten largest private equity managers worldwide were members of the Principles for Responsible Investment (PRI).

Eccles et al. (2022) identify three key factors driving ESG strategies within the private equity industry:

i) ESG principles are becoming increasingly important to limited partners in the sector. The largest investors, such as sovereign wealth and pension funds, are especially aware of the impacts of climate change and inequality. According to a report from the Higher Institute of Education, Administration and Development (ISEAD), 90% of private equity investors incorporate ESG strategies into their investment decisions, while 77% use them to select managers.

   The rise of co-investment, mentioned earlier in this document, also places additional pressure on managers.

ii) Many investors and managers believe that ESG policy will be crucial for maintaining the traditional high returns associated with private equity. Academics like George Serafeim from Harvard Business School support this view, arguing that ESG strategies can enhance the higher returns of private equity compared to public companies.

49 Eccles et al. (2022).

iii) Finally, private equity portfolio companies themselves recognise the importance of ESG, which is evident in the preferences of their employees and customers.

Leading private equity managers focusing on ESG have refined their approaches in three main ways: i) by integrating ESG factors into due diligence, investment periods, and exit strategies; ii) by increasing transparency in reporting sustainability returns; and iii) by evaluating and enhancing the ESG capabilities of their portfolio companies.

According to the *Clean Energy Startups Radar* study by the consulting firm Oliver Wyman, venture capital has significantly boosted investments in clean energy start-ups, multiplying its investments sixfold in just three years. Investment surged from $1.9 billion before the pandemic to $12.3 billion. This historic increase occurred despite a decline in private equity activity.

The Oliver Wyman study identifies the primary catalysts for the boom in private equity and venture capital investment in green energy as the Inflation Reduction Act in the United States and the European Union's Net Zero Industry Act.

According to data from McKinsey's annual report on private markets,[50] 2022 marked the best year on record for raising ESG funds. In the first half of 2022, $24 billion was raised. Transactions classified as sustainable reached $200 billion, reflecting a 7% increase compared to the previous year, with energy and transport leading the sectors in terms of deal volume.

It is estimated that the proportion of fundraising routed through managers with an investment policy that incorporates ESG factors has climbed to 66% of the total, representing a new historic milestone.

According to McKinsey, the increasing integration of ESG criteria into investment policies stems from several key factors. First and foremost is the evidence showing a positive correlation between ESG performance and profitability. McKinsey's studies reveal that companies with superior ESG practices, compared to competitors who excel in growth and margins, achieve shareholder returns that exceed those of their peers by 200 basis points. In other words, better ESG performance translates into higher returns for shareholders. The second factor involves government incentives for specific ESG investments, such as the US Inflation Reduction Act. The third factor includes various geopolitical and macroeconomic dynamics that have intensified investor interest in alternative energy sources and the pursuit of energy independence. Finally, investors are increasingly incorporating ESG factors into their capital allocation processes. A recent survey revealed that 75% of investors in private markets would consider halting capital allocation to managers that do not meet acceptable ESG standards.

50 Mckinsey (2023).

In essence, the consideration of ESG factors goes beyond fundraising; it encompasses the entire investment cycle, including asset selection, value creation, and exit planning.

In Spain, SpainCap published the report *Compromiso con la sostenibilidad del capital privado* (Commitment to Sustainability in Private Equity) in December 2024, which details compliance with and monitoring of key ESG aspects based on a survey of 91 managers.

Conclusions

Private equity and credit markets have seen consistent growth, particularly notable from the end of 2016 to 2022. The substantial levels of available capital during this period have enabled financing for the more mature stages of companies without the need for public offerings. Moreover, this capital has facilitated larger transactions in both equity and debt, allowing for the funding of larger enterprises.

Private equity and credit markets have become crucial for funding small companies and innovative sectors that often struggle to access traditional bank financing. The growth of private credit has largely resulted from banks withdrawing from financing leveraged transactions in response to regulatory changes following the 2008 crisis, as well as the increased capital requirements for loans to SMEs. In fact, asset managers have even launched credit ETFs to tap into this market.

The significant development of private markets in recent years goes beyond being a temporary or exceptional trend, even though the past levels of growth are unlikely to be maintained. This evolution is rooted in regulatory changes affecting credit institutions after the major financial crisis, alongside structural shifts in the companies seeking financing. While the low interest rate environment has encouraged the entry of investors and funds into private markets, particularly in private equity, several factors are contributing to the ongoing significance of these markets. These factors include the preference for this type of financing within the technology and healthcare sectors, regulatory changes prompting banks to withdraw from financing certain companies, the information costs associated with listed firms, and the governance styles of new economy companies, which typically have lower fixed capital requirements. As noted in the Draghi report, bank financing, with its associated capital costs, often proves unsuitable for innovative companies. In this context, private equity and credit can play a crucial role, as demonstrated by trends in the United States. A potential area for research involves analysing and monitoring possible valuation bubbles in sectors experiencing significant inflows of private equity, such as artificial intelligence. It would also examine the potential impacts of a decline in private funding on industry development, as well as any systemic effects that may arise.

A high interest rate environment could slow the entry of new funds into private equity markets, extend distribution periods, negatively affect the valuations of investee companies, and reduce value creation through leverage. Given the concentration in fundraising observed in 2023 and 2024, we may see a consolidation process among the current pool of over 10,000 managers in the coming years. The private credit segment is expanding even in a high interest rate environment, driven by the potential for higher returns and a shift from leveraged transactions to credit. However, as most private financing deals are at variable rates, this new landscape of elevated rates could threaten the viability and profitability of companies.

Regulatory authorities need to closely monitor private markets due to their increasing significance and their connections with emerging firms, regulated markets, and retail investors. The shift from public to private markets may lead to reduced supervisory capacity and the transfer of risks to unsupervised entities, potentially impacting monetary policy transmission mechanisms. Alliances between private credit managers and investment banks are becoming increasingly common. In these partnerships, the managers supply the funds while banks focus on identifying and engaging potential clients. We can also expect collaborations between private managers and traditional investment funds to emerge, aimed at distributing alternative products to a wider range of investors. Currently, while the growing volume of managed assets does not pose an immediate systemic threat, it is essential to maintain monitoring procedures for these activities. While the use of leverage as a value-creating tool has decreased in favour of operational improvements, there has been an increase in add-on acquisitions without debt. This trend necessitates careful analysis and monitoring of relationships with credit institutions and other regulated financial agents, particularly regarding the rising levels of indebtedness among acquired companies. Special attention should be given to ensuring that, following the anticipated recovery in activity, credit quality requirements for LBO financing do not decline ("race to the bottom") due to competition between banks and private lenders. It is also important to track the volume of loans requested by managers that are secured against the value of their assets (NAV loans) and to consider the implications of these transactions for credit institutions. Finally, it is important to assess the growing interrelationships between private equity managers and insurers, particularly in relation to how the acquisition of illiquid assets might impact private pension commitments.

To protect retail investors, significant safeguards must be implemented when distributing private equity and credit instruments. Their inherent illiquidity and lack of available information can complicate valuations and may lead to potential conflicts of interest between managers and various investors. The challenging fundraising environment is prompting many managers to target retail investors as a diversification strategy, given their substantial growth potential. While private equity and credit investments can offer significant diversification benefits, it is crucial to provide financial education for retail investors, who have historically been excluded from this asset class. Understanding the unique characteristics of these investments is essential for making informed decisions. This need for education is especially pertinent as retail investors are increasingly drawn to growth companies, as evidenced by their substantial involvement in trading on BME Growth. However, high valuations of more mature companies present dual risks. Retail investors may enter at prices that offer limited upside, while there is also the danger of failed IPOs negatively impacting other offerings. European stock markets are contending with intensified competition for IPOs from Nasdaq and NYSE, particularly in the technology sector, where venture capital backing is prevalent.

Spanish private equity maintains investment levels relative to GDP that are comparable to the European average and surpass those of countries like Germany. The distribution of investments across sectors closely aligns with European averages, and, similar to trends observed across the continent, a substantial majority – 80% in Spain – comes from foreign managers. This reliance on non-EU capital, particularly from the United States, is especially pronounced in funding rounds for more mature companies that require larger amounts of capital.

Bibliographical references

Aldasoro, I., Doerr, S. & Zhou, H. (2022). "Non-bank lenders in the syndicated loan market". BIS, *BIS Quarterly Review,* March.

Aramonte, S. & Avalos, F. (2021). "The rise of private markets". BIS, *BIS Quarterly Review*, December. Available at: https://www.bis.org/publ/qtrpdf/r_qt2112e.pdf

Ares (2020). *The Rise of Private Markets: Secular Trends in Non-Bank Lending and Their Economic Implications.* February. Available at: https://www.calpers.ca.gov/docs/board-agendas/202207/full/day1/03-c-01-private-debt-background2-a.pdf

Bain & Company (2023). "Global Private Equity Report. Why Private Equity Is Targeting Individual Investors". February. Available at: https://www.bain.com/insights/why-private-equity-is-targeting-individual-investors-global-private-equity-report-2023/

Bain & Company (2024). *Global Private Equity Report 2024*.

Barber, F. & Goold, M. (2007). "The Strategic Secret of Private Equity Why "buying to sell" can generate a much higher return on investment than the public company practice of "buying to keep"". *Harvard Business Review.*

Begum, E., Kant, R., Miller, A. & Sprague, K. (2016). "Grow fast or die slow: Why unicorns are staying private". McKinsey & Company. May.

Berkner, M., Kaufman, J. & Foster, J. (2019). "Dual-Track Processes: How to Turbocharge Your Exit". Harvard Law School forum on corporate governance.

Bernstein, S., Lerner, J. & Mezzanotti, F. (2019). "Private equity and financial fragility during the crisis". *Review of Financial Studies,* Vol. 32, No. 4, pp. 1309–1373.

BIS (n.d.). "Credit from All sectors to Non-financial corporations at Market value, US dollar, Adjusted for breaks".

BlackRock (2023). *Private debt: a primer.* November.

Bloomberg (2023). *Private equity's latest money-making trade: Buying its own debt.* April.

Boston Consulting Group (2021). *Potencial del Capital Privado para las aseguradoras y fondos de pensiones.* January.

Brau, J. C. & Fawcett, S. E. (2006) "Initial public offerings: An analysis of theory and practice". *Journal of Finance,* Vol. 61, pp. 399–436.

CNMV (2023). *Analysis of the behaviour of retail investors in the financial markets during the COVID-19 crisis.*

CNMV (2024). *Preguntas y respuestas sobre la normativa de IIC, ECR y otros vehículos de inversión colectiva cerrados.*

De Mol, A., Ramaswami, I., Rainey, B., Habbel, M. & Skolnik, O. (2023). *Global Private Equity Report Why Private Equity Is Targeting Individual Investors.* Bain & Company.

Dealroom (2024). *The Spanish tech ecosystem Report 2024.* Available at: https://dealroom.co/reports/the-spanish-tech-ecosystem-report-2024

Draghi, M. (2024). *The future of European competitiveness.*

Eccles, R.G., Shandal, V., Young, D. & Montgomery, B. (2022). "Private Equity Should Take the Lead in Sustainability". *Harvard Business Review*, July-August.

Eccles, R.G., Shandal, V., Young, D. y Montgomery, B.(2022). "Private Equity Should Take the Lead in Sustainability". *Harvard Business Review*, July-August.

Erdogan, B., Kant, R., Miller, A. & Sprague, K. (2016). "Grow fast or die slow: Why unicorns are staying private". May.

European Central Bank (2007). *Large banks and private equity-sponsored leveraged buyouts in the EU.* April.

European Central Bank (2017). *Guidance on leveraged transactions.* May. Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.leveraged_transactions_guidance_201705.en.pdf

Ewens, M. & Farre-Mensa, J. (2019). *The Deregulation of the Private Equity Markets and the Decline of IPOs.* NBER, Working Paper 26317. Available at: http://www.nber.org/papers/w26317

EY (2022). "EY Global IPO trends 2022". Available at: https://www.ey.com/ content/dam/ey-unified-site/ey-com/en-gl/insights/ipo/documents/ey-global-ipo-trends-2022-v1.pdf

EY (2023a). *I Estudio de la rentabilidad de los fondos de capital privado en España 2021.*

EY (2023b). *II Estudio de la rentabilidad de los fondos de capital privado en España 2022.*

Financial Stability Board (2023). *The Financial Stability Implications of Leverage in Non-Bank Financial Intermediation.* September.

Financial Times (2023a). "EU tightens rules on leverage for private credit funds". 23 July.

Financial Times (2023b). “Private equity firms offer sweeteners to lure reluctant investors”. 7 August. Available at: https://www.ft.com/content/05b0d935-678b-418c-8a86-b1a99bb045ea

Financial Times (2023c). “Private equity firms pivot away from traditional buyouts”. 24 September.

Financial Times (2023d). “UK regulator to launch review of private market valuations”. 27 September.

Financial Times (2023e). “Moody’s warns of ‘systemic risk’ from leveraged lending market”. 28 September.

Gunter, E., Latour, A. & Maquire, J. (2021). “Private Debt: A lesser-known corner of finance finds the spotlight”. S&P Global. Available at: https://www.spglobal.com/en/research-insights/featured/special-editorial/private-debt

Gurley, B. (2015). “Investors Beware: Today’s $100M+ Late-stage Private Rounds Are Very Different from an IPO”. Available at: https://abovethecrowd.com/2015/02/25/investors-beware/

Harris, R. S., Jenkinson, T. & Kaplan, S. (2012). “Private Equity Performance: What Do We Know?”. *Journal of Finance.*

IOSCO (2023). *Thematic Analysis: Emerging Risks in Private Finance Final Report.*

Jensen, M.C. (1989). “Eclipse of the public corporation”. Harvard Business Review, *Magazine*. September-October.

Jensen, M.C. (1993). “The modern industrial revolution, exit, and the failure of internal control systems”. *The Journal of Finance,* pp. 831–880.

Kaplan, S. & Schoar, A. (2005). “Private equity performance: return, persistence and capital flows”. *Journal of Finance,* Vol. LX, no. 4, pp. 1791–1823. Available at: https://web.mit.edu/aschoar/www/KaplanSchoar2005.pdf

Kaplan, S. & Strömberg, P. (2009). “Leveraged buyouts and private equity”. *Journal of Economic Perspectives,* Vol. 23, pp. 121–146.

Latour, A. (2021). “Covenant-lite deals exceed 90% of leveraged loan issuance, setting new high”. S&P Global. Available at: https://www.spglobal.com/market-intelligence/en/news-insights/articles/2021/10/covenant-lite-deals-exceed-90-of-leveraged-loan-issuance-setting-new-high-66935148

Lukatsky, M. (2022). “Leveraged loan financing for LBOs deteriorates as cost of debt rises”. Pitchbook, October. Available at: https://pitchbook.com/news/ articles/leveraged-loan-financing-for-lbos-deteriorates-as-cost-of-debt-rises

McKinsey & Company (2023). *Global Private Markets Review 2023: Private markets turn down the volume.*

McKinsey & Company (2024). *Private markets: a slower era.*

Moonfare (2023). *Navigating Private Equity Value Creation Primer.*

Nadauld, T., Sensoy, B. A., Vorkink, K. & Weisbach, M. S. (2016). *The Liquidity Cost of Private Equity Investments: Evidence from Secondary Market Transactions.*

Oliver Wyman (2023). *Clean Energy Startups Radar.*

Phalippou, L. (2024). *The Trillion Dollar Bonus of Private Capital Fund Managers.*

Pitchbook (2022). “European PE breakdown”.

PitchBook (2023a). “The evolution of private markets secondaries”.

Pitchbook (2023b). “Private equity vs. venture capital: What’s the difference?”. Pitchbook Blog, February. Available at: https://pitchbook.com/blog/private-equity-vs-venture-capital-whats-the-difference

Simmons & Simmons (2022). “Recent Spanish tax developments impacting dividend recaps”. Available at: https://www.simmons-simmons.com/en/publications/cl8l-gik425q430b24svyk3ktm/recent-spanish-tax-developments-impacting-dividend-recaps

The Economist (2023). “Big business. Goliath´s triumph”. 26 August.

The Economist (2024). “Private Markets. In for a trillion”. 27 January.