Newsletter

BURGES SALMON

Private Equity News

Summer 2015

Welcome

Welcome to Private Equity News, our private equity update which keeps you informed of current issues and news in the private equity industry.

For further information on any issues raised in Private Equity News or private equity generally please email **richard.spink@burges-salmon.com** or **mark.shepherd@burges-salmon.com**

This issue of Private Equity News is published against a backdrop of a strong UK job market and low inflation, improving growth in the Eurozone, but huge uncertainty in Greece. The prospect of a referendum will almost inevitably lead to further upheaval on the financial markets.

The indirect consequences of a Greek exit could be significant for British growth and impact on other areas within the Eurozone.

We are increasingly involved in cross border transactions, with the Eurozone and the US understandably being key. However, much of that is dominated by Germany and the US, and our experience in the UK domestic market is that businesses are relatively resilient. As has been well publicised, it does appear to be a seller's market.

Being able to resource advice, whether legal, commercial or financial, that is fit for purpose in each jurisdiction is key, whether through close alliances of quality independent advisory firms or multi office practices. In this edition of Private Equity News, our feature article looks at the current shape of the **private equity world outside the UK** from four of our trusted "preferred firms".

We're also seeing an increased use of **warranty and indemnity insurance policies** to facilitate deals and in our article on page 5, we share our thoughts on how best to ensure a smooth process.

We also take a look at ongoing **concerns (and opportunities) in relation to defined benefit schemes** and our article on **employee share schemes** looks at how best to incentivise management whilst keeping an eye on exit.

With ever increasing corporate governance and regulation in mind, we comment on **what constitutes a shadow director**, in our article on page 5-6.

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Spotlight on international private equity

According to recent figures released by the BVCA, over 2,200 companies in the UK are currently backed by private equity and venture capital, with over £30 billion invested and together employing more than 800,000 people. But what is happening in the private equity arena further afield?

In this edition of The Venturer, we have asked four independent overseas law firms with whom we have, over many years, developed strong relationships to share their thoughts on the current status of the private equity market in each of their jurisdictions.

United States

Thompson Hine LLP

Since the "great recession" in late 2008, private equity firms have been longing for a return to the robust deal activity that was seen in the mid-2000s, marked by relatively straightforward fundraising and a market of eager sellers.

Private equity in the United States has shown slow, but steady improvement, albeit not generally to pre-2008 levels. Fundraising in 2014 showed a modest decline compared to 2013, although the decline should not be taken as dispositive of a long-term drop in fundraising, as 2013 was the best fundraising year since 2008. In 2014, United States private equity funds raised $189 billion, a 14% decrease from 2013 levels. As to the number of transactions, the first quarter of 2014 showed great promise—with 851 deals closing—but the end of the year proved disappointing with a low-water mark of 625 deals in the fourth quarter, resulting in a near-equal number of private equity transactions based in the United States year-over-year (2,947 in 2013, 2,955 in 2014). In terms of overall deal value, invested capital increased by 1% (to $523 billion) largely due to a higher number of upper middle-market deals (with deals with values between $100 and $500 million increasing by 15% from 2013). Interestingly, private equity exits were also strong in 2014, with 904 exits occurring with a total value of $241 billion, and this value representing the largest figure in ten years.

Garrett D. Evers

William M. Henry

This increase in exits suggests that private equity sellers are (perhaps wisely) realizing that the multiples from sales are higher now than they will be in a few years when interest rates are expected to rise and obtaining financing may be more difficult.

These recent fundraising and deal volume figures suggest that private equity firms are continuing to deploy capital, albeit not demonstrating the rapid growth for which many an investor and seller would have hoped. With regard to private equity exits in particular, private equity firms appear to be reaping the returns from acquisitions made from 2009-2011, with the exits occurring within the typical three to five-year window for private equity portfolios.

Correspondingly, non-private equity sellers are finding that due to the recovering economy, coupled with low interest rates, there are many more viable buyers now than in the late 2000s, consisting of both private equity companies and strategic acquirers. Accordingly, 2015 has proferred more of the same in the United States private equity market—slow but steady growth winning the M&A race generally, with certain areas experiencing robust activity. Healthcare is quite active currently, and several private equity players have been raising funds for and looking closely at opportunities in the oil and gas sector.

> *"private equity sellers are (perhaps wisely) realizing that the multiples from sales are higher now than they will be in a few years when interest rates are expected to rise and obtaining financing may be more difficult."*

A principal challenge for private equity buyers is in persuading prospective sellers that now is the time to sell their businesses, rather than biding their time for the markets (and their businesses' enterprise values) to continue improving. A principal challenge for private equity sellers, on the other hand, is that as the recovering economy's growth flattens out in the coming years, and interest rates rise, it may be harder to sell existing platforms a few years down the road and to receive the same returns.

So far, these challenges appear to have balanced each other out, preventing a "bubble" or unanticipated spike in deal activity, but likewise, preventing a lull in private equity activity. Whether this balancing act is tenuous or, alternatively, reflective of an ongoing trend in the coming years remains to be seen.

France

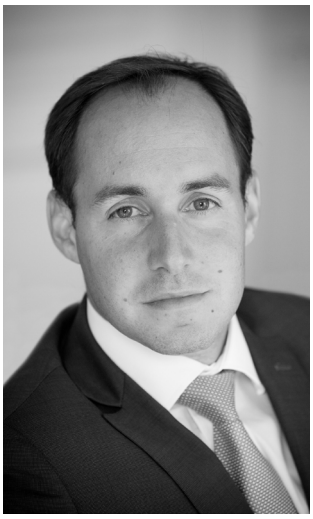
August & Debouzy

Over the last ten years, the French private equity market has generated an outstanding 10.7% net IRR, which is above the American and European averages.

After a significant decrease in the last few years, investments have rebounded dramatically in 2014, with the first half of 2014 representing a 39% increase compared with H1 2013. Same goes for buyouts, with 87 deals worth $11.5bn, making France the most popular country for private equity deals in that timeframe.

> *"The dynamism that we are observing both from our clients' mindsets and our ongoing operations is confirming the foreign press' opinion about French Private Equity being "back in vogue"."*

Throughout the year, there were 8 LBO operations that exceeded or neared €1bn. One third of the operations made by funds are build-ups. Financing is available again and allows for transmissions that were impossible up to now, either for tax reasons of because of the unavailability of debt.



Julien Wagmann

Debt continues to be cheap for good transactions. High yield usually makes sense starting at €150-200M debt, while unirate starts at €20M and usually does not exceed €200M of debt. Mezzanine is often used as an extension through bonds issues in a lot of LBOs. The development of unirate debt was accompanied by a drop in pricing, which makes it more attractive.

Looking back at the most highly valued PE deals of 2014, it appears that the vast majority were in the healthcare, pharmaceutical, veterinarian and geriatric industries, closely followed by construction and logistics.

Julien Aucomte

The Loi Hamon legislation, which imposes on management to inform employees of company buyouts did not seem to have a negative impact on Private Equity so far. The dynamism that we are observing both from our clients' mindsets and our ongoing operations is confirming the foreign press' opinion about French Private Equity being "back in vogue".

Italy

Gianni, Origoni, Grippo, Cappelli & Partners

During 2014, private equity activity registered a significant increase and development in Italy.

Indeed, according to a paper dated March 20, 2015, of the Italian Private Equity and Venture Capital Association ("AIFI", which institutionally represents the venture capital and private equity activity in Italy) in 2014, an overall amount of Euro 1,348 million was collected by PE funds on the market, which represents an increase of 116% in comparison to the funds raised in 2013 (i.e. Euro 623 million).

The investments made by PE funds in 2014 amounted to Euro 3.5 billion, for an overall number of 311 transactions, out of which 106 transactions were destined to seed and startup. Italy also registered an increase in the investments by international PE funds, which invested Euro 1,905 million, as compared to the amount of Euro 1,366, invested by international funds in 2013.

Raimondo Premonte

Finally, the number of buyout transactions almost doubled in 2014 (for an overall amount of 91) as compared to 2013 (when only 50 buyout transactions had been implemented).

The sectors that experienced the highest volumes of transactions were the Information Technology (IT) sector, where a total amount of 47 transactions were implemented, and the luxury sector, where a total amount of Euro 680 million was invested by PE funds.

> *"The AIFMD Directive is expected to provide a boost to the marketing of alternative investment funds (including private equity funds) in Italy."*

It should also be noted that in 2014 the regulatory framework changed in Italy, mainly by virtue of the implementation of the AIFMD, which was implemented on March 25, 2014, by means of the Legislative Decree No. 44 of March 4, 2014.

The AIFMD Directive is expected to provide a boost to the marketing of alternative investment funds (including private equity funds) in Italy. This is mainly due to the introduction of new marketing rules, including the introduction of a "European marketing and management passport" for EU and non-EU alternative fund managers.

Therefore, also thanks to the implementation of AIFMD, it can be argued that the private equity activities in Italy could experience a further increase in the future.

Germany

Noerr LLP

With 112 PE transactions in 2014, equalling 19% of the over-all M&A transactions in Germany, according to numbers published by Ernst & Young, Germany has again proved an appealing and popular investment market within Western Europe. Especially, the small to mid-market deals have attracted PE investors.

> *"German investors identify Western Europe, the USA and Canada to be the most attractive investment destinations for the next few years."*

The number of PE transactions has increased and is expected to further increase in 2015. However, the volume of PE investments in Germany remains to be conservative compared to the levels of before 2008. The value of investments (as far as it has been announced) has, compared to 2013, decreased significantly in 2014 by 23% to 10 billion Euro. The EBITDA multiple for exits with German PE Sellers was on average only 7.6 times earnings, whereas European sellers overall achieved 12.7 times earnings on their investments. High appraisals and an increased competition with company groups investing strategically have contributed to the current over-all German PE market situation. The financing conditions have improved and remain to be good. German investors tend to use less debt than their international counterparts, e.g. in 2014 the debt-to-equity ratio of their investments has often remained below 40% and never exceeded 50% debt.

Thomas Schulz

Looking at the target industries for future investment, industrial production and consumer products are likely to continue to be the sectors of particular PE interest in Germany. Healthcare, energy and business services remain active target sectors, but have declined somewhat.

Looking at the national target markets, German PE investment has mainly focussed on the German home and Western markets. German investors identify Western Europe, the USA and Canada to be the most attractive investment destinations for the next few years.

Robert Korndörfer

Planning your share scheme for an exit

Establishing a share scheme is a little bit like starting any new relationship. In the exciting discussions of future growth and achievements to come, sometimes it doesn't feel necessary to nail down what happens at the end of it if things go well, go badly or if individuals leave. It can also seem like a lot of effort and money to expend on what is, at the end of the day, a gamble. However, relationships and circumstances change. It helps therefore to remember the following principles:

Getting the message across

Making the incentive too hard or too complicated lessens its effect and so effort and resource spent on implementation can be wasted. Complicated share rights might protect investors but do the employees have any sense of what they need to do to realise value? Employees will aim to hit clear targets even if they are stretching. Above all remember that your plan will only be an effective incentive if your employees understand it.

Buyers want to buy clean

The primary concern in a share sale is that all options and rights to acquire shares are cleared out on completion. Strangely some schemes are still not designed with an easy exit in mind and options, for example, could survive completion causing difficulties for the buyer. Will you be heading for a straight share sale or could the exit be a shareholder exit or a business sale? Plan your scheme for all likely outcomes.

Keeping key employees on board post exit

Ideally, key employees who have been incentivised well will be happy with the outcome so that the buyer is confident of continued success. However, there can be a concern with employees being "too" rewarded so that they leave. That can be dealt with in a variety of ways (deferred consideration, lock in, new incentives or negotiations at the time of exit). Remember that the buyer is likely to want to make these decisions themselves, so leave flexibility to do so. Make sensible decisions about leavers - what should happen to an employee who leaves before shareholders cash out?

Ultimately plan for the exit

Well drafted schemes avoid unnecessary time being spent dealing with kinks in the share scheme paperwork in the run up to a sale completion. At the worst these kinks can result in potential tax charges which sit with the company or risk a claim for corporation tax deduction. Keep all your records, make all the correct HMRC returns on time, and get all the tax indemnities you need from participants. Choose competent advisers used to unwinding schemes, to draft your scheme. It might cost a lot more, later, in legal fees to unpick mistakes if you cut corners on implementation.

Contacts

Caroline Harwood
Director
0117 307 6005
caroline.harwood@burges-salmon.com

Paula Hargaden
Senior Associate
0117 307 6981
paula.hargaden@burges-salmon.com

Employee share plans: Action required ! The New online regime

All companies who operate employee share plans, or whose employees or directors hold shares, share options or other "securities" in connection with their employment, or who are thinking of so doing need to know about the new online registration and reporting regime.

The deadline for registration with HMRC is **6 July** and failure to comply will result in automatic penalties. *See our recent briefing* Employee owned shares: **act now for more information on the registration of employee share plans and annual returns.**

Is a defined benefit scheme always a deal breaker?

Acquisition of a company or business with a defined benefit pension scheme requires careful investigation and planning. If shares in the target company are acquired, direct and indirect exposure to its defined benefit scheme can arise.

Direct exposure arises from the target's own liabilities to the scheme, which will obviously affect its potential to generate dividends and accordingly its value. Indirect exposure can also arise if the Pensions Regulator decides to exercise its moral hazard powers and impose liability on parties connected to the acquired company. For example, liability could be imposed on an entity within a private equity group if it is shown that excessive dividends are being extracted to the detriment of the pension scheme. Separately, if increased levels of debt are being introduced to fund the acquisition or in a subsequent refinancing of shareholders loans, and this affects the pension scheme's creditor rights, the Regulator may look for some form of compensation for the pension scheme to mitigate against this.

Acquiring the business and not the shares of a target generally means that pension liabilities remain with the seller. However, this cannot be taken for granted and the Pensions Regulator can impose liability on a business acquirer in some circumstances.

Given the continuing phase of low interest rates, deficits in defined benefit pension schemes are increasing in spite of what may be improving business conditions. The potential exposures can be huge. In a competitive transactional market place, a good understanding of pension schemes and the Pensions Regulator and scheme trustees' powers can enable an investor to make quicker and more informed decisions on the implications of a pension scheme, potentially unlocking a deal, as there are a number of ways to manage or ring-fence liabilities with careful planning.

Thinking about a warranty & indemnity insurance policy?

The use of W&I policies is well documented, and is an increasingly common feature of PE deals. Frequently driven by the sellers at the outset, but ultimately set up by the buyer, these policies are being used to fill gaps in warranty cover provided by management or other sellers, particularly on secondary buyouts. The process is now generally well understood, but planning is key.

Unlike many insurance products, W&I policies are bespoke contracts rather than 'one-size fits all' and it is of vital importance that they are carefully drafted so that they dovetail with the SPA to protect against the agreed risks. It is crucial to match the SPA and the policy coverage and identify any gaps; resolving or getting comfortable with those gaps before completion. This requires insurers, brokers, lawyers and the would-be insured to work together to put the policy in place within often tight deal timescales.

Our tips to ensure a smooth process:

- Choose an experienced broker specialising in W&I policies who knows the market.
- Use lawyers with the expertise that insurers would expect for the transaction.
- Engage with potential insurers early on. Start discussions as soon as the potential need for cover is identified. The more information that can be provided to insurers at the outset the better – this will help to minimise the risk of gaps in coverage later in the process.
- Get an indicative costing at an early stage and build those costs into the overall funding process.
- Provide insurers with drafts of the key transaction documents as soon as possible. Keep them updated as the transaction negotiations progress.
- Provide insurers with good quality due diligence information; keep the sellers' disclosure process moving.
- Obtain clarity at an early stage as to the warranties the insurer is prepared to stand behind and those that it will not (or only to a limited extent). Most insurers now provide a schedule specifying each warranty and whether or not it is covered. Obtain this schedule as soon as possible; identify the gaps and act quickly to try and resolve them (through negotiation and/or further provision of information).
- Allow sufficient time in the transaction schedule to arrange the policy. As a rule of thumb, expect a policy to take between two and four weeks to put in place, but insurers can, and do, now react to shorter timescales when needed.

> *"To obtain the best coverage position, early preparation is key. We do this by asking for confirmation on the key cover whilst there is competitive tension amongst the potential insurers."*
>
> *Richard French, Transaction Risk Insurance at Howden Insurance Brokers.*

De Facto and Shadow Directors

The nasty shock of discovering you are a director

Despite what lawyers might wish to believe, corporate structures are rarely managed as a series of distinct entities in which only duly appointed individuals recorded at Companies House ever influence decisions made by each group company. Leading shareholders, joint venture partners, appointees of holding companies or private equity investors and others frequently have a say and an influence. In some structures, trusted individuals can be brought in permanently or temporarily to buttress the decision making experience or to manage particular issues on an executive basis.

Contrary to their expectations, such individuals can find that the law regards them as directors (even when not listed as such at Companies House). Immediately this gives rise to a range of issues, for example:

- With effect from 26 May 2015, the Small Business, Enterprise and Employment Act 2015 has amended section 170(5) of the Companies Act 2006 to clarify that the general duties of directors set out in sections 170 to 177 of the Companies Act also apply to shadow directors, to the extent that they are capable of applying;
- Personal exposure to liability for safety breaches;
- The limitations on engaging in substantial property transactions with the company; and
- Issues of coverage under D&O policies.

During the last couple of years, the courts have been called on several times to decide whether individuals involved in management of companies have crossed the legal line to make themselves (by accident) directors.

Exercising decisive influence can have the same pitfalls as taking too much control. In the real world of complex corporate structures, individuals involved in delivering the business outcomes should always have one eye on the risks of making themselves more exposed than they had intended. This is particularly the case in investment arrangements, joint ventures and shareholder led businesses.

Individuals associated with holding companies, joint ventures and investors need to be particularly careful that their involvement in subsidiaries does not overstep the bounds into involvement in decision making and being seen by third parties as a director. This is particularly the case where they (or their business) have other interests with which the company is doing business.

Types of Director:

- **De jure director**
  director at law, registered in Companies House (alternate directors are also de jure and themselves should normally be registered at Companies House. Covers Executive and Non-Executive directors).
- **Shadow director**
  not a de jure director but someone in accordance with whose instructions the board is accustomed to act (not being a professional adviser retained to advise, or someone who gives instructions in exercise of a function conferred by or under legislation); (section 251 Companies Act)
- **De facto director**
  director in fact, not a de jure director someone who behaves and is taken by the company and other directors (if any) to behave as a director (within the definition of director in section 250 Companies Act).

Burges Salmon appoints six new partners

Burges Salmon appointed six new partners to the partnership in May this year, half of whom trained with the firm and have progressed from trainee to partner.

This brings **Burges Salmon's total number of partners to 81** and reflects the firm's continued growth across a number of sectors and practice areas.

Jonathan Eves became a partner in the firm's **Corporate team**. He joined Burges Salmon as a trainee in 2004 and qualified in 2006. Jonathan specialises in a range of practice areas including Corporate Advice, Mergers and Acquisitions and Private Equity and has a particular focus on the Energy sector.

Lloyd James became a partner in the **Construction and Engineering team** at Burges Salmon. He joined the firm in 2008 and advises funders, developers and contractors across the construction and engineering sector, with particular emphasis on energy and infrastructure.

Richard Pettit, who joined Burges Salmon as a trainee in 2004, is a member of the firm's **Pensions team**. He advises companies and pension scheme trustees across the full range of pensions issues including moral hazard investigations, corporate restructuring, Pension Protection Fund work, funding negotiations, scheme documentation, closures and mergers. He is dual qualified in Northern Ireland and England and Wales.

Matthew Sims became a partner in the Burges Salmon **Real Estate team**. He specialises in UK real estate investment and portfolio management work including acquisitions and disposals and landlord and tenant work. Matthew has a strong track record in acting for clients in the office market, the retail sector and the hotel, leisure and tourism sectors and has particular expertise in the West End and luxury and premium brand markets.

James Sutherland is a member of the firm's **Disputes and Litigation practice**, specialising in Real Estate Disputes. He has particular expertise in advising banks, institutional and commercial landowners and occupiers in relation to landlord/tenant disputes, real property disputes and property related insolvency.

The sixth new partner, **Nathan Curtis**, is an energy projects specialist and joined the firm's **Energy and Utilities sector group** as a partner in April from Clifford Chance.

Burges Salmon's managing partner, Peter Morris, said:

"We know that clients value the partner led service that we provide at Burges Salmon and we are therefore delighted to welcome these six new lawyers to the partnership.

"Lloyd, Jonny, Richard, Matt and James are all exceptionally talented and will have an important role to play in the ongoing growth of Burges Salmon across a number of the firm's key practice areas and industry sectors, by continuing to provide an excellent service to our clients.

"We are also pleased to welcome Nathan who will provide our Energy and Utilities sector group with additional skills and a high level of sector expertise that will strengthen our capability in this area."

Contacts

Richard Spink
Partner
0117 939 2218
richard.spink@burges-salmon.com

Mark Shepherd
Partner
0117 902 6624
mark.shepherd@burges-salmon.com

Follow @BurgesSalmon

Visit our website at www.burges-salmon.com

One Glass Wharf
Bristol BS2 0ZX
Tel: +44 (0) 117 939 2000
Fax: +44 (0) 117 902 4400

6 New Street Square
London EC4A 3BF
Tel: +44 (0) 20 7685 1200
Fax: +44 (0) 20 7980 4966

www.burges-salmon.com

BURGES SALMON