Newsletter

BURGES SALMON

Private Equity News

Winter 2013

Welcome

Welcome to The Venturer, 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 The Venturer or private equity generally please email **richard.spink@burges-salmon.com** or **mark.shepherd@burges-salmon.com**

It was a very successful sporting summer with Andy Murray finally winning Wimbledon, Chris Froome winning the Tour de France, a spectacular Lions tour and England now in Australia to defend their Summer Ashes win. And, of course, we've even managed to benefit from some uncharacteristically British good weather.

In the private equity world, the long-awaited **Alternative Investment Fund Managers Directive** (AIFMD) finally came into force and our article focuses on the procedural changes that will have an impact at both fund and portfolio company level.

New **tax breaks for employee shareholders** and **improvements to Entrepreneurs Relief** treatment of EMI options have been brought in and may be useful to incentivise management teams, in certain circumstances. Changes to **tax treatment of interest on shareholder loans** in private equity (PE) structures may impact management team and private equity executors going forward.

Finally, it seems that continuing low interest rates are finally having a positive effect on business confidence, with the economy showing real signs of recovery and growth across a number of sectors. which should be good news for the private equity industry.

The renewable energy market remains an attractive proposition for many funds and our article on page 5 considers the, as yet, largely untapped area of the renewable heat market and the **Renewable Heat Incentive** offered by the government.

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The AIFMD - a new era for PE in Europe

On 22 July 2013 the controversial and epoch making Alternative Investment Fund Managers Directive was finally implemented in the UK and other EU Member States. Its objective is to create a single European market for alternative investment funds, including private equity funds. As many of our readers will be only too aware, its impact on the PE industry will be substantial as fund managers that have previously been subject to very few regulatory requirements adjust to the "new normal". However, the Directive also brings significant opportunities, most obviously potential access to a wider pan-European investment pool.

This article focuses on certain key aspects of the Directive which will involve PE firms having to change their procedures - including requirements around depositaries, remuneration and the impact at the level of portfolio companies.

Who is caught by the Directive?

The Directive regulates the managers of alternative investment funds ("AIFs"). The definition of an AIF is very broad and will include most private equity funds. However, the managers of smaller PE funds may be able to benefit from a "sub-threshold" regime under the Directive. This will apply to any PE fund manager who, on aggregate, has assets under management of less than EUR 500 million, provided all of its AIFs are i) unleveraged and ii) do not permit redemption during the first 5 years following initial investment (where these requirements are satisfied, the level of the threshold is EUR 100 million). Under

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the sub-threshold regime (which is not described in detail in this article) managers are subject to limited obligations under the Directive - but, conversely, are not able to take the benefit of an EU marketing "passport" in relation to their funds.

Each qualifying AIF is required to have a single manager who will need to be authorised by the FCA and shall be responsible for ensuring compliance with the requirements of the Directive. The manager may be an external management company or the AIF itself where the AIF's governing body chooses not to appoint an external manager. Most PE funds are structured so that the AIF manager will be an external entity.

The majority of UK PE fund managers will already be FCA authorised, so the authorisation requirement will, in practice, mean applying to the FCA for a variation of permission to manage an AIF. Transitional provisions allow a "grace" period of up to one year for managers that were managing an AIF immediately prior to 22 July 2013 - however, the FCA is advising such firms to apply for authorisation as soon as possible and by no later than 22 January 2014.

What are the depositary requirements?

One of the most controversial aspects of the Directive has been the requirement for AIF managers to ensure that a single depositary is appointed for each AIF it manages. The functions of a depositary will include (among other things) the safekeeping of the AIF's assets. Although standard practice for funds investing in financial instruments (e.g. listed shares etc), the depositary concept is generally unfamiliar to the UK PE industry where most funds have historically operated without such custody arrangements. As such, concerns have been raised about the cost benefit and value of appointing entities to perform a function which has not previously existed.

The FCA has gone some way to addressing these concerns by opting to make use of a concession under the Directive. The concession - which is clearly directed at the PE market - allows certain AIFs with a five year lock-up period to appoint non-bank depositaries (for example, lawyers and notaries) to perform the depositary function. The hope is that this will lead to new entrants into the depositary market, thereby making it more competitive and driving down costs. Whether the concession has the desired effect remains to be seen.

What is the impact on remuneration?

AIF managers will be required to comply with stringent new rules on the form and level of remuneration for senior employees. These requirements will be new for many PE firms. The purpose of the new rules, which have caused considerable debate and controversy, is to seek to prevent compensation structures that potentially encourage risky short term strategies and behaviours over the long term interests of investors. Notably, there is an expectation that between 40-60% of variable pay should be deferred (with the deferral period being at least 3 to 5 years) and at least 50% of variable pay to be in non-cash instruments.

Carried interest arrangements are specifically mentioned as being within the scope of the remuneration requirements and these arrangements will need to be considered carefully for compliance.

"AIF managers will be required to comply with stringent new rules on the form and level of remuneration for senior employees."

What is the impact of the Directive at portfolio company level?

The Directive also imposes a number of significant notification and disclosure obligations which impact the level of investments into portfolio companies. In particular, an AIF manager must notify the FCA whenever the proportion of voting rights that an AIF holds in a non-listed company reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 70%.

An AIF manager is also required to make further notifications when it acquires control of a non-listed company to the company itself, the company's shareholders and the FCA. "Control" for these purposes is broadly regarded as 50% or more of the voting rights in the non-listed company. Among other things, the notifications will need to include details of: (i) the resulting situation in terms of voting rights in the company; (ii) the conditions under which control has been reached; (iii) the policy for preventing and managing conflicts of interest; and (iv) the policy for external and internal communications relating to the company, in particular as regards employees. An AIF manager must also provide the FCA and the AIF with information on how the acquisition has been financed.

There are also new requirements placed on PE fund managers to disclose to the investee company and its employees their intentions regarding the future business of the company and the likely repercussions on employment.

In addition, the so-called "asset stripping prohibition" in the Directive provides that where an AIF acquires control of a non-listed company, the AIF manager must not for a period of 24 months facilitate, support or instruct any distribution, capital reduction, share redemption or acquisition by the company of its own shares.

It is likely that some or all of the above requirements will need to be reflected in transaction documents.

Passporting rights

It is clear that the Directive marks a sea change in the PE industry and will undoubtedly mean increased costs and operational requirements. However, it should not be forgotten that the Directive also provides the opportunity of accessing a wider European market through enhanced passporting rights. It is to be hoped that in time the payoff for the considerable efforts demanded of the industry will be the emergence and recognition of an AIFMD brand of quality to benefit both investors and PE fund managers.

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Relief for employee shareholders

This year's Finance Act extends two welcome tax reliefs to incentivise employee shareholders. Both may be relevant for PE structures in certain circumstances

The first allows companies to award an amount of share value to an employee free of tax, while the second widens the scope of entrepreneurs' relief from Capital Gains Tax (**CGT**) to include shares acquired through the exercise of Enterprise Management Incentive (**EMI**) options.

Tax free share value for employees

Employees who receive shares free of charge can now take the first £2,000 of value without incurring any liability to income tax and NIC. Even more importantly, in the PE context, when the free shares are eventually sold, any gains made on up to £50,000 worth of shares awarded (valued at the outset) may be exempt from CGT. HMRC will agree values for the shares in advance of the shares being issued.

In return for these tax breaks, the employee must give up certain statutory rights, including unfair dismissal. Employees are free to negotiate contractual protections which go some way to compensate for the rights given up, for example, an employee might negotiate a longer notice period, in substitution for unfair dismissal rights.

The tax exemptions are not available where the employee or an individual connected to the employee has (or had in the year prior to the special shares being acquired) a 'material interest' in the employer company or a parent of the employer company, essentially being a 25% interest. There are connected party tests here, and care will need to be taken in analysing these connections, to ensure that management will benefit as intended from the tax exemptions.

Subject to the 'material interest' test, management can hold shares which benefit from these special tax exemptions in addition to holding ordinary sweet equity.

The shares must be issued for no payment or consideration (other than signing the agreement to give up employment rights). This raises some technical issues and commercially this may be unattractive to PE houses who wish to see real money subscribed by key management. However, it is a structure worth considering particularly given that, unusually, tax efficiency can be achieved for shares in subsidiary companies (which fail the qualifying requirements for the use of the tax efficient EMI and approved schemes).

> *"The potential for a 10% tax rate on gains make EMI options an even more attractive way of using shares to incentivise employees."*

The government's intention is for the scheme to be used in growing companies and whether it will be used in practice in many PE situations remains to be seen. On balance, the loss of employment rights may not be felt to be significant where they can be substituted contractually. Employees will need to bear in mind that leaver provisions may well apply in relation to the shares which would impact disposal value such that the CGT exemption is less valuable and, of course, that the value of the equity on exit may not give rise to a significant (or indeed any) gain in any event.

Ironically the requirement for the employee to be advised on the financial aspects is more easily dealt with in a PE deal than would otherwise be the case outside of the PE context.

Entrepreneurs' Relief for EMI option shares

Entrepreneurs' relief from CGT now applies to disposals of shares acquired pursuant to the exercise of EMI options, subject to certain conditions.

Entrepreneur's relief from CGT arising on the disposal of shares ordinarily requires that the individual must have held the shares for a qualifying period of at least 12 months prior to the disposal and hold a shareholding which represents at least 5% of the voting shares in the company.

Now, where the shares sold are acquired by the exercise of EMI options, the time from the date on which the EMI options were granted (as well as the time the shares are held) is counted for the purposes of the 12 month qualifying period, and, significantly, there is no minimum shareholding requirement.

The potential for a 10% tax rate on gains make EMI options an even more attractive way of using shares to incentivise employees.

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Also, because the terms of EMI option grants can be flexible it may be preferable to use an EMI option to deliver shares even where it is intended for an employee to hold shares from the outset, where the shareholding will be under the 5% threshold.

Extra care will need to be taken to monitor 'disqualifying events' (events which freeze the income tax relief for EMI gains), as failing to exercise options within 90 days of such an event will jeopardise entrepreneurs' relief. Existing EMI schemes should be reviewed as their terms may not permit exercise in these circumstances and so prevent an employee from claiming entrepreneurs' relief.

This extension of relief applies to EMI options exercised, and shares disposed of, on or after 6 April 2013. There are transitional provisions dealing with shares acquired during the 2012/13 tax year. Individuals who exercised their options before 6 April 2012 will not benefit.

Given the right circumstances, these reliefs could prove to be significant, particularly to start-ups, high growth enterprises or companies seeking to provide an element of ownership-based remuneration to employees in a tax efficient manner. However, the usual qualification issues for EMI will still be relevant for PE backed businesses where the PE firm holds a majority stake.

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Tax on Loan Notes: change in law

Many readers may be aware of a recent change in law under which the Government has restricted the ability of UK income tax payers to claim "corresponding adjustments" in respect of debt interest. This may impact on how individual managers of private equity backed portfolio companies holding loan notes are taxed on payments of interest.

Private equity-backed acquisitions will usually involve an acquisition SPV or SPVs financed almost entirely by bank and shareholder debt, including "rollover" loan notes from management. A tax deduction will be sought in respect of the interest cost on shareholder debt, which can be offset against the profits of the target company or group.

However, part of the tax deduction for interest costs on shareholder debt is usually disallowed for tax purposes, under the "transfer pricing" rules. In broad terms, interest can be disallowed on the portion of the shareholder debt that is not considered to be on arm's length terms (i.e. if the amount lent, or the interest rate, exceeds the terms on which a third party would have lent).

Where interest is treated as non-tax deductible for the payer under the transfer pricing rules, the recipient can make a claim for the interest received to be treated as non-taxable. This is known as a "corresponding adjustment" and is intended to achieve symmetry in the tax position. Previously, it was sometimes (but not always) possible for management teams to obtain tax-free treatment on a proportion of any interest received on their loan notes by claiming "corresponding adjustments" on payments of interest which had been treated as non-tax deductible for the paying company.

However, HMRC perceived the rules to have been exploited as a result of the different tax rates applying to individual managers and portfolio companies. In other words, a disallowed interest payment can result in additional tax cost for the company at the corporation tax rate, but a corresponding adjustment claim by an individual lender can result in a tax saving at the (higher) income tax rate.

The Government has now implemented rules, which took effect from October 25th, which provide that, where a corresponding adjustment is claimed for loan note interest on the basis set out

above, the effective tax rate on the interest will be the dividend rate (current top effective rate of 30.56%) rather than the rate for other types of income (current top rate 45%). Although this is clearly less generous than the previous position, under which interest could be received tax free once a corresponding adjustment was claimed, it is still possible for management to claim corresponding adjustments, and achieve tax savings, on some (but not all) of the interest received on their loan notes. Following the change in law, however, the tax rate will only fall from 45% to 30.56% rather than from 45% to 0% as under the previous rules.

The Renewable Heat Incentive: an attractive investment?

With the Energy Bill being hotly debated by Parliament, various recent refinements being made to our existing renewable heat and electricity incentive mechanisms and DECC publishing its proposed 'strike prices' for renewable electricity projects larger than 5MW from 2017 onwards, one could be forgiven for thinking that renewable energy developers may be taking a breather to reflect. Not so. Despite the uncertainty, the UK is still very highly ranked globally in terms of being an attractive place to invest in the renewable energy sector, and certainly on the basis of current activity levels we are seeing in the market, projects are still coming to fruition at a significant rate. Admittedly, with reductions in incentive levels having taken place over the last couple of years under the Renewables Obligation (RO) and Feed-in Tariffs, developers (and their advisors) are having to be smarter, more streamlined and more cost-effective in bringing projects to the market, but for those that are successful, investor appetite remains high.

> *"...the UK is still very highly ranked globally in terms of being an attractive place to invest in the renewable energy sector..."*

One area which has remained largely untapped in terms of PE investment until recently has been the renewable heat market. As a result of the Government's ambition that 12% of heating will come from renewable sources by 2020, the Government has already introduced a Renewable Heat Incentive (RHI) for **non-domestic** renewable heat installations, which has been open for applications since November 2011. Thus far, the vast majority of installations accredited have been small and medium scale biomass boilers, although some recent increases in the tariff levels for ground source heat pumps, solar thermal installations and large-scale (>1MW) biomass installations are likely to encourage greater interest in these markets in the near future.

The non-domestic scheme provides a 20 year, RPI-indexed income stream, to the owners of eligible renewable heating systems. The tariff levels underpinning this income stream vary depending on the type and size of the installation, but each tariff has been designed to provide a 12% rate of return for investors. From a funding perspective, unlike electricity projects where the distribution or transmission network provides an outlet for electricity which is not used on-site, the general lack of district heating networks in the UK means that revenues are very dependent upon what heat can be and will be 'usefully' used on-site. The incentive levels on offer will undoubtedly see increasingly significant investments being made in this sector over the coming years. Successful business plans will need to overcome the challenges posed by the eligibility rules underpinning the RHI regime and the risks of fluctuating on-site heat demands. Nevertheless, it seems certain that many businesses will succeed.

A second phase of support for **domestic** installations is expected to open for applications in April 2014. The financial incentives underpinning such domestic projects have been designed quite differently, with tariffs only being paid over the first seven years of an installation's lifetime. It remains to be seen whether the domestic RHI will have the same impact on the solar thermal and ground-source and air-source heat pump industries as the Feed-in Tariff has had on the solar PV industry. It will also be interesting to see whether the design of the domestic RHI scheme will encourage developers and investors to bring forward "free heat" offerings to householders. The rules governing the payment of RHI tariffs are certainly more restrictive than under the Feed-in Tariff, therefore business models will need to cater for the complexities of the regime as the detail of the domestic regime emerges.

> *"...each tariff has been designed to provide a 12% rate of return for investors."*

If you wish to discuss any renewable energy opportunities or ideas with us, please contact James Phillips on +44 (0)117 902 7753 or james.phillips@burges-salmon.com or Ross Fairley on +44 (0)117 902 6351 or ross.fairley@burges-salmon.com

Disclosure of beneficial ownership in UK companies

Following closure of the consultation period on 16 September 2013, the Department for Business Innovation and Skills (BIS) is currently reviewing the responses it has received to its discussion paper on the options to enhance the transparency of UK company ownership and increase trust in UK business. The paper set out a number of key proposals on which BIS sought feedback, including creating a central registry recording the beneficial owners of UK companies. A number of organisations responded, including the BVCA.

Creation of register of beneficial owners

The paper proposed that a company (and potentially LLPs) would be required to hold the name and address of beneficial owners and details of the shares they are interested in. A beneficial owner would be defined as any individual with an interest in more than 25% of the shares or voting rights of the company, or who otherwise exercises control over the way that the company is run (regardless of whether they hold shares). The holding of individuals acting in concert would be aggregated.

As the proposed rules are currently drafted, there is a risk that private equity assets owned by limited partnerships through English companies could be required to publicly disclose the investors in those funds.

BVCA response to the consultation paper

The BVCA's response to the paper identified a number of areas of concern, with their focus being on the increased disclosure burden on companies, the effect on the competitiveness of the UK and its attractiveness as a location for investment, particularly at a time when the Government is seeking to promote the UK's fund management industry.

Key areas of concern identified by the BVCA are:

1. Using the concept of a 'beneficial owner' would mean looking through a company to identify the ownership interests of individual limited partners/investors. The BVCA have suggested that it would be more appropriate to disclose the identity of the general partner or the investment manager, being the person with day to day control of the fund.
2. BIS's starting point is that all UK companies would be within the requirement to maintain a register, although companies listed on the Main Market of the London Stock Exchange would be exempt. The BVCA consider that this exemption should be extended to all regulated entities as managers of UK private equity funds are usually LLPs authorised and regulated by the Financial Conduct Authority and, in due course, authorised as Alternative Investment Fund Managers under the Alternative Investment Fund Managers Directive, meaning that significant information and assurance as to their status will already be publicly available.
3. The BCVA consider that requiring companies to disclose beneficial ownership could be a disincentive to investors to invest in the UK as passive investors typically want their investment strategies to be kept confidential and fund managers usually have strong obligations of confidentiality to their investors. Again, the BVCA consider this concern could be addressed by limiting the register to identifying the fund and general partner or investment manager (see point one above).

Nominee directors

One of the other key proposals in the paper is that nominee directors will be required to disclose that they are a nominee and on whose behalf they have been appointed. The paper assumes that "individuals acting as a director of over 50 companies are almost certainly acting as nominee directors". The BVCA's view is that it is arbitrary to use the number of directorships as a criterion given that for private equity and venture capital fund managers it is important to be able to appoint common officers to the boards of large numbers of investment holding companies and underlying portfolio companies. A requirement to identify the nominees would adversely impact the governance arrangements private equity managers have established.

The timing for BIS to respond to the views received is not yet known.

The full paper can be found here: **https://www.gov.uk/government/consultations/company-ownership-transparency-and-trust-discussion-paper** and a copy of the BVCA's response here: **http://www.bvca .co.uk/Portals/0/library/BIS%20 discussion%20paper%20Transparency%20and%20Trust.pdf**

Recent deals

In the private equity world Burges Salmon has recently been involved in the following transactions:

Swift Technologies

Advised certain members of the Swift management team in connection with the acquisition of the Swift group by Wellspring Capital Management from Gresham Private Equity.

Arla Foods

Advised management on the buy-out of the Crediton Dairy from Arla Foods.

Trunki

Advised Business Growth Fund on its £3.92m growth capital investment Bristol-based Trunki (Magmatic Limited), which was BGF's first investment in the South West.

Oasis Healthcare

Advised management on the buy-out of Oasis Healthcare backed by Bridgepoint private equity from Duke Street.

Stage Electrics

Advised management on the MBO of Stage Electrics Partnership Limited from its founder.

Petrochem

Advised selling shareholders on the sale of Petrochem Carless Holdings to HIG backed Haltermann Group.

Kings Court Trust

Advising Bath-based Kings Court Trust on its £4m development capital investment from Smedvig Capital.

Spear Group

Advised institutional and management shareholders on the sale of the group to private equity backed Constantia Flexibles Group.

Beechbrook Capital

Advising Beechbrook in connection with buyouts of The SR Group backed by Baird and Sitex Orbis.

Belltown Power Ltd

Burges Salmon have advised Belltown Power Limited on the acquisition of land at Watchfield in Somerset for the development and construction of a Solar PV project.

Ingenious

Advised on the acquisition by Ingenious investor companies of three "shovel-ready" solar projects through the purchase of SPVs.

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