Private Equity Director

Corbett Keeling

CMS Cameron McKenna

Kleinwort Benson

The Newsletter for Executive Directors of Private Equity Backed Businesses April 2011

Welcome to the April 2011 issue of Private Equity Director, the quarterly newsletter for executive directors of private equity backed businesses. PE Director™ covers financial, legal, tax, wealth management and similar issues that are crucial to building and realising the value of your business.

Last month PE Director ran an Exits Seminar explaining how to maximise value on sale or other exit from your business. This was well received, and we therefore plan to re-run it for those who were unable but wanted to attend.

The next Exits Seminar will be held on the morning of 15 September 2011 from 8.15 to 9.30am. This will again be hosted by our partner CMS Cameron McKenna at their offices: Mitre House, 160 Aldersgate Street, London EC1. These seminars are an excellent opportunity to delve in more detail into the issues that are discussed in this newsletter. **If you would like to attend the Exits Seminar, please put the date in your diary and e-mail meganpeel@pedirector.com indicating this and providing your contact details so that we can send you more information on the seminar.**

In this edition, we look at some of the key issues private equity backed businesses face in 2011 including:

- **The impact of the budget (pages 1 to 2);**
- **The Bribery Act (pages 2 to 4);**
- **Recent world events from the Japanese earthquake to Middle East unrest (pages 4 to 5);**
- **Market activity (pages 6 to 7).**

With best wishes

Megan Peel, *Editor*
(meganpeel@pedirector.com)

A Budget for growth?

On 23rd March, the Chancellor of the Exchequer delivered his first regular Budget. Here, Aaron Fairhurst of lawyers and tax advisors CMS Cameron McKenna asks whether it really was, as billed, "a Budget for Growth". He concludes that, broadly, it was – but it depends which industry you are in. He also considers the Budget in more detail to uncover some particular points of interest for managers in the private equity industry.

In general, the private equity industry will find much to welcome in George Osborne's first non-emergency Budget. Highlights aimed at supporting investment and boosting growth include additional cuts to corporation tax rates, the expansion of entrepreneurs' relief and enhancements to the Enterprise Investment Scheme. However, in contrast with the generally positive tone of the new measures introduced, the Chancellor announced some significant and unexpected tax rises affecting the oil and gas industry, as well as further increases to the bank levy.

Corporation tax will drop from 28% to 26%

Corporation tax: Previously announced reductions in the main rate of corporation tax are to come sooner than formerly envisaged.

The headline rate for corporation tax will drop from 28% to 26% for the financial year beginning April 2011 and then reduce to 25% for the financial year beginning April 2012.

Not every sector will benefit from these reductions, however: the rates for ring-fenced profits from oil and gas will remain at 30%. When combined with an increase in the supplementary charge for oil and gas companies from 20% to 32%, these measures will not be welcomed by companies operating in this sector. In the current economic climate, it appears that the oil companies are as much fair game as banks when it comes to populist vote-winning measures.

Entrepreneurs' relief is to be doubled to £10 million of gains

Entrepreneurs' relief: Also set out in the Chancellor's plan to kick-start the economy and rejuvenate the private sector were enhancements to entrepreneurs' relief, which allows a capital gains tax rate of 10% (reduced from 28%) for individuals making qualifying disposals. This relief was previously subject to a lifetime limit of £5 million worth of gains, but this limit is to be doubled to £10 million of gains for disposals on or after 6th April 2011. The good news is that this increases the maximum tax value of the relief to £1.8 million – and potentially double that, if use can be made of your spouse's relief.

EIS extended on all fronts

EIS: Further steps taken to encourage investment in new and growing businesses involved extending the scope of the Enterprise Investment Scheme. The proposed income tax relief provided under the scheme will increase from 20% to 30%. And that's not all: the maximum size of the companies that qualify for investment was raised, the amount that can be invested in any such company was increased to £10 million, and the amount that any individual can invest in any year was also raised, to £1 million.

Non-doms: Finally, changes are to be introduced to the tax regime for non-UK domiciled individuals. The government intends to implement the changes with effect from April 2012, following consultation on the detail. The proposed changes include removing the tax

charge on remittances of income or capital gains to the UK for the purposes of commercial investment and the introduction of a higher annual charge of £50,000 for individuals who have been UK resident for 12 years or more and who claim the remittance basis. Crucially, the Chancellor has given assurances that these will be the last changes to the non-dom tax regime in this Parliament, which should enable individuals to plan ahead.

So, in conclusion, this was a broadly positive Budget and should genuinely help to encourage investment – just as long as you aren't in the oil or banking sector.

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The Bribery Act: the countdown begins

With just two months to go before the Bribery Act takes effect, CMS Cameron McKenna outlines what it will mean for the senior managers of private equity backed companies. Among other things, CMS finds – to PE Director's immense relief – that taking clients to Wimbledon should not fall within the scope of the Act, as long as the hospitality isn't too lavish.

After its consultation last year, the Ministry of Justice has at last published its guidance for businesses on putting in place adequate procedures to prevent bribery, as required under the Bribery Act 2010. The Act will come into force on 1st July 2011, so companies will have to work fast to design and implement compliance programmes. The directors of the Serious Fraud Office (SFO) and Department for

Public Prosecutions (DPP) have also published joint guidance on how prosecutors should make their decisions under the Act.

The Ministry's guidance is split into two sections:

- the government's intended interpretation of, and policy on, certain key elements of the Act; and
- the statutory guidance on steps businesses can take to put in place adequate procedures, which are organised under six key principles.

The Act – government policy and intention

While it will of course be for the courts to interpret the Act, the government sets out how it wants the Act to apply and uses examples to respond to the criticisms levelled at the legislation. Key points include the following:

An **associated person** is someone who performs services for a company and can make it automatically liable for their corrupt acts. Though broad, the scope of this term is not unlimited: the guidance highlights that a supplier of goods (without services) will not be an associated person under the terms of the Act. It also explains the government's view on supply chain transactions. Bribery risk can be mitigated if the principal employs appropriate procedures in dealings with his counterparty, and this can include asking the counterparty to adopt appropriate procedures with the next party in the chain.

The guidance differentiates between **joint ventures** conducted through a legal entity and those that are purely contractual. Where there is a legal entity, "a bribe paid by the joint venture entity may lead to liability for a member of the joint venture if the joint venture is performing services for the member and the bribe is paid with the intention of benefiting that member". Similarly, a "bribe paid on behalf of the joint venture entity by one of its employees or agents will . . . not trigger liability for members of the joint venture simply by virtue of them benefiting indirectly from the bribe through their investment in or ownership of the joint venture". However, an agent employed by a participant in a contractual joint venture (where there is no separate joint venture entity) will probably be regarded as a person associated only with the participant if there is no evidence that "the agent is acting on behalf of the contractual joint venture as a whole". The person performing the services for the joint venture who pays a bribe must also intend to obtain or retain business or a business advantage for the joint venture.

In the same way, if bribes are paid by an employee or agent of a subsidiary company, then the parent company or other subsidiaries in the group will not be automatically liable – even if those entities retain some indirect benefit from the bribe – unless the employee or agent intended to obtain or retain business for the parent or those other subsidiaries.

Kenneth Clarke . . . "Rest assured – no one wants to stop firms getting to know their clients by taking them to events like Wimbledon or the Grand Prix"

Corporate hospitality is not outlawed by the Bribery Act. Bona fide hospitality and promotional expenditure is permitted, as long as it is proportionate and reasonable relative to the business being conducted. The guidance includes some reassuring examples: "an invitation to foreign clients to attend a Six Nations match at Twickenham as part of a public relations exercise designed to cement good relations and enhance knowledge in the organisation's field is extremely unlikely . . . to be evidence of an intention to induce improper performance of a relevant function." In his foreword to the guidance, Kenneth Clarke elaborates: "Rest assured – no one wants to stop firms getting to know their clients by taking them to events like Wimbledon or the Grand Prix".

The guidance recognises that whether hospitality given to a foreign public official amounts to an improper inducement probably depends on the circumstances: "the more lavish the hospitality . . ., generally the greater the inference that it is intended to influence the official to grant business or a business advantage in return".

Prosecution should probably be brought if there are large or repeated payments, if they are planned for or accepted as a standard practice

The guidance accepts that it will not always be in the public interest to prosecute **facilitation payments**. It refers to the DPP and SFO's joint

guidance, which advises that a prosecution should probably be brought if there are large or repeated payments, if they are planned for or accepted as a standard practice, or if the corporate policy on facilitation payments has not been followed. Where it can be shown that reasonable steps were taken to try to avoid making facilitation payments and they were not simply accepted as part of doing business, a prosecution is less likely to be in the public interest.

Six principles for adequate procedures

Guidance on adequate procedures for bribery prevention is based on six principles, which are neither prescriptive nor intended to be "one size fits all". They are:

- Proportionate procedures
- Top-level commitment
- Risk assessment
- Due diligence
- Communication (including training)
- Monitoring and review

The key principle is "proportionality"

The key principle is "proportionality", but particular emphasis is also placed on "communication", with a focus on training: "like all procedures, training should be proportionate to risk but some training is likely to be effective in firmly establishing an anti-bribery culture whatever the level of risk." The guidance suggests mandatory general training for new employees or agents at induction. In any event, training will need to be tailored to address "specific risks associated with specific posts".

In our view at CMS Cameron McKenna, the guidance reflects a commercial, commonsense compromise between the need for robust anti-corruption laws and the need for clear and practical guidance to help businesses understand how to stay on the right side of the law. It reassures the business community that normal, legitimate practices will not suddenly be outlawed and the corporate hospitality industry will not be killed off. Unfortunately, it is unclear how much weight the courts will give to the guidance, particularly the parts that are not required by the statute.

Still, now that we have the guidance and a date for its implementation, businesses that have not already done so should not delay in assessing their bribery risks and putting proportionate procedures in place.

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Kleinwort Benson – Wealth Management

A run of bad luck for the world economy

More than a decade of generally benign economic conditions came to an abrupt halt with the advent of the credit crisis. Now the authorities in western economies are trying to engineer an exit from the extremely supportive measures introduced to soften the impact of the crisis, but Jeremy Beckwith, Chief Investment Officer of Kleinwort Benson, finds that the global economy has encountered several strong headwinds which are making life difficult for them – and the private equity industry is unlikely to escape unscathed.

20 million Chinese workers every year left agricultural work

In the years up to 2007, the global economy experienced several positive trends which boosted "disinflationary growth". That is, they were good for growth but also helped to keep inflation low. The main reason for this was the transition of the Chinese population from farms to cities. Some 20 million workers every year left agricultural work which barely managed to feed them and instead migrated to the cities to find new manufacturing jobs at wages they could previously only have dreamt of. Even so, their wages were fractions of those paid to similar workers in developed economies.

The result was a massive Chinese trade surplus, which was re-invested into Western economies. That set up a virtuous circle: it kept down both the Chinese exchange rate and interest rates in the developed economies, whose consumers could therefore go out and borrow more, which they duly spent on Chinese imports. Inflation, as seen in the cost of goods in the shops here in the west, was held down. Western wages were

kept low as jobs were outsourced to emerging economies, and yet global growth was strong. Other factors, such as the steady freeing-up of world trade and the transforming power of the internet on all human interactions, were similarly positive forces for disinflationary growth. Life was good, and Gordon Brown kept reminding us that he had "abolished boom and bust".

We are now approaching the critical point where government stimulus will either fade or be reversed

The crash of 2008 severely weakened the global financial system, requiring fiscal and monetary stimulus on an unprecedented scale to pull the world economy out of recession and back on to a path of growth. We are now approaching the critical point where government stimulus will either fade (as in the US and China) or be reversed (as in the UK and Europe). So the world economy is more than usually vulnerable to external shocks. Now, shocks can be positive or negative – the impact of Chinese urban migration was a positive shock for the world. So far in 2011, however, the shocks have all been negative. Instead of enjoying "disinflationary growth" shocks, we are enduring "stagflationary shocks" – events which are bad for global growth and simultaneously push up prices.

Higher oil prices quickly translate into higher end prices for all goods

Political unrest in North Africa and the Middle East has hit oil production in Libya and Yemen, while Bahrain's troubles have reminded investors that it lies just 60 miles from the world's largest oilfield, Saudi Arabia. Sharply rising oil prices have always been intensely stagflationary for the world economy. The reasons are obvious. As a key input cost into most manufactured goods and the key cost in transportation, higher oil prices quickly translate into higher end prices for all goods. Without compensating higher wages, consumers have less disposable income to spend on other goods and services, and so overall economic demand declines, leading to the combination of higher prices and lower growth – the dreaded stagflation.

Many workers, mostly foreign but some Japanese, have left Tokyo because of fears of radiation in the capital

Another stagflationary shock was the Japanese earthquake, followed by the tsunami and nuclear meltdown. Although the rebuilding of homes, roads and power stations will eventually provide a boost to economic growth, the immediate result is a severe slowdown in Japan. The nuclear fallout is potentially the most harmful aspect. Many workers, mostly foreign but some Japanese, have left Tokyo because of fears of radiation in the capital. Similar concerns will have long-term effects on the demand for Japanese-produced food and water. Electricity production is down by 10% because of the disaster. This is now a key supply constraint for Japanese industry – they will struggle to produce more and their costs of production will be higher because their overheads will be spread over a lower volume of production.

On top of all that, we have rising food prices, which are also stagflationary: when food prices rise, poor workers are forced to demand wage rises in order to survive.

The world economy has stumbled into a run of bad luck with these shocks

At the very least, the world economy has stumbled into a run of bad luck with these shocks. Obviously, they aren't connected, but the timing of these shocks, and their combined power, is not ideal, especially coming at such a critical time for economic policy. George Osborne and other policy-makers worldwide have their work cut out to foster the growth we need.

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This note is intended to give an insight into the thought processes that lie behind our investment views and our investment strategy. They do not necessarily reflect the current investment policy of Kleinwort Benson. This note is intended for information purposes only and does not take into account the investment objective, the financial situation or the individual needs of any particular person. Investors should obtain independent advice based on their own particular circumstances before making investment decisions.

Market activity: steady as she goes + some optimism

Private equity activity followed the broader UK economy on a downward path around the end of 2008. Since then, deal-making has levelled out. Here, in his regular quarterly commentary, Jim Keeling of corporate finance advisor Corbett Keeling assesses the latest data to see what has been happening in recent months and where activity might go next.

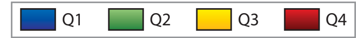
If we take a broad view of the Unquote's buy-out statistics for the last ten years, the striking feature is the downward step change in activity in the final quarter of 2008. That change has broadly stuck with us ever since.

So the big question for principals looking to execute MBOs, and for their advisers, is whether the market will remain at these lower levels or recover to something nearer the heady heights of the mid-2000s. Or is there a third route – could there even be a further fall?

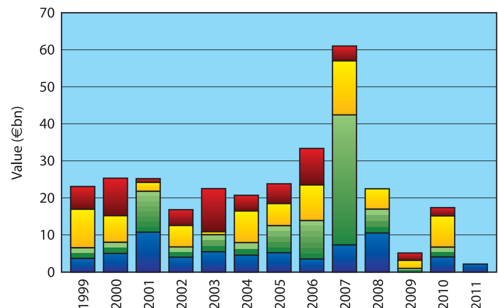
Could there be a further fall?

To assess which seems the more probable outcome, let's first look at the facts, starting as usual with larger UK buy-outs of more than €150 million enterprise value, then UK buy-outs of less than €150 million and finally early stage and expansion capital deals.

- The aggregate number and value of **larger UK buy-outs** (€150 million or above) in the quarter just finished – at just four deals completed for a total of €2 billion – was by both measures only marginally below the average for the preceding eight quarters. So, on the face of it, the picture here looks steady compared with the downturn period since the end of 2008. It shows no evidence of either an upturn to prior levels or a further downturn.
- It was a similar picture for **smaller UK buy-outs** (below €150 million), with 20 deals for a total of €600 million. This is again just below the average for the preceding eight quarters, but not so far below as to suggest any material evidence of a downturn. Indeed, compared with the final quarter of last year, the total value of deals has increased by 30%.
- **UK early stage and expansion capital deals** don't present such a reassuring picture. The number of deals, at just 22, is around half the average for the preceding eight quarters, and the total funding of €413 million, whilst stronger than the final quarter of 2010, is



€150m+ Buy-outs by Value

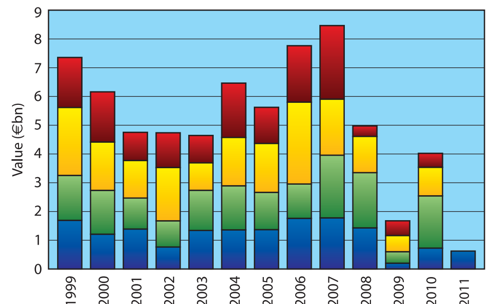


about two thirds of the quarterly average for the whole of calendar years 2009 and 2010.

Alongside these hard facts, it is probably helpful to bear in mind some softer factors.

- Some of the recent budget changes produced a clear incentive to delay deals until after 5th April. For example, the

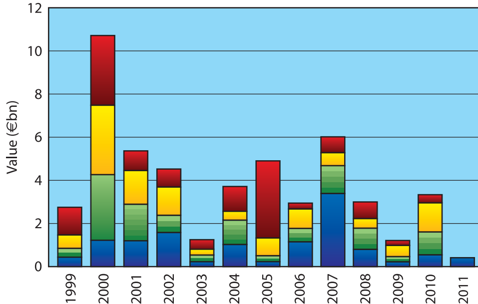
Sub €150m Buy-outs by Value



increase in entrepreneurs' relief to £10 million produced a potential additional tax saving of £900,000 for an owner-manager selling a business after that date rather than before – a clear incentive to delay some deals that would otherwise have closed around the end of March.

- Statistics coming in from other regions are also encouraging: for example, mergers and acquisitions activity in the US jumped 84% in

Early-Stage/Expansion Deals by Value



the first quarter compared with the same period in 2010, fuelling a rise of 26% in global M&A activity.

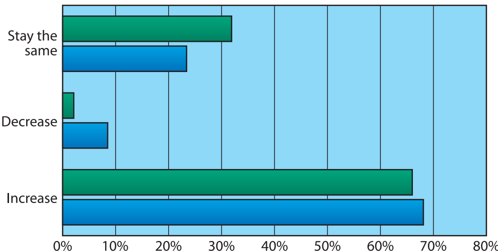
- And there is positive news nearer home, too. The Argos Mid Market Index tracks median EV/EBITDA multiples (the ratio of enterprise values of businesses acquired to their earnings before interest, tax, depreciation and amortisation) on a 12-month rolling basis, and the latest data from Argos showed a 2010 year-end figure of 6.7 times, 15% up on six months earlier.
- Looking forward, Unquote's survey of deal-makers' expectations suggests sustained (if slightly tempered) optimism about deal activity, with around two thirds of respondents expecting the number of MBOs to rise. At the same time, there is an increased majority saying the supply of debt funding is now sufficient to support this deal-making.

Survey of Future Expectations

Do you expect activity levels to increase, decrease or stay the same over the next six months:

for smaller buy-outs (<€150m)?

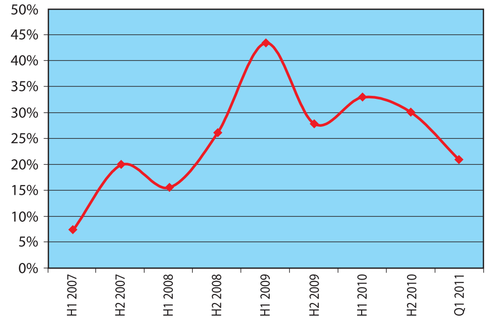
for larger buy-outs (>€150m)?



Most private equity investors have made far fewer new investments in the past 24 months than they would like

- Finally, there is of course the simple fact that most private equity investors have made far fewer new investments in the past 24 months than they would like. Their funds are mainly fixed life, and so their fund providers are now demanding they put their feet down on their deal-doing accelerators.

***All Equity* Funded Buy-outs to *All* Buy-outs**



If we look at the broader picture of soft factors, there is a case for optimism

To conclude, there is definitely no evidence of a further downturn. At worst, it is "steady as she goes". Perhaps, however, if we look at the broader picture of soft factors, there is a case for optimism, and we should expect an upturn over the coming year towards pre-2009 activity levels. That should come as a beacon of hope for executives of private equity backed businesses hoping to launch a deal with private equity funding – be that for a further funding (for example for a buy & build strategy) or a secondary buy-out.

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