# Private Equity Director

Corbett Keeling

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*The Newsletter for Executive Directors of Private Equity Backed Businesses* January 2010


*Welcome to the January 2010 issue of PE Director™, the quarterly newsletter for executive directors of private equity backed businesses. PE Director covers financial, legal and risk issues that are crucial to building and realising the value of your business.*

**In summary 2009** was as much of an *annus horribilis* for the private equity industry as the wider economy, but conditions are picking up and the outlook for mergers and acquisitions is turning noticeably brighter. We at PE Director are therefore becoming cautiously optimistic about the prospects for 2010 – particularly for management teams that can keep, or maybe get, control of businesses they run. Nevertheless, the credit crisis is set to cast a shadow over the private equity sector for some time, not least in the shape of higher tax rates and tighter regulation. Inside, we discuss some of the key issues facing private equity backed directors over the months and years ahead.

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If you want further information on any of the topics covered, please contact us at PE Director or get in touch with the authors using the contact details given.


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# Unloved orphan investments

*Does your backer view your business as an unloved orphan asset? And, if so, is there anything you can do about it? Jim Keeling of corporate finance advisors Corbett Keeling looks at the problem – and offers a solution.*

A key feature of private equity funders is that they back business plans for the medium to long term, typically three to five years. As they like to invest in growth companies, these plans frequently include a commitment to provide additional funds over time – for instance, to enable bolt-on acquisitions or a retail rollout. And the continuing commitment to the business is not just cash; it will also include close collaboration by the backer with the business, not least through board representation.

But what happens if your business is meeting – or broadly meeting – its plans at a time when your backer's activities have gone awry? The recession of the past 18 months has had a material adverse impact on all private equity funds. With fund-raising extremely tough and exits from portfolio companies almost impossible, many have seriously under-performed. Who would have thought that the business of the great house of Candover would implode so spectacularly, or that the future existence of other well-known private equity names would be cast into doubt?

Among the many knock-on effects of these conditions, two key ones stand out: many private equity firms have seen a significant reduction in headcount; and available capital is carefully guarded. You may find that, even if your business is on plan, promised capital is no longer forthcoming. Furthermore, the people you knew at your backer may have left and been replaced by others, who possibly do not share the same commitment to – or enthusiasm for – your business.

In this situation, it is crucial for management not to let the business drift like an uncared-for orphan. Rather, management should take the initiative and challenge its investor: either support the business or allow it to find a new investor willing to provide the required funds and board-level input. And management teams should be in no doubt that, although some

## Unloved orphan investments

funds have failed, plenty of others are still looking for opportunities.

Margaret Rice-Jones, former CEO of Advent International-funded telecoms business AIRCOM, explains the problem: "A lot has changed for many private equity investments since they attracted backing three to four years ago. During that period, many investors have shifted their deal size or sector focus, and some have stopped investing altogether. When you add to that banks' very different attitude to lending, it's hardly surprising that changes of backers are needed to regain alignment between investors and their investments – which, once that's achieved, will lead to the growth that all parties want."

The problem was seen as critical by John Herring, a Corbett Keeling associate, who was non-executive director of a London-based retail business comprising some 25 stores when it found itself with a major private equity investor that had lost enthusiasm for the business. In this case, the lack of support arose mainly because the funder's focus had moved on to larger deals, so it was no longer willing to provide additional, urgently needed, expansion capital.

The business felt like an unloved orphan, but to let it drift sideways would have been highly damaging – the momentum for growth needed to continue. So, with the approval of the investor – it is ideal, if possible, not to alienate your backer – Herring helped initiate a formal process to find a new private equity parent. This was secured over the course of a few months and provided both an acceptable return to the original investor and, critically, the working capital needed to continue the retail rollout. The business is now thriving, with 100 outlets.

So, a win-win solution is possible – if you can take the initiative and move your business on from one backer to the next.

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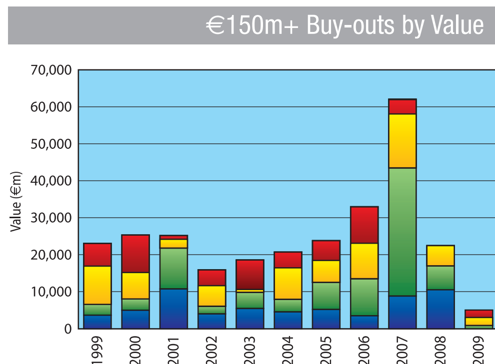
# Deal-making update – optimism pervades

*After the economic crisis that was 2009, it is perhaps somewhat surprising to find a spirit of optimism prevailing in financial circles – which will be good news if you are thinking of doing a secondary buy-out or selling out alongside your backers. In his regular quarterly commentary on market activity, Jim Keeling of corporate finance advisors Corbett Keeling sifts through the data produced by private equity journal Unquote in order to assess the evidence.*

Well, now it's official! Across the board, by whatever measure you take, Unquote's statistics for 2009 UK private equity activity show that the year was the worst ever – and that's comparing it with all the ups and downs of more than ten preceding years.

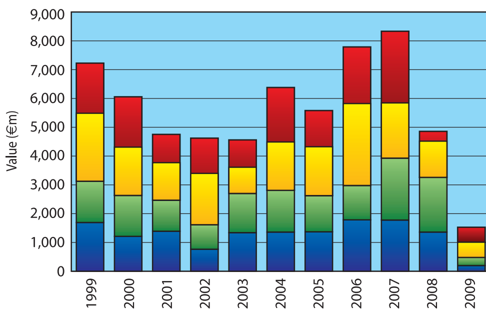
This record contrasts sharply with a degree of optimism among practitioners in the market – and with some positive signs from deals done towards the end of the year. But, before we get carried away by any positive market views, let's take a closer look at the facts for the last quarter of 2009 and the year as a whole. We will examine first 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 market for **larger UK buy-outs** (of €150 million or above) has continued to improve, albeit from a very low base. Readers of previous editions of this review will know that there was an unprecedented slowdown in larger deal activity at the end of 2008, with the two quarters straddling the year-end both recording nil activity – previously an unheard-of event for even one quarter. But there were two or three deals in each of the second and third quarters of 2009 and then five in the fourth. The total value of larger buy-outs for the year was €5 billion, compared with a low of €15 billion in the preceding ten years. Nevertheless, the larger-deals snowball seems to have started rolling again and now appears to be gathering pace.



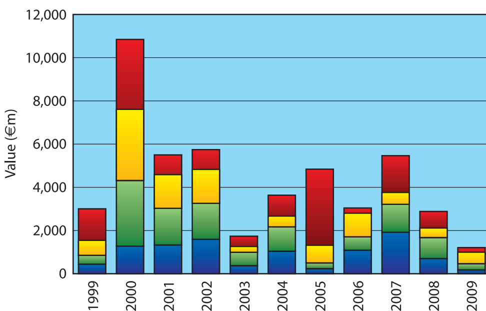
- The picture for **smaller UK buy-outs** (below €150 million) has been much steadier – though of course this part of the market never suffered such a catastrophic decline in the first place. Deal numbers have hovered around the 15 per quarter mark all year, albeit with a small up-tick to 19 in the third quarter. But the total number of deals for the year remains half of the ten-year low point – previously 2003. The aggregate deal value was even harder hit, being less than a third of the previous low.

Sub €150m Buy-outs by Value




- **UK early stage and expansion capital deal** numbers is the one statistic that, though lower than in any preceding years, is not markedly down. There were 172 deals in the year, spread pretty evenly across all quarters. However, the aggregate amount invested (€1.1 billion in the year) was a long way down on the previous low water mark of €1.7 billion in 2003.

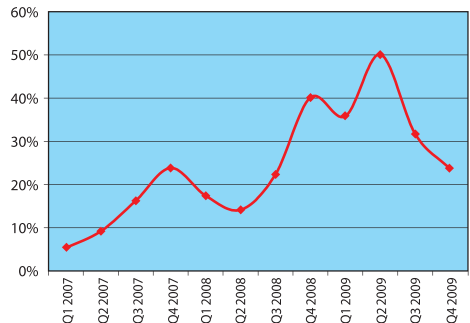
Early-Stage/Expansion Deals by Value




So what do we conclude from this? In the previous quarter, a large proportion of the deals were completed in the final month – during September 2009. The question then was whether this trend would be continued. The good news is that it has and, in the case of larger transactions, the deal rate has even accelerated. But will this trend be sustained into 2010?

As well as reviewing historic statistics, Unquote carries out a survey of future expectations. The view on smaller deals remains bullish, with roughly 80% of survey respondents expecting deal activity to increase. And around 60% are optimistic about larger deals – well up from the previous quarter's figure of 45%. One larger-deal funder commented to us that his firm had not done a deal for 18 months, and his team is now 'really hungry' to get a transaction over the finishing line. Another firm, fed up with finding itself the under-bidder in too many auctions, is increasingly prepared to bid at higher multiples than in recent months. At the same time, debt funders are coming back into the fray, as evidenced by the decreasing ratio of all-equity deals. So the market certainly appears to expect a continued increase in deal activity.

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




Our view, based on the activity of our own clients and contacts, is that market confidence is well-placed. Assuming that, as Unquote's market survey also indicates, some deal prices still have further to fall and that visibility of operating profits will improve from its current low level, we see all the more reason to expect a recovery in deal volumes and values across the board.

So the outlook for those wanting to do deals – be they secondary buy-outs if you want to stay with your business and roll the dice again or sales if you want to exit with your backers – is that it will become increasingly easy to get transactions across the line. We look forward to 2010!

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*This is an edited version of an article published in the private equity journal unquote". Statistics are provided by unquote" and Incisive Financial Publishing.*

# Time to rewrite the compensation playbook?

*It's been a turbulent 18 months for the global economy, and the period has left its mark on the private equity industry. Here, Mark Hoble and James Fagan of employment advisors Mercer Ltd (a sister company of Marsh) explore whether it is now necessary to update the industry's management pay model.*

Not too long ago, senior executive pay packages at private equity backed businesses were the envy of many a public company CEO. With some deal sizes well into the billions of pounds and with 'sweet equity' pots growing as the competition for talented management heated up, it is not surprising that many saw this opportunity to grow their net worth exponentially as too appealing to pass up. Of course, inherent in this bargain was a high degree of risk: if executives failed to create value for the business, they would walk away with very little – and even stood to lose investments they may have had to make in the business. In the private equity industry, at least, there was always a real downside.

Since then, much has changed. Undoubtedly, the past 18 months – witness to significant overall depreciation in the values of many private equity portfolios – have had an indelible effect on the private equity landscape. Whereas in the past senior executives might have selectively chosen to focus on the upside while dismissing the potential for real risk to their own personal wealth, now even the most talented senior executive would be foolish to underestimate market forces. This, in turn, has opened up a host of compensation issues for new management members who are joining a private equity backed business – particularly if they are doing so to turn around a business after a period of decline under the previous management team.

Of course, there are still the practical issues for new management and ownership to negotiate. These include: settling on appropriate fixed compensation, deciding short-term bonus opportunities and agreeing awards of sweet equity. On this last point, owners may not be able or willing to distribute any more equity. If they can and do, however, there is the more fundamental challenge of making the value of such equity compelling to potential new members of the management team. For businesses which have underperformed – or in which the opportunity to crystallise value depends on some now-uncertain exit event – the value of equity is likely to appear lower for prospective new managers. That can put the owners, who are generally accustomed to negotiating from a position of power, in an unaccustomed position. If there are pressing reasons for attempting to recruit the new managers it has in mind, it will become a paramount concern to ensure that the rewards on offer are a compelling package.

So the key may rest in the owners' ability to be flexible, to reconsider some of the long-held tenets on private equity compensation where necessary while remaining true to the fundamental ethos that makes private equity backed businesses different from their publicly owned counterparts. That does not mean a wholesale movement to crudely aligned three-year share plans with annual grants, as commonly seen in executive compensation packages at many public companies. Rather, it may mean tweaking the compensation model from time to time to ensure competitiveness in the markets for management talent. Examples of these alternative arrangements might include:

- offering moderately higher base pay to compensate for more incentive risk, especially when exit timeframes are less certain;
- making performance-driven cash incentives a more significant part of the compensation package;
- allowing management to monetise some portions of their equity stake within shorter, though still long-term, time horizons;
- and, conversely, allocating less sweet equity where other parts of the package are more generous.

For the owners, after all, it is a question of putting the best interests of the business first while ensuring that the key drivers of value – cash flows, EBITDA and debt management – remain at the forefront.

These objectives can be accomplished through structures which have not typically been found in the private equity compensation playbook. It is still about getting the risk-reward balance right; but it's also about ensuring that the best management team possible is in place. For that reason, although it may not yet be time to rewrite the private equity compensation playbook completely, it may be necessary to add a couple of new pages.

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# The Finance Act 2010 – cushioning the blow

*April is fast approaching, and the high earners in your company may well find it the cruelest month if they are affected by the terms of the Finance Act. Peter Baynham, a Principal at employment advisors Mercer Ltd (a sister company of Marsh), discusses some key considerations for employers – and concludes that it's still possible to take some practical steps to mitigate the impact.*

Despite an initial spell in the headlines, the effect the Finance Act will have on executive pay, benefits and motivation has not been fully appreciated. The impact on the unprepared will be profound. The loss of even one senior executive to an overseas competitor can have severe implications for a company's competitiveness, so organisations should already be reacting in anticipation of the changes. The April deadline is fast approaching.

However, in a recent poll carried out by Mercer among HR directors in over 200 companies, 39% had completely failed to investigate the impact of the Finance Act on their staff. Of those that had, only 5% had already taken action on the issue, 18% said they would be taking action in the fourth quarter of 2009, while 30% were taking action in 2010 and 3% in subsequent years. And 43% were not planning any further action at all.

At Mercer, we think the current situation is very different to higher-rate tax moves in the 1970s and 1980s. Back then, there were plenty of tax-planning opportunities, and workforce mobility was relatively low. The reverse is true today, which increases the risk that key talent will take flight from the UK in pursuit of more lucrative opportunities elsewhere. It also means that high-earning 'inpats', workers from overseas who have specialist skills, will be more reluctant to move to UK companies if this issue has not been addressed with sufficient rigour.

Several key actions need to be addressed well in advance of 5th April 2010, both to prepare employees for the change and to ensure that employers are not at risk by misleading employees with out-of-date material.
These include:

- identifying which segments of the workforce might be affected by different elements of the tax changes;
- communicating with employees to prepare them for the impact on April's pay packet;
- supporting employees to ensure they don't fall foul of anti-forestalling pension rules – the minimum should be to provide them with the information they need to complete their tax returns;
- checking pension scheme booklets and literature, to ensure that pensions are promoted to all as an extremely tax-efficient form of investment;
- considering bringing forward some components of reward if possible – such as paying bonuses due in April at the beginning of the month;
- preparing policy and, if appropriate, procedures for employees aged 50-55 who are urgently seeking to draw retirement benefits before 5th April 2010; and
- understanding the impact of the anti-forestalling regulations on pension scheme reconstructions, for example in an M&A situation.

Companies may find that employees with base salaries below the relevant threshold are also affected immediately or are likely to be in the medium term, and that needs to be considered in respect of long-term investments, such as pensions. The value of bonuses, equity awards and income from other investments or property rentals can all have an impact in this regard. Taking a few tactical steps now may well help avoid unwelcome surprises. Time is tight, but it's not too late – yet.

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# The AIFM Directive – an update

*In the last issue of PE Director, we had a brief look at the European Union's proposed Alternative Investment Fund Manager (AIFM) Directive. Here, Arthur Stewart of lawyers Simmons & Simmons assesses the latest developments as the proposals take shape – and some of the possible implications for the private equity sector.*

As more details of the proposed AIFM directive emerge, it has become clear that it poses a significant regulatory and political challenge for the private equity industry. If enacted in its present form, the directive would impose substantial new costs on the sector and make Europe a less attractive place to conduct private equity business.

Of particular interest to companies held by private equity firms are the additional disclosure requirements for portfolio businesses. Under the directive, private equity fund managers are required to disclose information on all portfolio companies where the fund owns (individually or in syndicated deals) 30% or more of the voting rights. The only companies with an exemption from these requirements would be small and medium-sized enterprises – those employing fewer than 250 people, with an annual turnover of less than €50 million or a balance sheet not exceeding €43 million.

Private equity managers and other alternative investment fund managers that satisfy the requirements would have to make a notification of any such acquisition. They would be required to issue a statement (similar to public company disclosures) explaining how this position was achieved and is held and the resulting effect on voting rights. Additional information would then have to be provided, including details of the acquisition, how conflicts of interest between the manager and company would be handled, the development plan for a non-listed company and policies on internal and external communications. In addition, where the shares of an issuer are no longer admitted to trading on a regulated market after acquisition of a 30% or higher holding, the company would have to continue to comply with the Transparency Directive for two years from the date of withdrawal from the regulated market.

**AIFM Directive* – Key Concerns**

| Issue | Requirement | BVCA response |
| --- | --- | --- |
| **Capital requirements:** | Additional regulatory capital (generally one quarter of the manager's fixed annual overheads). | Rejection of proposal (FSA's light capital regime has not given rise to any failures). |
| **Disclosure:** | Must disclose information on:<br>■ the fund;<br>■ portfolio companies where the fund owns a 30% or greater stake. | The disclosure of information should consistently apply to every kind of private investor. |
| **Structural issues:** | Must appoint an independent valuator, custodian and depository. | Rejection of proposal (the fund's assets are share certificates in private companies – no requirement for an independent custodian). |
| **Marketing:** | Must notify FSA (which will notify its EU counterpart) of any proposed fund marketing (including final form documents), which may not be altered without telling the regulator. | The notification requirement should be restricted to notifying the home state regulator. |
| **Investor access and global competitiveness:** | The only funds which may be marketed to European professional investors are those which have an authorisation under the directive. | Rejection of proposal (no rationale, and discriminatory). |

** To be put to vote in plenary in the European Parliament in July 2010.*

Although some of the specific disclosure requirements are similar to those set out in the current Walker Guidelines, they will affect a far larger number of companies. And, crucially, these provisions would not apply to competing private businesses owned by families, conglomerates, banks or others.

Few developments in the campaign on the EU AIFM Directive have occurred over the New Year break, but HM Treasury and the Financial Services Authority continue to hold further cross-industry meetings to discuss progress. The British and European venture capital trade bodies are co-ordinating efforts to encourage MEPs to table amendments. Particular areas of concern include portfolio company disclosure, capital requirements, requirements for custodians and depositaries, and restrictions relating to funds from non-EU countries.

The British Venture Capital Association's agenda includes the removal of the disclosure requirements altogether, because it sees them as discriminatory and having no cost benefit justification. At the very least, it wants to ensure that there is no obligation to disclose trade secrets or confidential information.

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# Crystal-ball gazing for 2010

*Last year proved to be a disappointing one for the private equity industry, but what will 2010 have in store for us? Arthur Stewart of lawyers Simmons & Simmons looks at some of the factors which may shape the landscape.*

**Regime change**

With a General Election due in the first half of the year, the industry will be looking for support from the incoming government. Judging by the recent press coverage, the Conservatives are positioning themselves as a 'supporter of private equity', acknowledging that private equity firms in general raise productivity, increase innovation and add employment. In addition, the Conservatives are proposing reform of the UK tax system to make it 'simpler, fairer and in time lower'.

These are all good things at any point and particularly so in difficult economic times.

However, the Conservatives' support for private equity is conditional and will not necessarily result in a reduced UK regulatory or tax burden for private equity. Paraphrasing the words of George Osborne, provided the private equity industry becomes more transparent, does more to promote "proper" venture capital and shoulders its social responsibility, then it can rely on Conservative government support. Whichever party wins the General Election, the private equity industry can expect a renewed focus on the tax deductibility of interest on acquisition debt, a reconsideration of taxation of carried interest in the buyout industry and continued support for the Walker Guidelines on transparency in private equity. And venture capital firms can expect to retain more of their existing freedoms and benefits when compared with private equity buyouts.

**Trends in M&A activity**

Despite optimism that 2010 will bring more private equity deal activity, the concern remains among private equity professionals that the credit crunch's long-term impact will prove more dramatic than many had hoped. Judging by recent polls, the strongest areas of expected activity are in mid-market buyouts, growth capital to help companies without the use of debt, follow-on investments to restore financial covenants and bolt-on deals to boost existing portfolio companies. Given market conditions, greater innovation is being seen in deal structures and terms. That includes more joint ventures, seller loan financing, deferred consideration, share-for-share exchanges, and enhanced deal protection in the form of retentions, escrows, guarantees and warranty and indemnity insurance.

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