Private Equity Director

Corbett Keeling

CMS Cameron McKenna

Kleinwort Benson

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

Dear Reader,

Welcome to the January 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.

For this issue, we are delighted to welcome as a new partner one of the most distinguished names in British banking, Kleinwort Benson. With over 200 years of experience, Kleinwort's can certainly bring a long-term perspective to its analysis of financial markets. Their commentary is written by Jeremy Beckwith, Chief Investment Officer of the bank, on behalf of its Wealth Management Teams.

For anyone contemplating an exit in the near future, we will be holding a seminar on exit strategies on the morning of 31 March from 8.15 to 9.30am. This will 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 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 the industry faces as we enter 2011:

- Deal activity in the fourth quarter was disappointingly low, in terms of both deal numbers and values, but market participants remain optimistic, suggesting that **2011 could prove to be a fertile ground for management teams looking to get a deal done (pages 2 & 3);**
- We assess the outlook for economies and financial markets in 2011 and find that, despite some substantial risks, growth should remain positive, providing **a broadly positive backdrop for activity within the private equity industry (pages 4 & 5);**
- For managers who want to take advantage of the opportunities this year presents to engineer an exit, **we offer some useful tips to help managers navigate the exit process** – and to avoid potentially damaging conflicts with your private equity backers **(pages 6 & 7).**

Don't forget that PE Director is available by e-mail as a pdf. If you would prefer to receive it in that format, please send your e-mail address to: meganpeel@pedirector.com.

I trust that you will find this issue of PE Director interesting. If you have any questions on any of the topics covered, please don't hesitate to contact the authors, using the e-mail addresses supplied at the end of each article.

We wish you all the very best for 2011!

Megan Peel, *Editor*

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Optimism belies the dip in M&A activity

After an encouraging third quarter – when both the number and the value of deals rose – the final quarter of the year came as something of a disappointment. To make matters worse, the weakness was fairly evenly spread across deals of all sizes.

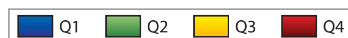
Yet Jim Keeling of corporate finance adviser Corbett Keeling, who has been looking at the latest evidence from surveys of sentiment, finds industry participants in a buoyant mood. That gives grounds for believing that much of the activity may have simply been postponed, which augurs well for managers looking to get deals away in the first half of this year.

Last time we reported on private equity activity – at the end of the third quarter of 2010 – the statistics, from Unquote, revealed increasing numbers and values of deals. The question we asked then was: would that last, or was it just a temporary phenomenon, caused by the coincidence of a handful of larger deals? Well, judging by Unquote's statistics, it looks increasingly like the latter, with the most recent results showing a sharp down-turn in activity in the fourth quarter. Yet these statistics are in stark contrast to the prevailing optimism in the market-place.

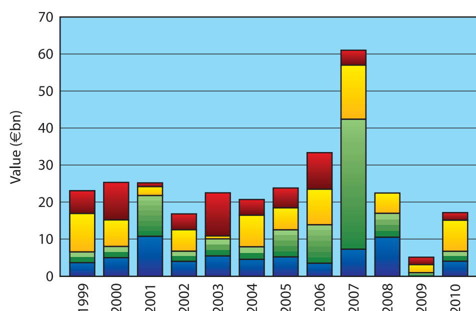
So let's look at the facts, as usual starting with larger UK buy-outs of more than €150 million enterprise value, then UK buy-outs of less than €150 million and finally early stage and expansion capital deals.

It appears to have been considerably harder to get deals closed in the last three months than the preceding nine

- The aggregate value of **larger UK buy-outs** (€150 million or above) in the quarter just finished was, at just €1bn, almost the lowest final three months on record, beating only the exceptionally weak fourth quarters of 2001 and 2008. Indeed, there were only two larger UK buy-outs. So, although the year as a whole was encouraging for deal-makers – and an enormous improvement on 2009 – it appears to have been considerably harder to get deals closed in the last three months than the preceding nine.

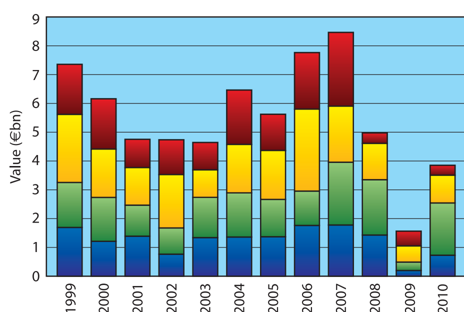


€150m+ Buy-outs by Value



- The picture for **smaller UK buy-outs** (below €150 million) was similar, with just 12 deals for a total of €340m – a record-breakingly weak fourth quarter on both counts. Again, though, the picture for the whole of 2010 is much more encouraging, with aggregate deal values more than double the 2009 figure and volumes also well ahead.

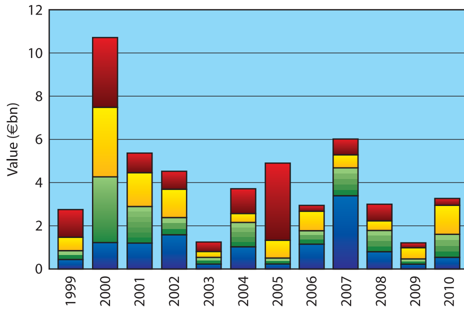
Sub €150m Buy-outs by Value



The year as a whole paints a more favourable picture for those hoping to get deals done

- Last time we reported, there was some solace for deal-makers from the statistics for **UK early stage and expansion capital deals**. This time, there is none: at just 28 deals and total funding of €320 million in the fourth quarter, the result was exceedingly weak. As with buy-outs, however, the year as a whole paints a more favourable picture for those hoping to get deals done, with both deal volumes and values coming in at around the average level for the preceding 11 years.

Early-Stage/Expansion Deals by Value



The key question is: what has caused the recent slow-down? When we at Corbett Keeling noticed that the City was eerily quiet in the run-up to Christmas, we put it down to the freezing weather and the consequent seizing-up of public transport. But was it in fact a sign of an impending economic freeze?

Not so, say our other indicators.

First, Unquote's survey of deal-makers' expectations suggests that, despite the last quarter's result, optimism is increasing.

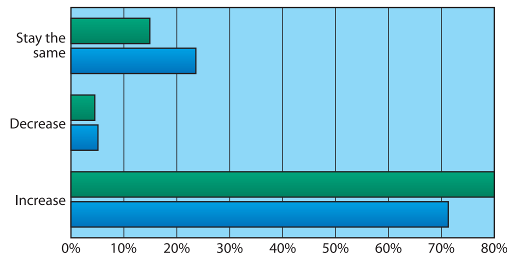
- The proportion of survey respondents expecting a rise in smaller deal activity is up from the already high level of 70% at the end of quarter three to 80% at the end of quarter four.
- It is a similar picture for larger deals, with 70% of respondents now being optimists – i.e., thinking deal activity will increase – compared with 40% at the end of quarter three.

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)?

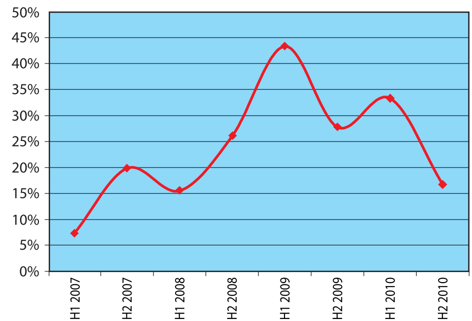


- At the same time, the market appears to think business valuations have bottomed out, with more survey respondents now expecting prices to rise than fall.

The supply of debt funding appears to be freeing up

Secondly, the supply of debt funding appears to be freeing up. That is the implication of the declining proportion of all equity funded buy-outs to all buy-outs, which was 20% for the second half of 2010, down from a peak of 45% 18 months ago. So the banks appear to be doing their bit to provide fuel for deal activity.

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



The chatter around the market is resolutely of stronger deal pipe-lines

Thirdly, the chatter we hear around the market is resolutely of stronger deal pipe-lines. These are driven not just by economic conditions but also by the length of time that owners – be they fund managers or owner managers – have held on to assets. As time goes on, they have an increasing desire to realise value by selling to a new owner.

So our conclusion is that, during the big freeze, deal-makers didn't stop work but instead continued to nurture deals from their homes and mobile phones, even if not from their offices. As the large proportion of optimists indicates, transaction volumes and values can be expected to increase in the year ahead. That points to a thaw in market conditions which should allow managers to push through any deals that were frozen in the fourth quarter.

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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.

Outlook for economies and financial markets

Although 2010 brought its fair share of crises, it was actually a reasonable year for economies and financial markets, with most types of assets producing decent gains. So what is in the offing for 2011? Jeremy Beckwith, Chief Investment Officer at Kleinwort Benson, sifts the evidence and concludes that, despite persistent risks, we are likely to see more of the same, with the economic recovery continuing at a steady pace and markets making further advances. That should provide a fairly constructive backdrop for deal-making in the private equity industry.

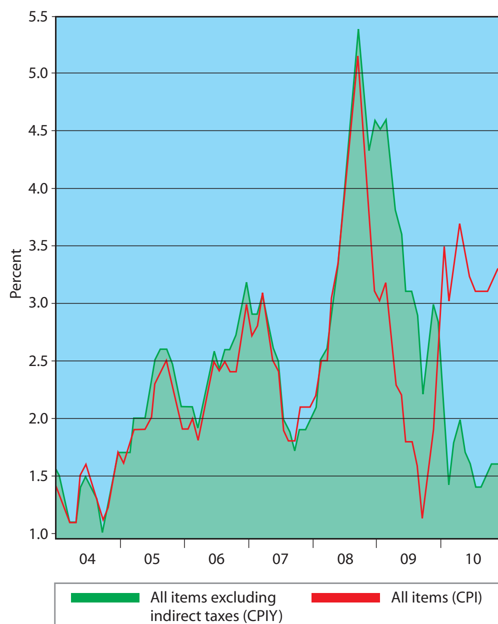
Last year was in fact rather better than it felt. Markets were volatile, as investors reacted to the vicissitudes of the latest economic data and the crisis in the euro-zone. Nevertheless, virtually all assets ended the year sitting on tidy gains. We expect the picture in 2011 to be much the same:

- Investors make money in range-bound markets (e.g. equities), the unemployed don't find jobs, credit crises fill the news media.
- The economic recovery continues in the West, but it is steady, rather than sharp.
- Emerging market growth remains strong at present but may disappoint in 2011.
- Equity markets continue to grind higher over the year, but don't move in a nice straight line.
- After the recent sell-off, government bonds should also offer positive returns in 2010.
- Alternative assets offer interesting opportunities for diversification.
- Gold remains an important insurance policy for the substantial risks that could hit markets.
- Western governments and banks need to issue about $5 trillion of gross new debt in 2011. If buyers do not appear for this debt, we can expect more credit crises.

First, let's look at the economic backdrop. We remain in a phase of balance-sheet de-leveraging in the West, as households and governments struggle to repay debt. As a result, the recovery is slow and steady, rather than sharp. Growth expectations of 3% in the US and 2% in the UK have been improving recently. However, they are not sufficient to have much impact on the labour market. Until unemployment is clearly falling, it will be difficult for Western central banks to start increasing interest rates. If anything, the Federal Reserve may seek to ease policy further in the US.

Inflation poses something of a dilemma: it is too high for those who focus on commodity prices; but, for those – such as central bankers – who focus on the core rate of inflation, it is dangerously low.

UK Consumer Price Inflation



In the short term, emerging markets are suffering overheating pressures, and their authorities are seeking to dampen the inflationary pressures, with the added complication that they don't want to do this by letting their currencies rise. The risks here are that forecasts for emerging market growth in 2011 are too high.

We expect equity markets to move higher over the year

So what does all this mean for markets? We expect equity markets to move higher over the year. On top of the solid economic growth, margins should continue to expand, delivering healthy growth in earnings per share. This earnings growth is delivering substantial free cash flow for companies, and their balance sheets are in rude health. That opens up the possibilities of better-than-expected dividend growth, share buybacks and cash-based merger and acquisition activity, all of which should be positive for markets. Furthermore,

earnings and cash-flow-based measures of valuation are below their historical averages, providing valuation support to markets.

Within **equity** markets, we prefer US smaller companies, reflecting the fact that the US economy continues to receive the greatest support from monetary and fiscal policy. We also like the UK market, because of its exposure to commodities and its openness to international takeovers. In addition, it has companies that are culturally most likely to increase dividends.

Government bonds have been sold off significantly over recent months. That has brought their prices back to fairer levels and the expectation of positive returns for this year. We are most upbeat on government bonds from emerging markets, given their high yields, lower debt levels and better economic prospects. They are also denominated in their own currencies, which we expect to rise over the long term.

Alternative assets present some interesting opportunities. **UK commercial real estate** has a place in income-seeking portfolios, although the prospects for capital growth are pretty muted. We would stick with high-quality tenants, however. **Commodity** prices are a key pressure point for the world economy and are closely correlated to emerging market growth. However, if prices rise too fast it will have a negative impact on the rate of economic growth. Market conditions are becoming more favourable for **hedge funds**, as the world outlook turns more complicated than the period from summer 2008 to summer 2010, when it was a simple question of taking either more or less risk. **Private equity** is still adjusting to a changed environment where banks will not lend at their previous multiples or interest rates. We expect returns to be made only by those who can engineer their investments operationally, rather than financially.

The “cheap” major **currencies** are the dollar and the pound, and their immediate growth outlooks appear relatively healthy. We expect them to perform better than the yen and the euro in 2011.

Although we expect the economic recovery to remain on track this year, substantial risks remain in the financial system, and we continue to advise holding gold in portfolios as an insurance policy against them. Western governments and their banking systems will need to issue over $5 trillion in gross debt in 2011. That is $20 billion every trading day. Issuers that fail to find buyers for their debt may quickly find themselves facing a credit crisis of their own.

Biggest risk is the debt situation in the governments and banking systems of the eurozone

The biggest risk is the debt situation in the governments and banking systems of the eurozone. EU leaders need to agree a fundamental change in the economic governance of Europe, which will mean Germany paying substantial amounts of money to poorer nations. In return, those nations will be told by Germany how to run their economies and how much money their governments can spend. If not, the markets will force a crisis, and the eurozone is likely to lose members. That would trigger another banking crisis in Europe.

Another major risk is inflationary pressures in emerging markets. Governments in emerging markets are very sensitive to rising food prices, which account for a much higher proportion of household spending than in the West. As a result, they are likely to take strong action to avoid popular unrest.

On the other side of the Pacific, we would not want to see a rise in protectionism in the US. One of the few things Republicans and Democrats might be able to agree on is the idea of taxing foreign companies that are subsidised by artificially low exchange rates. Protectionism is easily presented as defending domestic jobs, but it is the sort of policy action that made the 1930s such a miserable economic period.

To conclude, we expect a continuation of the progress made in economies and financial markets over 2010. Yet it won’t be all plain sailing, and markets will remain vulnerable to sudden swings of investor sentiment as the risks we have enumerated intensify or fade.

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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.

Plotting the exit

So the original private equity investment is a distant memory, your company has performed beyond all expectations, and now you and your PE backers are looking to exit from the investment. What are the likely exit routes and what issues should you have in mind at the planning stage?

An exit presents a range of problems for managers and, in several respects, the interests of managers and those of their backers can be at odds. Here, Richard Bull of CMS Cameron McKenna discusses some of the key issues and provides some useful tips to help managers navigate the exit process successfully.

Managers of PE backed companies will almost invariably be hoping to hit the exit trail at some point. And, typically, PE investors will want to exit within three to seven years from the date of the original investment. The main forms of exit for PE investments are:

- **IPOs**, in which the company's shares are listed on a public stock exchange;
- **trade sales**, in which the company is sold to a third party trade buyer; and
- **secondary or tertiary buyouts**, in which a new PE house backs a buyout of the company.

Less common exit routes include **share redemptions**, where redeemable preference shares held by the PE investor are redeemed by the company, and **portfolio sales**, where the PE investor divests a number of investments jointly as a portfolio, usually at a discounted price.

Given the current resurgence in trade sales, this article focuses on this particular form of exit. When undertaking a trade sale, the main structural decision will be whether to proceed by way of a share sale or an asset sale. In the overwhelming majority of cases, a share sale will be preferred.

Investors vs management team

From the PE investor's perspective, trade sales are attractive mainly because:

- they are relatively straightforward;
- they allow the investor to make a complete exit (which is normally structured in a tax-efficient manner); and
- they limit residual risk, thus enabling the PE fund to return capital to its investors or to recycle and deploy the capital elsewhere.

From the manager's point of view, however, it is crucial to give careful consideration to a number of issues that rest largely with them on exit. These may include tax issues, whether they will lose their job or be required to agree to onerous non-compete provisions and whether, as part of the sale process, commercially sensitive information will have to be passed to competitors who are potential buyers.

One of the main areas of tension between backers and managers on an exit is usually the provision of warranties and indemnities

However, one of the main areas of tension between backers and managers on an exit is usually the provision of warranties and indemnities. PE investors are generally unwilling to provide warranties and indemnities to buyers. Indeed, the equity documentation usually contains specific provisions stating that the PE investor will not give any warranties and indemnities on an exit. PE investors will argue that this position is justified because they have not been involved in the day-to-day management of the business and hence cannot adequately assess the correctness of the warranties or the risk associated with giving them. Furthermore, they will want to return the proceeds to their investors. Managers, by contrast, are usually required to give warranties and indemnities to a buyer in order to support the sale price (which all the sellers will share in). They will therefore commonly seek to limit their liability under the warranties, for example by placing a financial cap and other limits on their exposure.

As some level of warranty protection for the buyer is a commercial necessity, the

management team and the PE investor will often agree some form of compromise, such as:

- **Insurance** – the management team gives warranties which are insured under a warranty and indemnity insurance policy or provides very limited warranties which are supplemented by insurance. The cost of this policy is usually picked up by either the purchaser or the institutional seller.
- **Retention pot** – the management team gives warranties, while the investor agrees that a fixed percentage of its sale proceeds can be contributed to a pot for one or possibly two years. The pot can then be put towards satisfying any future warranty claims or specific indemnities, thus effectively reducing the managers' exposure and sharing some risk. Alternatively, an amount may be withheld from the investor and held in a joint account or under some other escrow arrangement.

The key to a successful exit is careful, thorough planning

Tips for a successful exit

Planning and thorough due diligence are key. It is a common refrain from advisers, but the key to a successful exit is careful, thorough planning. Managers should ensure that a pre-exit health check is undertaken and that the company's records and documentation are in good shape so as to satisfy potential buyers. A well-organised and comprehensive data room containing all relevant information (such as details of employees, key contracts, pension details and registered intellectual property) will appeal to potential bidders and show the professionalism of the management team and its PE backers. If key contracts have not been properly documented, or the share structure is too complicated, a pre-sale clean-up can pay dividends.

It is important to disclose any potential deal breakers as early as possible

Get the bad news out early. As part of the due diligence process, managers should try to anticipate issues that could have a negative impact on the sale process and so will have to be worked around. In this regard, it is important to disclose any potential deal breakers – such as prospective litigation, regulatory risks or a pensions deficit – as early as possible in the process, while there is still a significant degree of competitive tension between rival bidders. Such issues, if raised late in the process once exclusivity has been granted, may derail the sale or give the buyer significant leverage on price and the provision of warranties and indemnities.

Take care of transitional arrangements. One area that will be of particular interest for buyers (especially foreign buyers) is any arrangements to ensure a smooth transition of the business to the new ownership. In this regard, second tier managers (those with no equity stake) should be incentivised to facilitate the sale process and potentially stay on with the business for a specified period after the sale.

Consider the tax. Tax issues will usually be the primary driver behind the type and structure of the exit chosen and they will affect managers most of all. This is an especially complex area, which is beyond the scope of this article to address – but more detailed information was set out in the October 2010 edition of *Private Equity Director*.

To recap, from a manager's perspective, the keys to a successful exit are:

- early planning and preparation – a pre-exit health check may save time and cost in the long run;
- thorough due diligence identifying key issues affecting the transaction (e.g. tax, regulatory, employment, pensions, environmental);
- an awareness of the different perspective on warranties between the management team and its PE backers, and possible solutions to bridge the gap; and
- obtaining appropriate advice on the exit, including for tax structuring.

Paying attention to these key areas and getting the proper advice can make all the difference, enabling managers to get the most out of the value they have created in the business that's being sold.

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Corbett Keeling is a corporate finance advisory firm focused on:

- Raising funds for management teams to do buy-outs.
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Kleinwort Benson has over 200 years' experience in British banking and a network of offices across the UK and Channel Islands. It offers its clients individually tailored wealth management solutions delivered with a highly personal service.

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