

Private Equity Director

Corbett Keeling

Marsh

Simmons & Simmons

The Newsletter for Key Executive Directors of Private Equity Backed Businesses July 2009

Dear Reader,

Welcome to the inaugural issue of Private Equity Director, the newsletter for key executive directors of private equity backed businesses. PE Director™, which will be published quarterly, is aimed at helping you to build – and realise – the capital value of your business.

The articles will cover legal, tax, risk and employment issues. There will also be a quarterly review of mergers and acquisitions activity in the private equity markets, together with commentary on funding structures. All this will be provided by our panel of experts: Marsh, the global risk advisers; international law firm Simmons & Simmons; and Corbett Keeling, specialist advisers to management teams on raising capital and selling businesses in the private equity markets.

This issue focuses on:

- Signs of a pick-up in deal volumes (page 2)
- Tax-efficient ways to incentivise management teams (pages 4 & 6)
- How to get the most from your bank facilities (page 5)
- Limiting liabilities on exit (page 7)

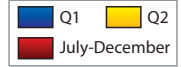
We hope you will find the newsletter helpful and informative. If you have any topics you want to see covered in future issues or any other comments – or if you have colleagues who would like to receive a copy of PE Director – please email us on meganpeel@pedirector.com.

With best wishes



Megan Peel, *Editor*

Is the deal drought ending?

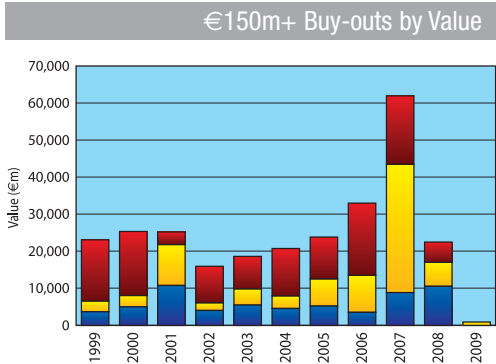


When your backers start to think about selling their stake in your business, you may want to roll the dice again, re-investing in a secondary buy-out with a new funder, or you may want to sell alongside your backer. Either way, you will be interested in the state of the mergers and acquisitions (M&A) and funding markets for private equity owned companies. Jim Keeling from corporate finance advisor Corbett Keeling takes a look.

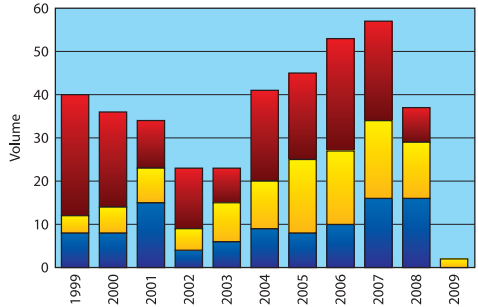
At the end of quarter three 2008, the deal-making world fell off a cliff, with transaction volumes grinding to a halt. Deal structures and valuations that were commonplace in the spring and summer of 2008 would be unimaginable today. There are not yet any significant signs of let-up, so the drought will almost certainly last until the end of the third quarter. Nevertheless, we do see some rays of hope. Before we get over-optimistic, though, let's look at what the facts say about historic volumes and values of management buy-outs.

Larger buy-outs

The market for larger buy-outs (of €150 million or above) has been weak, though not quite as difficult as in the preceding two quarters. The initial reaction in larger buy-out circles to last autumn's events was to shut the door completely on all new deal activity, and the door remained firmly shut for six months, with no larger buy-outs completed at all. However, the door is now perhaps being pushed open – albeit only a little. In the second quarter of 2009, a couple of larger buy-outs were finally done. These were not in the mega-value bracket of previous years, with the two deals comprising only €900 million enterprise value in aggregate, but at least some funders have decided it is once again worth putting their money to work.



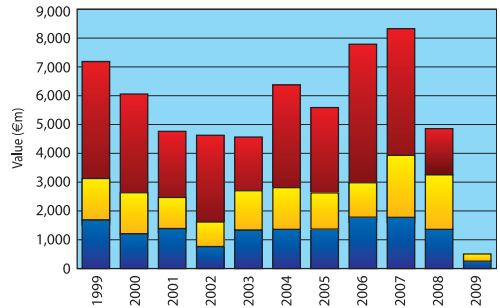
€150m+ Buy-outs by Volume



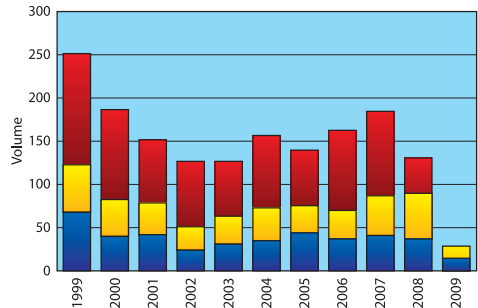
Smaller buy-outs

The door never shut so completely on smaller buy-outs (below €150 million): 10 were recorded in the final quarter of 2008, 14 in the following quarter, and another 14, with an aggregate value of €250 million, in the quarter just finished. One funder, LDC, has even reported a mini-boom in deal volumes.

Sub €150m Buy-outs by Value



Sub €150m Buy-outs by Volume

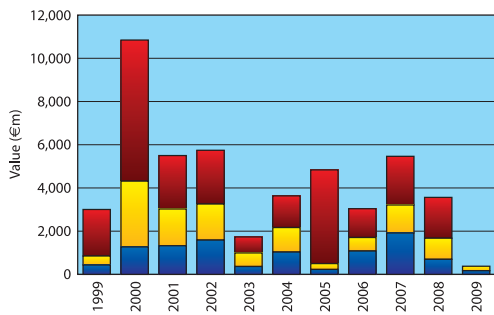


However, with deal numbers in the first six months of this year at one third of their level in the same period last year and values even lower, one must be cautious about drawing overly optimistic conclusions from these statistics.

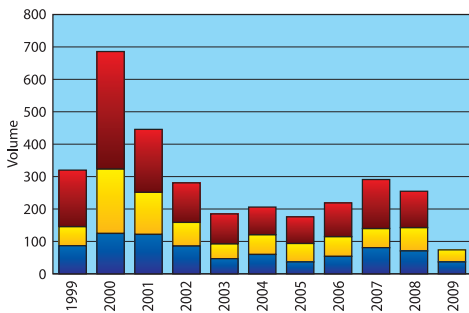
Early stage or expansion capital

The picture for early stage or expansion capital is slightly better still, with deal numbers for the first six months of 2009 at around 60% of their level in the same period of 2008. The relative buoyancy of this part of the market is perhaps explained by the fact that it includes restructurings – of which there have of course been plenty in recent months.

Early-Stage/Expansion Deals by Value



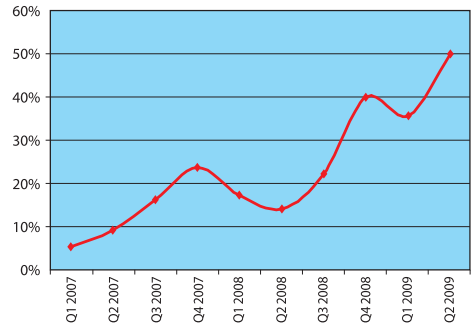
Early-Stage/Expansion Deals by Volume



So perhaps it is surprising there has not been more early stage or expansion capital activity; but maybe that's because debt providers have been unwilling to bail out each others' deals, so equity funders are increasingly left to carry the day alone – as illustrated by the chart showing the ratio of *equity only* funded buy-outs to *all* buy-outs. Yet this part of the market seems to provide some clear rays of hope to light what has otherwise been a difficult landscape for those wanting to get businesses funded and deals done.

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

Equity Only Funded Buy-outs to All Buy-outs



Brightening mood

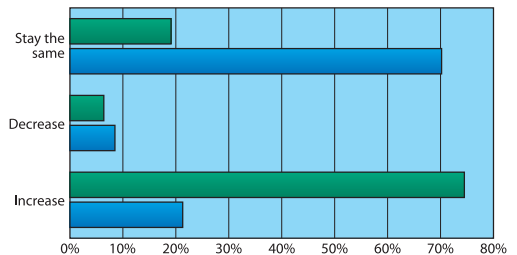
But, of course, what we are really all concerned about is the future. So, what does the survey of future expectations tell us about market practitioners' views for the coming months?

This may be the most remarkable feature of the quarter: there has been a significant shift in optimism about buy-out volumes, with three quarters of those surveyed thinking smaller buy-out numbers are on the up and twice as many thinking larger buy-outs will increase as predicting a decrease. At the same time, values at which deals are done are expected to fall, decreasing the gap between buyers' and sellers' expectations.

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)?



So this is good news, for buyers certainly – but also for sellers, as they should finally be able to get their deals done. That matches our view, based on what we see at the deal-making coal-face. So, although the summer may be as quiet as ever, we believe we can look forward to an autumn with an increasing number of completed deals.

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Taxing times? Not necessarily...

As if difficult markets and a corresponding lack of exit opportunities aren't making it hard enough to incentivise a good management team, the government's proposed tax and pension changes have made things even more difficult. However, several types of arrangements may still be worth considering, as Darren Oswick of lawyers Simmons & Simmons explains.

In the classic private equity (PE) model, a management team invests alongside their PE backers, with a view to obtaining an exit in three to five years. Traditionally, the carrot for management was not the salary or bonuses they were paid, but the expectation of a cash lump sum, enhanced through the use of leverage, on the sale of their shares, on which they would pay tax at capital gains rates (historically 10%, now 18%).

With the seizures in the markets leading to a drought of exits, private equity funders are having to consider other means to incentivise their management teams. With the unavailability of approved (tax-favoured) share schemes to PE-backed businesses, many businesses are turning to cash-based arrangements to keep good management teams happy and in situ. However, as the proposed income tax and national insurance rises from April 2011 are increasing the top rate of tax to an effective 51.5%, straight cash bonuses look even less attractive when compared with the traditional capital gains rewards. After the Budget, the opportunity to shelter this increased tax liability through additional pension contributions is no longer available to employees earning more than £150,000 a year (unless a company introduces new pension arrangements which apply to 20 or more employees).

So how can businesses provide management with tax-efficient remuneration? Increasingly, employers are looking at two principal types of arrangements – employee benefit trusts (EBTs) and employer financed retirement benefit schemes (formerly known as FURBS).

EBTs

These are offshore discretionary trusts funded by contributions from the employer or another group company which would otherwise have been paid as bonuses. The trust is outside the UK tax net, so any investment growth of the trust fund will not be taxed. Key employees are made beneficiaries of the trust, along with their

families. If arrangements are structured in the right way, employees can make use of the gross amount of funds in the trust with either no or minimal tax cost, rather than receiving such funds through a fully taxable bonus payment, which would also attract national insurance contributions. As the beneficiaries of the trust can also include children, grandchildren etc., it can in addition be used as a tax-efficient vehicle for succession planning, without the constraints of inheritance tax allowances.

Unlike bonus payments, an employer will not be able to claim tax relief on a contribution. In the current economic climate, a business may have sufficient other tax losses to make the unavailability of tax relief a non-issue. Alternatively, the trust could be funded on a basis which takes account of the lack of tax relief (for example, a company which pays corporation tax at 28% might choose to fund a trust with £72, instead of £100).

Retirement benefit schemes

These are unapproved pension schemes whereby employers make regular contributions for key employees. As the arrangements do not have the same tax benefits as approved pension schemes, they are far more flexible. For example, the entire pot can be paid out in a single payment. An employee is not taxed on any contributions made to such a scheme by his employer and will receive the benefit of an investment return on the entire amount contributed. When he receives any payment from the scheme, it is subject to income tax. However, if the employee in question is living in a different country at the time he receives a payment from the scheme and that country has an appropriate tax treaty with the UK, no UK tax will be due, even if the individual returns to the UK at a later date. Such arrangements are therefore potentially of interest to employees who may be considering retiring abroad, even if only for a year or two.

Any corporation tax relief for the employer on such contributions is deferred until the scheme pays out to the employee. If this is a problem, the scheme could be funded on a net basis, as described above.

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Documentation: prevention is better than cure

The credit crunch and resulting economic conditions have not only reduced the availability of credit but have also highlighted some other important issues relating to bank debt. As always, taking preventative action sooner is better than seeking a cure later, says Richard Hughes of lawyers Simmons & Simmons.

Leveraged facilities are characterised by interminable documents with complex provisions. However, businesses need to operate within the terms of the facilities, so management teams need to understand the scope of the restrictions and where flexibility has been created in order to deal with issues in the business or to take advantage of opportunities.

Forward start facilities

If existing facilities are due to mature in the next year or so, a forward start facility may be the answer. Forward start facilities have rapidly gained in popularity since appearing in the last half of 2008. Still largely confined to the corporate (or investment grade) lending market, where debt maturities tend to be shorter, they may in time be used in the leveraged market.

A forward start facility is an agreement entered into today for refinancing an existing facility which is due to mature in several months' time. The forward start facility can't be drawn until the existing facility matures and so provides a backstop where not all of the lenders in the existing facility are prepared to extend its maturity. Forward start facilities are used to ensure continuity of debt funding for a business by giving certainty of price and terms in advance. Typically, lenders will expect to receive upfront fees and top-ups to the margin and commitment fees on their outstanding loans and commitments under the existing facility to reflect (and bring forward) the pricing agreed for the forward start facility.

Disappearing lenders

Up to now, the insolvency of finance parties (lenders, facility agents, security trustees or issuing banks) has not been addressed in facility documentation.

This is not an issue where the insolvent finance party is a lender of a drawn term loan – the lender's insolvency doesn't entitle the lender to seek early repayment of the term loan. However, the position is different where the insolvent finance party is a lender of a revolving loan or has a commitment for undrawn loans or other credit. For a drawn revolving loan where

the intention is to "roll" the loans, facility documentation is usually drafted on the basis that the loan will be repaid and redrawn, even though lenders may in practice deal with the repayment and redrawing through book entries, with no actual cash payments. In these



circumstances, applying the black letter of the facility documentation may result in the borrower repaying the loan but the insolvent lender failing to fund its participation in the next loan, leaving the borrower with a shortfall. To mitigate this, it may be possible to argue that the practice of documenting rollover loans through book entries is more appropriate and that no cash payments should be made.

Borrowers will not want to pay commitment fees to insolvent lenders where the likelihood is that the lender will not fund a loan or other extension of credit if requested to. However, if borrowers withhold a portion of the commitment fee in respect of the insolvent lender, facility agents may apply the reduced amount pro rata across all of the lenders (including the insolvent lender), causing a shortfall and a payment default for the borrower. Some borrowers have requested a loan in the minimum amount permitted in their documentation in the expectation that the insolvent lender will fail to lend, so that they can argue that the insolvent lender is in repudiatory breach of its obligations and thus no longer entitled to receive commitment fees.

To address these shortcomings, the Loan Market Association has recently published changes to their suite of facility documentation (including the leveraged facility agreement) to deal with defaulting finance parties and cashless rollover loans. Although this is not of much help for existing facilities, borrowers should ensure that facility documentation entered into in the future contains these provisions.

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Saving cash on employee benefits

In today's challenging environment, management teams are focused more than ever on the cash and cost performance of their businesses. With private equity backers' strategies moving away from quick exits and towards a buy and hold model, the focus is increasingly on operational efficiency improvements. Peter Baynham and Phil Golds of employment advisors Mercer Limited (a sister company of Marsh) look at some of the options.

For many businesses, labour costs will be one of their largest expenses – if not the largest. This will typically comprise cash compensation elements of basic salary, overtime and bonuses, plus a number of other benefits such as pensions, life, accident, disability and medical insurances all topped off by National Insurance contributions. So what can management teams do to reduce employee-related costs?

Employee benefits may be the key. They are often considered part of the terms and conditions of employment, so reducing the level and type of benefits can prove challenging. Inevitably, there will be a loss of goodwill from employees, which could result in lower productivity, thus undermining any cost savings achieved by the reduction.

However, it's possible to change the way you provide benefits without reducing the level of those benefits. Changes can be made in a way that is cost-neutral or even beneficial to employees – and can provide significant savings to the company.

Salary sacrifice

A common example is salary sacrifice, which can allow companies to avoid National Insurance (NI) contributions. The most significant NI savings can usually be achieved through "pensions salary sacrifice". Employee pension contributions are converted into employer contributions, which do not attract NI. The pension scheme becomes non-contributory, while all other aspects of the scheme remain the same.

The saving is calculated as member contributions multiplied by 12.8% (or 9.1% if your scheme is contracted out on a defined benefits basis). Your employees will also benefit from an NI saving, and you could choose to pass on some of your own savings to employees as an extra pension contribution (see following table).

Salary sacrifice may not be appropriate for everyone, though, because of its interaction

Number of employees:	100	250
Average salary:	£30,000	£30,000
Member contribution rate:	5%	5%
Employer NI savings @ 12.8%:	*£19,200	£48,000
Employer NI savings @ 9.1%:	£13,650	£34,125

*E.g.: $100 \times £30,000 \times 5\% \times 12.8\%$
= a saving of £19,200.

with state-provided benefits. If your employees are contributing to a contracted-out, trust-based pension scheme, salary sacrifice is likely to be beneficial but, for some members of contracted-in pension schemes, salary sacrifice could have a net negative impact because of a reduction in state benefits, which are based on post-sacrifice salary. This can be offset by surrendering some of the employer saving, but it is frequently overlooked and needs careful analysis before taking any action.

Pooling insured benefits

Another potential saving for multinational companies that has little or no impact on employees comes from pooling insured benefits (life, disability, medical) across international operations. Economies of scale are captured by aggregating the global workforce, and additional savings may be available if claims experience is good, because excess profits at the insurer are redistributed as a dividend to the company. Savings from a well managed scheme would typically be in the region of 5-15%, but this is dependent on claims experience and is delivered retrospectively (at the end of the scheme year).

As well as the financial savings when claims experience is positive, multinational pooling provides the following advantages that help improve administrative efficiency:

- easier transfer of employees between countries;
- annual financial reporting globally;
- improved underwriting and other terms;
- coverage for small groups;
- enhanced local contract terms; and
- influence with local insurance companies.

Private equity owners have on occasions tried pooling insurance across disparate companies that are not themselves multinationals, such as those held in their funds, but this has

traditionally presented problems. With a pooled approach, information and claims experience must be shared, which can present administrative challenges among otherwise unrelated companies. There is also the question of how costs and dividends should be allocated. Although savings may be achieved across the portfolio as a whole, it does not follow that all companies will benefit; one company's good experience could end up effectively subsidising another's poor outcome. Not surprisingly, this is a potential area of friction when the management teams of each asset are solely concerned with – and incentivised on – their own company's performance.

But these challenges are not insuperable. With care, it is possible to keep portfolio companies administered separately while achieving the

benefits available from harnessing economies of scale. Costs are allocated individually, ensuring that all companies achieve the savings commensurate with their own claims experience. Savings from this approach are typically also 5-15% but are achieved by applying an up-front discount, which brings forward the cost saving.

In many private equity backed companies, these sorts of saving schemes have not yet been implemented. So there are opportunities for management teams to help backers with innovative ideas about employee benefits – sometimes to the benefit of the backers' wider portfolio as well as management's own business.

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Disposals: how to limit management liabilities

Disposals can be a testing time for management teams. Not only do they have a wide range of obligations, but they can also be involved in the transaction in more than one capacity. As directors, they can be exposed to post-sale allegations of misrepresentation from disgruntled buyers while, at the same time, they have potential liability in their capacity as selling shareholders. Their Directors' & Officers' insurance may cover some such claims, but typically they will want to put in place much stronger protection, says Edwin Charnaud, Managing Director of Marsh's Private Equity and M&A Practice.

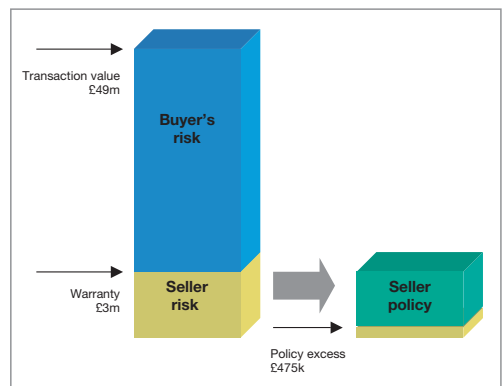
When a private equity house is exiting an investment, it will aim, normally with success, to avoid giving any form of contractual recourse to the buyer. In a buoyant sellers' market where buyers are vying for assets and offering high multiples, this can create issues for the buyer. However, in the current climate, buyers typically have the upper hand in negotiations. This can cause an even greater gap in expectations between the different parties, leaving management with the problem of bridging the gap.

Private equity funders' unwillingness to give warranties or indemnities means that buyers, under pressure from private equity, will often turn to management to provide the contractual recourse required to maximise the sale price and enable the transaction to go ahead. For management, this can create some real concerns. After all, it will be their personal funds that are in jeopardy on a breach of warranty or for a claim under the general tax deed.

For some years, the insurance market has provided specific solutions that ring-fence the exposures around warranties and indemnities given in a sale agreement. However, the private equity stance on contingent liability means that the motivation for using these deal facilitation tools has changed somewhat. In the early years, they were often used to provide comfort to retiring founders selling their solely owned business. Nowadays, for private equity exits where management are giving warranties to the buyer, they are used to provide a level of protection to management should the buyer make a claim.

Case Study

Below is a case study of a private equity exit in the UK where management gave warranties to 6% of the transaction value but insurance was arranged to protect them. Management's exposure was reduced from £3,000,000 to the policy excess of £475,000:



The insurance market for Warranty & Indemnity insurance is currently “soft”, meaning that premiums are low and terms have become increasingly broad and flexible. For UK and Western European transactions, the typical premium rate for insurance to cover warranty and tax indemnity exposure is 1.25-2.5% of the limit of insurance purchased. This is a one-off premium for the length of the policy, which typically mirrors the warranty periods negotiated in the sale and purchase agreement (up to seven years for tax warranties). In many instances, the private equity house will pay for, or contribute to, the cost of the policy to protect the management.

As well as liabilities for general warranties and tax, management may also be required to provide specific indemnities about areas of concern the buyer has identified when undertaking its due diligence. The potential exposure to management if the buyer claims under an indemnity can be particularly high.

Indeed, it can often far exceed management's proportion of the sale proceeds. Again, this is the personal liability of the management if they are giving the indemnity to the buyer in their own name and, while management teams are often reluctant to provide these indemnities, they may feel they have little choice, given the pressure of the transaction.

Fortunately, the insurance market has developed solutions that can ring-fence not just general but also specific issues, especially on tax, litigation and environmental exposures. By arranging a bespoke policy to insure, for example, the potential liability should HMRC challenge a previous tax restructuring, management may be spared the necessity of providing an onerous indemnity to the buyer. That can materially improve management's position and, to the mutual benefit of all concerned, keep the deal on track.

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Corbett Keeling is a corporate finance advisory firm focused on:

- Raising funds for management teams to do buy-outs.
- Selling of businesses.

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