Private Equity Director

Corbett Keeling
CMS Cameron McKenna
Kleinwort Benson

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

Dear Reader,

Welcome to the July 2011 edition of Private Equity Director, our second anniversary issue. A lot seems to have happened in those two years, some of it good and some not so good! The global economy has made progress along the path of recovery from the credit crisis but remains in a fragile condition, with big risks still looming, among them the continuing problems in the eurozone and the high cost of oil. This simultaneously creates danger and opportunity for our community of private equity backed companies.

Perhaps it's no surprise that the private equity industry is still suffering from a general lack of confidence, which has been reflected in a low level of deal activity. We at PE Director™ aim to help you by bringing you the latest news on what's going on in the market, the condition of the global economy and any developments on the legal, tax and wealth management front which are likely to affect the way you operate.

In that regard, we would like to remind you of the Exits Seminar CMS Cameron McKenna will be hosting in conjunction with our other partners, Corbett Keeling and Kleinwort Benson, on 15th September 2011. It will run from 8.15 to 9.30 a.m. and will be at CMS Cameron McKenna's offices: Mitre House, 160 Aldersgate Street, London EC1. These seminars are a good way for you to hear the latest views from the experts and your peers in the industry in a relaxed setting. **If you would like to attend the Exits Seminar, please e-mail meganpeel@pedirector.com with your contact details so that we can send you more information on the seminar.**

In this issue, we look at some of the key issues private equity backed businesses face at present, including:

- **The growing trend for refreshing management's incentive schemes (pages 2 to 4);**
- **The likelihood of a Greek exit from the euro (pages 4 to 5); and**
- **The latest data on deals in the industry – and whether the outlook is set to improve (pages 6 to 7).**

With best wishes

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

Don't forget, if you want to attend our Exits Seminar (see above) on the morning of 15th September (8.15 to 9.30 a.m.), please e-mail meganpeel@pedirector.com

Getting inventive with incentives

In the last four years, it has become a common problem for management equity to be valueless or at least to have insufficient value to provide any real incentive. This can be raised as an issue by management teams themselves, for obvious reasons. But it can also be brought up by investors concerned that managers no longer have realistic targets to encourage them to remain with the business, meaning that managements' interests are no longer aligned with those of investors. Nicholas Stretch and Richard Bull of law firm CMS Cameron McKenna set out some key issues for managers and investors in private equity backed companies who may find themselves in this position.

In some industries, investors may be happy with management equity that is significantly under water because of management underperformance. But that is rare in PE backed companies, where managers who are personally underperforming will simply be asked to move on. In other cases, including where the situation has been exacerbated in recent years as operational performance has been undermined by heavy debt servicing costs and unrealistic business plans conceived in headier days, current management should be incentivised to improve the company's performance in the future. In addition, they should be locked in and prevented from being poached until an exit. So there needs to be at least some prospect that management will obtain value in due course to make it worth their while staying.

Over the last few years, companies have taken several types of action to deal with these problems.

Amending the terms of management equity

There is an endless range of possibilities here, from increasing management's share of the equity proceeds to reducing the level at which their equity begins to have value under a ratchet arrangement. In certain cases, rather than all shareholders' bearing the cost of new arrangements, only some of the shareholders may give up part of their equity or rights in favour of management.

Working out the precise form of any new incentive is crucial and would make an entire article by itself. However, aside from what the new arrangements should be – where every commercial arrangement will be different and will reflect the mutual bargaining power between management and investors – the trickiest issue is often tax.

Shares vs Cash – Shares can receive more favourable tax treatment	
Capital Gains Tax Rate	Income Tax (and Employee's NICs)*
28%	52%

*Assuming the employee will have more than £150,000 of taxable income in the tax year in question.

Managers pay a maximum capital gains tax rate of 28%, or just 10% if entrepreneurs' relief is available

One of the benefits of management equity is that it usually provides capital gains treatment on any appreciation in share values. As a result, managers pay a maximum capital gains tax rate of 28% (or just 10%, if entrepreneurs' relief is available). Obviously, that compares very favourably with the 50% income tax rate, plus National Insurance contributions (NICs). The capital gains treatment applies only if managers pay full value for their shares at the time they acquire them and do not receive any special benefit on their shares subsequently. This can cause problems when changing terms because a special benefit would include enhancing the value of shares already held. If that gives value to the shares, this would be subject to income tax (and NICs), not capital gains tax, and would be payable at the time of the change even without a market for the shares.

However, for a tax charge to arise, it is not enough just for paper rights to be improved. There has to be some value attributable to the change and, where a ratchet arrangement is currently underwater but changes are made to make it less so, it is not clear that there is any chargeable value injected into the shares. So not every change to a ratchet or other arrangement in management's favour will lead to a tax charge.

To take an informed view on this may require an independent valuation. Even then, that will not be definitive. There is always the risk that

HM Revenue & Customs will disagree with any estimate. In that case, they will demand extra tax and NICs from the company and will seek penalties against the company and the employee. Quite where these risks should lie will depend on negotiations in each individual case. In some, management will be prepared – or required – to dip into their pockets if any tax is due. In others, they will seek an indemnity from the company or investors. Depending on the company's circumstances and its confidence in its or its advisers' valuation, the uncertainty may be too much to proceed along this route.

"Growth share" arrangements and "freezer" shares

For this reason, some companies have not changed ratchets or the level at which management equity value kicks in. Instead, they have offered equity participation in a different way. They have given management the chance to retain their existing shares but also receive a new class of share which allows them to receive growth in value from (or slightly above) the current point. The managers would normally need to pay only a low nominal value for these shares to avoid receiving any discount, and so they would be exposed to less valuation risk. Payout on the new shares would be capped at the level at which managers' existing equity starts to pay. These have become known as "growth share" arrangements, with managers' existing equity known as "freezer shares".

Example: management's current equity (B shares) provides for payout of excess equity proceeds on a sale or IPO of £50 million or more. If a company's current equity value is £20 million, this arrangement is under water. A further class of shares is created (C shares) which give management the right to share in sale proceeds above £25 million. So, given that the company's current value is £20 million, the management would probably have to pay only a small amount for the C shares. The management would also keep their B shares so that, if the company were sold for an equity value of £70 million or more, their C shares would get their share of the value between £25 million and £50 million, but their proportion of sale proceeds from £50 million to £70 million would be received through the B shares, where value kicks in at £50 million. In this example, management has received a perhaps unnecessarily good deal in hindsight!

Cash arrangements

Cash arrangements undoubtedly have the merit of simplicity and, since the abolition of financial assistance rules for private companies, cause few issues in company law. Many companies turn to these because other issues or consents become intractable or simply for reasons of speed.

One issue is that equity arrangements for management will incentivise only where the equity can have value at the time of exit. Where this is not likely, cash will often be the only solution – though we have worked on some interesting projects when management received debt in a company where not all debt was expected to be repaid. Even though it was too optimistic to expect the equity to have value in the available timeframe, at least here there was an incentive to increase the recoverability of the debt during the remaining ownership of the PE house.

Cash arrangements can also be personalised and kept reasonably confidential from competitors and other managers. By contrast, equity arrangements are often more public and, as they are usually based on one class of share being held by management, common terms and thresholds have to apply to all managers.

Cash arrangements are also quick to implement as lawyers and valuers will need to be less involved than they are with equity

Cash arrangements are also quick to implement, as the list of consents needed is generally smaller. They tend to incur lower professional costs, because lawyers and valuers will need to be less involved than they are with equity as the tax risks are non-existent and the knock-on consequences are smaller. Moreover, our experience is that managers can value them more highly as they give what management want in the ultimately convertible form.

In tax terms, cash payments are likely to be fully taxable and subject to NICs, which can be a downside where management expect capital gains tax treatment. On the plus side, however, they can be tax deductible in the company's hands. Of course, a company which has not met its management equity targets in the past is unlikely to be profitable, and so this may not be of any real benefit anyway.

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Consents

Finally, the elements of the process need to be considered. New equity arrangements are likely to need the buy-in of other shareholders and often debt holders or banks too. Each circumstance will be determined by a company's articles of association or shareholders' agreement. Shareholder and class resolutions will be needed and new articles of association adopted with any new or amended class of share, together with investors' consents and bank waivers.

Conclusion

It has become accepted that management incentives – which once used to be fixed at the time of the buy-out for the life of that PE house's ownership, with limited flexibility for joiners and leavers – can now be reset. Increasingly, incumbent managers and existing investors are seeking and accepting modifications, and there is growing ingenuity in this field.

It has become accepted that management incentives can now be reset

PE houses will be sensitive to how changes to arrangements in one portfolio company will be perceived by the management of their other portfolio companies, and any precedent this may set. However, this needs to be weighed against the positive impact of the incentives which the changes produce.

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Kleinwort Benson – Wealth Management

The Monthly Musings of a CIO – July 2011

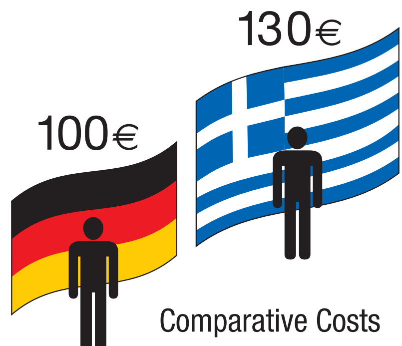
Making a drachma out of a crisis?

Politicians and central bankers have failed to take adequate steps to address the crisis in Greece and other peripheral eurozone countries. Here, Jeremy Beckwith, Chief Investment Officer of Kleinwort Benson, suggests there is ultimately only one solution: Greece must leave the euro. And that will have implications for the wider European economy – and for how companies, not least in the private equity sector, operate across Europe.

The second quarter ended with markets rallying on the news that the Greek government had managed to deliver a parliamentary majority for the further austerity measures demanded by the International Monetary Fund (IMF) and the European Union. That was a condition for continued access to bailout monies so that it can avoid defaulting on debt repayments. For Greek politicians, this means that they can keep their jobs and the goodwill of other European politicians for a little while longer. For German and French politicians, it means they can claim to be good Europeans (for helping out a fellow eurozone country in distress and ensuring that there is no crisis within the euro) and at the same time not be forced into providing a second bailout of their own banking systems, which have lent heavily to Greece.

Greece has more euro-denominated debt than it ever can afford to repay

However, for the voters in the countries providing further bailouts, this is a blatant waste of money. Greece has more euro-denominated debt than it ever can afford to repay. So supplying the Greeks with more debt that does not have priority over the existing debt – which is trading at half of its face value in the secondary markets – is just giving money away and most certainly breaks the spirit, if not the letter, of the Maastricht Treaty.



Greek voters are being condemned to a decade or more of total economic misery. The experience of the last two years shows that savage austerity has had little impact on budget deficits because the spending cuts and tax rises have led to such a decline in the overall growth rate of the economy that normal tax revenues have fallen sharply. Greece's bigger problem – which is commented on far less often than its government finances – is its competitiveness within the eurozone. Since joining the euro, the Greek private sector has become approximately 30% less competitive relative to Germany. To correct this would require either a 30% cut in private sector wages in Greece or a 30% increase in wages in Germany. The latter is not going to occur, and the strength of the Greek unions means that the former can occur only by severely reducing the number of people in employment, as companies go bust.

The formula requires savage cuts to the public sector deficit and a market-led devaluation of the currency

For several decades, the IMF has adopted a standard formula for dealing with countries which have gone bankrupt, as Greece is today. The formula requires savage cuts to the public sector deficit but *at the same time* a market-led devaluation of the currency in order to stimulate the private sector by making it substantially more competitive. In this way, the bankrupt economy, after a period of pain, finds an export-led path back to growth. However, given the political requirement that no one is allowed to leave the euro, Greece is suffering the public sector pain but getting no private sector boost to allow its economy to recover. Economic depression is the inevitable result of such a policy. Little wonder, then, that the Greek people have taken to the streets.

If Greece gave up euro membership, introduced a new drachma at 1:1 to the euro for all financial assets and liabilities within Greece and then immediately let the currency float to find its market level, which would probably be at 50% of its current value, tourists considering going on holiday to Greece would find that it has halved in price, and many more will go there, boost the economy and set it back on a path towards growth.

The other, but slower, route is that voters in Germany, Finland and the Netherlands get tired of their politicians throwing away their hard-earned tax revenues

In the end, this will happen. But the voters in Greece may have to make their politicians understand this by voting them out (or overthrowing them), which could take a little time. The other, but slower, route is that voters in Germany, Finland and the Netherlands get tired of their politicians throwing away their hard-earned tax revenues in futile attempts to stop an insolvent borrower formally going insolvent, and instead vote into power politicians who focus much more clearly on their national interest than on some perceived common European interest, and they force Greece to leave the euro.

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A shiver runs through the market

Although there have been signs of an upturn in global mergers and acquisitions activity, the first half of 2011 has been a washout for private equity investment in the UK market, with both deal volumes and aggregate values at woefully low levels. In his regular quarterly commentary, Jim Keeling of corporate finance advisor Corbett Keeling concludes that even the most hardened optimist of a deal-maker must be feeling anxious – although he offers some crumbs of comfort for the future.

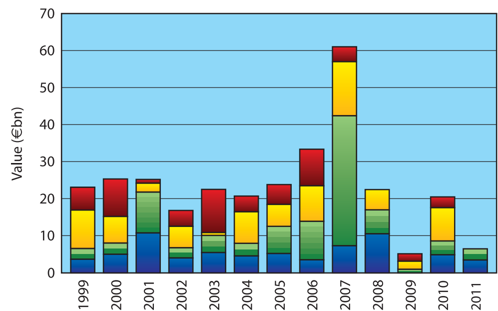
Recent press reviews of global mergers and acquisitions activity have contained some positive news. For example, data provider Dealogic reported that mid-market deal-making has got off to a good start in the first half of 2011 compared with an already strong 2010. In a similar vein, Mergermarket reported that buy-out activity for the first quarter of 2011 was well ahead of the comparable period in 2010.

But just a passing glance at the statistics provided by private equity journal Unquote, focused as usual on UK private equity activity, paints a different picture: one that is more likely to put a chill down the back of deal-makers than give them a glow of warmth.

Before rushing to any conclusions, though, let's sift through the detail of the hard facts. We will as usual start 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.

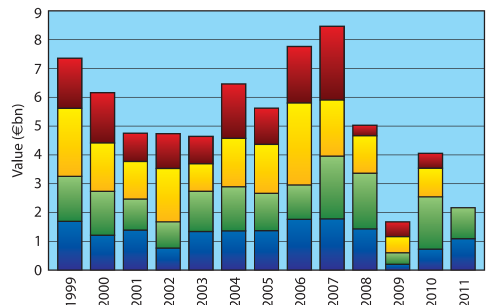
- Thirteen **larger UK buy-outs** (€150 million or above) have so far been reported as completed in the first half of 2011. Only 2002 and 2009 had weaker first halves, measured by numbers of deals. The picture is marginally worse in terms of aggregate values. At €6.5 billion, 2011 comes second from the bottom of the preceding 12 years, only 2009 being weaker.
- The picture for **smaller UK buy-outs** (below €150 million) is very similar. In terms of numbers of deals, the first half of 2011 – at 45 – was second from bottom. Again, only the 2009 result was lower. For these smaller deals, it is in terms of aggregate value, at €2.2 billion, that the first half has managed to be better than both 2002 and 2009, but no other years.
- The same theme continues for **UK early stage and expansion capital deals**. At 67

€150m+ Buy-outs by Value



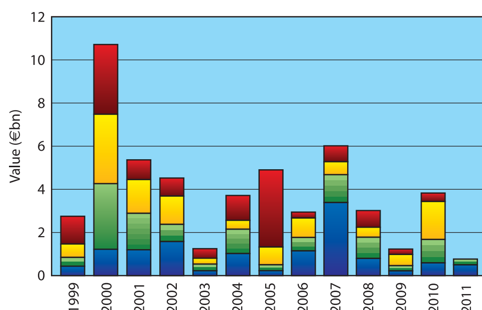
deals in the first half of 2011, the result is 25% below the worst other year on record! In terms of value, the picture is slightly better, with 2011 being fourth from bottom for first half results – but that is small comfort for UK private equity practitioners, given the depth and breadth of other adverse developments.

Sub €150m Buy-outs by Value



- Perhaps not surprisingly, the bad news is accompanied by an increasingly pessimistic view of life from industry practitioners that participated in Unquote's quarterly survey of expectations. Significantly lower proportions than three months ago think that deal activity will be on the increase over the next six months. Government cuts are expected to hit the sector hard. And industry participants believe that the net result will be private equity firms going out of business and a high

Early-Stage/Expansion Deals by Value



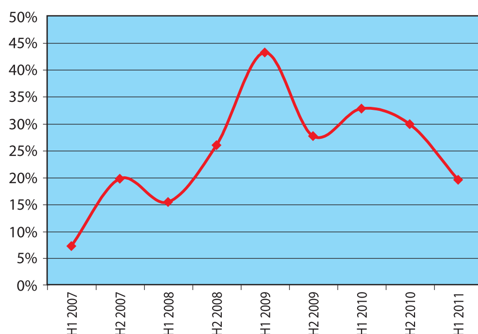
proportion of the deals done being pass-the-parcel, with one private equity owner simply passing its investment on to another.

It is just a matter of "hanging on in there", as our American cousins would say

What comfort, if any, can be drawn from this picture?

- First and foremost, we remain firmly of the view that all mergers and acquisitions activity is highly cyclical. It always has been and always will be: only a very brave person would venture to predict otherwise. With activity currently running at around 60% of levels seen a couple of years ago, one might not only wonder at the resilience of principals and advisers involved in the sector, but also realise that they are surely expecting in the long term (maybe more than six months) to be in for a strong upswing. It is just a matter of "hanging on in there", as our American cousins would say.
- Talking of which, the global picture – driven of course in part, if not mainly, by the United States – is encouraging as the Dealogic and Mergermarket statistics testify. Perhaps that is the most reliable lead indicator of things to come.
- And failing that, as I write, the European debt crisis is unfolding. One man's problem is another's opportunity. If the UK stays sufficiently on the edge of (not in) Greek and Spanish troubles, they too will throw up opportunities.
- For ourselves at Corbett Keeling, we are seeing a strong ground-swell of prospective transactions. The difficulty is in getting deals across the line, but the desire to do them is certainly there.
- And debt is increasingly becoming available, as evidenced by the chart showing a decreasing proportion of *all equity deals* to *all deals*.
- Lastly, the historic UK buy-out statistics that we are reporting on are, of course, preliminary. The final figures for the second quarter on which we are reporting are not yet in, and more deals are still likely to be reported as having finished in the period.

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



As the New Testament tells us, the same sun will shine on us all!

So we say to participants in the UK private equity sector, hold your heads up high. Whether or not you are among the despondent respondents to the Unquote survey, every cloud has a silver lining and, for this one, we believe it is not far away. Yes, the summer may as usual be quiet, but we are looking forward to the next 12-24 months. As the New Testament tells us, the same sun will shine on us all!

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