

Private Equity Director

Corbett Keeling

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

Welcome to the October 2009 issue of PE Director™, the quarterly newsletter for key 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.

Exits Seminar: This quarter, we are also offering the opportunity to meet the professionals who contribute to this newsletter. Partners and Directors of corporate finance advisers Corbett Keeling, international law firm Simmons & Simmons and global risk advisers Marsh will be speaking on *Exit routes – how to maximise value on exit from your business*. The seminar will cover the selection of your exit route as well as the exit process itself, including IPOs, trade sales and secondary buy-outs. You are very welcome to attend and, if you wish to do so, please register your interest by completing the form in the accompanying letter and returning with your contact details by post to:

**PE Director, c/o Corbett Keeling
13 St Swithin's Lane, London EC4N 8AL**

or email your contact details to:
meganpeel@pedirector.com

Exits Seminar

Subject: Exit routes – how to maximise value on exit from your business

Location: CityPoint, One Ropemaker Street
London EC2Y 9SS

Speakers: Marsh
Edwin Charnaud, Managing Director
Private Equity and M&A Practice

Simmons & Simmons
Arthur Stewart
Partner and Head of Private Equity

Corbett Keeling
Jim Keeling, Joint Chairman
and Malcolm Strang, Partner

Date/Time: 13th November 2009, 10.30am to
12.30pm followed by light lunch

This issue focuses on:

- Keeping your exit options open (pages 1 & 2)
- Deal-making – a light at the end of the tunnel? (page 3)
- Getting full value from risk management (pages 4 & 5)
- Taxing times for higher-rate pensions (page 6)
- Regulatory hot topics (page 7)

Keeping your exit options open

The recovery in stock markets since March has raised hopes of an imminent surge in IPOs for buy-out companies. But IPOs are just one exit route, and keeping your options open usually pays off, as Malcolm Strang of corporate finance advisor Corbett Keeling explains.

Exit options for management teams and shareholders of buy-out companies have been severely restricted over the past two years. While that has been due partly to the woeful state of the equity markets, it has also been the result of a lack of debt for funding secondary buy-outs or purchases from trade buyers. This lack of debt funding has been all the more painful as it contrasts markedly with the availability of cheap debt on favourable terms that helped to fuel the huge surge in buy-outs

up to 2008 at substantially better valuations than could have been achieved on Initial Public Offerings (IPO). These problems have been compounded by the poor trading experienced by many buy-out companies, some in breach of banking covenants, coupled with concerns that growth projections may not be achievable.

So it's no surprise that the stock-market rally has been welcomed with huge relief by management and shareholders alike, raising hopes of a surge in IPOs for buy-out companies in the last quarter of this year and especially in the first half of 2010. Initially, the most likely candidates for IPO will be either larger, well-established companies in defensive sectors with strong track records and stable earnings or specialist companies within niche sectors.

Keeping your exit options open

Institutional investors will be highly selective. They will be searching for competitively priced IPOs and will no doubt feel cautious about companies' growth assumptions. They will also look closely at the nature of the business, the reasons for IPO, the quality of the board and the management team as well as the future liquidity in the stock. Another area of interest will be the potential continued involvement of the private equity firm or other recognised cornerstone investors. In due course, if the equity market continues to rise and the first wave of IPOs performs well, investors will become less wary of smaller, less-established companies, which should allow a much wider group of companies to go to IPO.

Yet IPOs are just one exit route for buy-out companies. Management teams and shareholders will still be considering other exit options and may look to run several routes in parallel. The lead time once the exit process begins is typically three to six months, but further preparations for exit should have been carried out well before the process is initiated. The principle exit routes for buy-outs are: i) trade sale; ii) management buy-out (MBO) or management buy-in (MBI); iii) IPO; iv) re-capitalisation; v) receivership. The chart below details the *exits of buy-outs and buy-ins over the past 20 years*.

When looking at their exit options, the interests of management teams and shareholders may not always overlap. Traditionally, private equity firms have preferred the pricing certainty and greater control over the exit process given by a sale to a trade buyer or buy-out firm. That's because it allows them to sell their entire holding on exit, which is often not possible with an IPO.

By contrast, management teams may want to retain a holding on exit, so that they can benefit

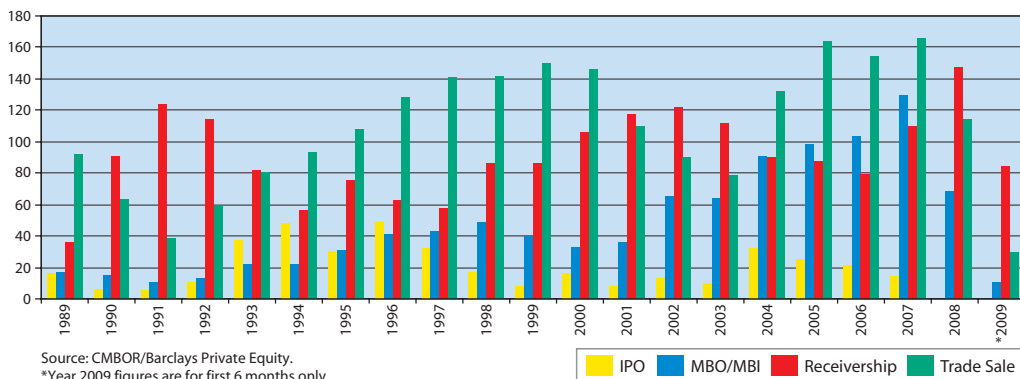
from any further upside in the business, which is easier to manage with a secondary buy-out or IPO. Management teams' aspirations are an important consideration; some have no desire to take on the additional responsibilities of running a public company, while others may fear for their jobs if their company is sold to a trade buyer. The exit route chosen will determine the incentivisation of key management and staff, share sales and lock-ins on exit and future share liquidity. One further important consideration for management after exit is the availability of additional funding to grow a company, whether organically or by acquisition.

Whichever exit route is chosen, the main consideration is optimising the price achieved on exit. Running the exit process in a way which creates competitive tension between all the interested parties will be key to achieving the best price and exit terms for both management and shareholders. In some cases, dual track processes will be run, where trade sales or secondary buy-outs are run in tandem with an IPO process.

These are a few of the key issues any exit strategy should consider. Yet every company will have several unique factors that must be taken into account, and some individual tailoring of the routes chosen will be required. That is why it is vital to obtain independent advice on exit strategies at an early stage in the planning process. Obviously, you need to know that your adviser does not have a vested interest in just one of the exit routes. A truly independent adviser should be able to help you review all the different alternatives, manage the exit process and assist in selecting specialist advisers where necessary.

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Exits of Buy-outs and Buy-ins over the past 20 years



Deal-making – a light at the end of the tunnel?

The talk in financial circles is all about a new dawn for private equity deals – which will be of particular interest if you are working towards a secondary buy-out as your backers think about exit. Jim Keeling of corporate finance advisors Corbett Keeling sifts through the data and market chat to see whether the dawn is likely to prove false.

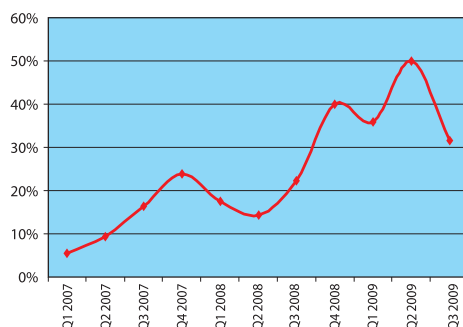
The preliminary statistics for the third quarter of 2009 (Q3 09) reveal a continuing dearth of deals. Nevertheless, some promising signs are emerging.

- The market for **larger UK buy-outs** (with an enterprise value of €150 million or above) remains weak. As in Q2 09, there were just two completed deals. Though better than the nil result in each of the two preceding quarters, that compares with a Q3 average of ten over the preceding ten years. The total value of deals is also low, at €1.9 billion versus an average for the preceding ten years of €7 billion. The only solace is that, although the Q3 value was low, it was easily the best of the past 12 months.
- **Smaller UK buy-outs** (below €150 million) also had their best result of the past 12 months, with 17 deals, up from an average of 14 in the preceding three quarters. The aggregate deal value was also up, at €450 million, compared with €280 million. That may support the view that a new dawn is breaking.
- By contrast, the picture for **UK early stage and expansion capital deals** shows a slight decline. The 38 deals compare with an average of 44 in the preceding three quarters, and the aggregate amount invested (€380 million) compares with an average of €410 million.

Of course, any dawn that has occurred is only in the few weeks since the world returned to work after the August break. So it has had just three – or at most four – weeks to make an impact on the preliminary Q3 figures.

But does market-place chatter corroborate talk of a brightening outlook? We repeatedly hear from funders that they have seen “more and higher quality” deals since the start of September. At one bank, the division that provides debt to buy-outs, which normally backs around 15 new deals every six months, had done only one in the second half of 2008

All Equity Funded Buy-outs to All Buy-outs



and another one in the first half of 2009. However, by mid-September, the team was already up to three deals, with many more apparently in the pipeline.

Perhaps this view of an increase in deals is reflected in the ratio of *all equity* funded buy-outs to *all* buy-outs (see graph). This fell sharply from 50% in the second quarter of 2009 to 30% in the third quarter, showing that equity providers are no longer being left to carry the day alone but are now getting much more support from the banks that provide debt.

Our survey of future expectations seems also to reflect optimism – at least in the short term:

- 46% of respondents think that larger buy-out activity is on the rise, compared with just 21% last quarter;
- the corresponding figures for smaller buy-outs have risen to 82%, from 75%;
- and there is more optimism this quarter that entry prices have fallen far enough to reflect economic conditions – and therefore trigger deal activity.

That said, large majorities of those surveyed also believe that funding for the private equity community (that is, into private equity funds, rather than from them to individual companies) will remain low and the dawn is false. Our view is that the trend in completed deals supports market opinion that a deal-making dawn is breaking. The question is whether the pessimists are right that the dawn will prove false. That is another story, which will only be told by the results for the fourth quarter.

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Getting full value from risk management

With private equity companies under intense pressure to cut costs, Edwin Charnaud, Managing Director of Marsh's Private Equity and M&A Practice, looks at ways to get better value from risk management and explains how insurance can be used as additional security when discussing lending facilities or as a solution to offset balance-sheet liabilities.

Businesses too often view insurance as a written-off commodity expenditure. In fact, managed properly, it can create additional working capital, delivering a higher return – which can give companies a critical edge, particularly in difficult economic circumstances.

This means using insurance only where it is the most effective way to finance the cost of risk. With economic and trading conditions improving, this is a good time for private equity firms to review how much risk they retain and how much insurance they buy, taking account of the likely loss profile of their businesses and their appetite for retaining risk. Such a review may help to release working capital that would otherwise be tied up in insurance, while ensuring proper protection is in place at times when margins may be squeezed.

Broadly speaking, some of the alternatives to buying insurance are: retaining risk on or off the balance sheet, through an alternative vehicle such as an in-house fund or a captive insurance company; or reviewing the amount of risk retained through policy deductibles. Some businesses have happily bought the same levels of insurance for years, only to realise on closer examination that insurance has become more expensive than the cost of capital for retaining the risk, either because of changes to the cost and availability of insurance or changes to the size or strategy of their company. In other words, buying insurance is no longer creating value for their businesses.

Of course, the reverse can also be true. A company which is retaining too much risk may find that, over time, an insurer's risk-adjusted return on capital would be a lower cost. In that case, the company would be better advised to transfer the risk via the insurance market. A thorough risk transfer optimisation review can help to establish the best options for the business.

Case study 1 – Re-assessment of risk profile

A risk assessment of a chemicals and pharmaceuticals company was undertaken to ascertain the greatest risks to the achievement of its business objectives. Using a combination of interviews and workshops, a catalogue was

produced which analysed the probability and impact of each risk. This formed the basis of future decision-making and the company's annual risk review. A new risk management programme based on the study reduced the total cost of risk by 25%, saving £1.5 million.

Case study 2 – Risk tolerance and insurance optimisation exercise

A retail company was expecting premium increases of over 40% in the following two renewal years. The company wanted to work out how much risk could be retained on its balance sheet. A risk tolerance assessment was conducted to establish the scope for retaining additional risk. Risk modeling helped to determine the expected losses and their uncertainty over the coming year and the effect on cost of risk at various levels of retention. The analysis helped to support them in marketing the risk to insurance companies at renewal and to demonstrate the company's commitment to managing and retaining risk. As a result, the premium was renewed 28% lower than the previous year, with the overall cost of risk reduced.

Case study 3 – Reducing employers' liability premiums through health and safety improvements

A manufacturer had introduced safety improvements but was concerned that insurers would not recognise these for some time, because of the lag between accidents occurring and employees bringing claims. It wanted to demonstrate its improving safety performance to the insurance market, so as to obtain better terms on renewal. The underlying indicators of performance relating to the company's Employers' Liability (EL) exposures were identified and guidance on the cost of EL risks to the business was provided. In addition, tools were built for capturing key metrics and tracking the trend and cost of risk.

Building the models enabled the company to identify areas of concern. A health and safety team carried out an on-site appraisal of health and safety systems at two sites. In addition, the models highlighted six areas for improvement. With better risk information from the model, the company's EL premium fell from £1.15 million to £780,000 – saving £370,000, with no increase in retained risk.

Other ways to address specific challenges

Many companies could use specialised insurance to mitigate or ring-fence liabilities on their balance sheets or to enhance the value of

assets. Examples include: using environmental insurance to free up provisions for unknown pollution risks; reviewing historic liability insurance policies to understand the amount of cover available under prior year policies for particular long-tail or latent risks, thus helping to quantify the true risk to the business; and using surety bonds to free up credit capacity for the business.

Contract terms typically modify a common law position which may result in the company accepting liabilities that are not covered by the company's liability insurance but which might be insurable with the specific agreement of the insurers. A sample review of contracts would help to identify the gap between risk and insurance and enable the company to manage those risks. For new contracts, the contractual review would seek to align risk more closely with insurance.

With access to capital still tight, trade credit insurance can help to support additional funding. Many companies use all or part of their debtor pool via an insurance policy to offset the cost and support their ability to negotiate or renew their facilities. As financial institutions continue to insist on potentially restrictive loan covenants, trade credit insurance backed by a positively rated insurer can enhance a company's ability to secure funds. In these troubled times, with a more cautious insurance market, a review of this product may offer a line of support to aid cash flow, maximise growth opportunities and reduce financial pressures.

The insurance market is reacting to changing global conditions by creating new insurance products, and a good awareness of these developments can help management teams to solve many of the various challenges they face. For example, new global supply chain policies can help to keep cash moving through the business in the event of a problem with a key link in the supply chain. They typically provide cover against any disruption or delay in the receipt of products, components or services from one or more named suppliers. Events covered could include pandemic, strikes, regulatory action and political risk.

And, of course, one other quick and easy way for businesses to boost their cash flow is to pay insurance premiums by installments.

Building business resilience

Non-financial risk mitigation techniques can also make businesses more resilient while reducing the cost of losses. When economic conditions are volatile, areas and levels of risk can change rapidly, so companies may now be exposed to risks that were previously not of concern. Key stakeholders in the business, including those

who provide funding, are likely to become even more interested in a management team's approach to controlling risk and to question how risks are prioritised and assessed.

For these reasons, companies should regularly review the range of risks to which they are exposed, their potential impact and the control and mitigation strategies used to manage them. For example, it can help to:

- Pay particular attention to political and labour unrest that may be exacerbated by rising food and energy prices around the world. This may threaten a supply chain or contract manufacturing.
- Revisit contingency planning. With margins under pressure, it is essential to have robust plans in place to respond to any adverse incidents. By ensuring that contingency plans reflect scenarios such as loss of a key supplier or customer, or intervention by a foreign government that restricts exports and thus prevents a company from receiving products or key ingredients, companies can become more resilient against external risks.

Present economic conditions make it critical that companies maintain their credit rating and therefore access to funds. Standard & Poor's will shortly make the strength of businesses' enterprise risk management (ERM) practices a component of their credit ratings methodology. This is yet another incentive for companies to make their approach to risk management robust and demonstrable.

Re-examining supplier management processes

Due attention should be given to detecting early warning signs that a company's suppliers are becoming financially stretched, evidenced, for example, by delayed or partial shipments or deteriorating product quality. Credit management reports on suppliers can be used in the same way they would for customers. It is also increasingly important to reduce as much as possible businesses' dependency on particular suppliers. That can be done by creating greater diversity not just among multiple suppliers, but also across geographic locations.

To conclude, at a time when margins are being squeezed, companies making informed decisions about risk retention and linking them to a review of effective risk mitigation strategies will not only be better placed to master the volatile economic conditions but should also emerge ahead of the competition as the recovery takes hold.

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Taxing times for higher-rate pensions

New tax rules will reduce the tax-efficiency of retirement savings for higher earners. So it may be time for private equity firms and management teams to consider other remuneration options, says Monica Ma of lawyers Simmons & Simmons.

Currently, individuals receive tax relief on their pension contributions and are not assessed to tax on any employer contributions (subject to the annual allowance limits). However, in this year's Budget, the Chancellor of the Exchequer announced two important measures affecting individuals with annual earnings of £150,000 or more making pension savings under registered pension schemes. These measures could have profound implications for the way the private equity industry remunerates its higher earners.

First, from 6th April 2011, tax relief on their pension savings will be restricted. The relief, which would otherwise be worth 50%, will be tapered away so that for those earning over £180,000 a year, it will be worth 20%, the same as for a basic rate payer.

Second, he introduced a special annual allowance charge, effective from 22nd April 2009. The purpose of this charge was to prevent individuals changing their normal pattern of pension savings to take advantage of higher-rate relief while it is still available. The charge applies to all individuals:

- who have a relevant income of £150,000 or more in the tax year in question or in either of the preceding two tax years. Relevant income is all income subject to UK income tax (including interest and other unearned income), reduced by certain allowable reliefs. Individuals will not be able to circumvent these measures by using salary sacrifice, although arrangements existing before 22nd April 2009 may continue;
- who increase their pension savings on or after 22nd April 2009 beyond their normal regular pension savings. Initially, only contributions paid at least quarterly were recognised as normal regular pension savings. A relaxation now applies if an individual has made average infrequent contributions (e.g., varying contributions each year, depending on bonuses) over the 2006/7 to 2008/9 tax years which exceed the special annual allowance, in which case the special annual allowance is increased to the lesser of the amount of the contributions and £30,000; and

- whose total annual pension savings, including any such increases, exceed the special annual allowance, being £20,000, or £30,000 (see above) for irregular contributions.

The special annual allowance charge is payable on any pension savings in excess of the special annual allowance. The charge will be at 20% for the tax year 2009/10 but is expected to increase to 30% for 2010/11, when the top rate of income tax rises from 40% to 50%.



Protection from the charge is sometimes available, but only when stringent conditions are met. The legislation is peppered with widely drafted anti-avoidance provisions to catch schemes one of whose main aims is to avoid or reduce the special annual allowance charge.

The removal of higher-rate tax relief will make pension savings an unattractive option for high earners – most people with annual earnings of £150,000 or more will be higher-rate tax-payers in retirement. Employers might wish to consider alternative arrangements for the provision of retirement or like benefits for high earners, such as employee benefit trusts or employer financial retirement benefit schemes. For further details, please see Darren Oswick's article in the July 2009 issue of PE Director. Please email meganpeel@pedirector.com if you would like a copy.

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Regulation time

The private equity industry is under pressure from all directions as firms cope with life in a de-leveraged M&A environment, tough general economic conditions for portfolio companies and a shift in the balance of power from private equity managers to their investors. All of these factors are exerting downward pressure on the investment returns delivered by private equity. In addition, the industry faces a mass of proposed new regulations which could have profound implications for the performance of private equity investments. Here, Arthur Stewart of lawyers Simmons & Simmons reviews some of the hot topics facing your private equity shareholders.

Regulatory issue	Impact on private equity funds
AIFM Directive:	Possible new onerous reporting requirements for PE funds, putting them at a disadvantage to other investors.
Carbon Reduction Commitment:	May be required to purchase annual allowances for each tonne of CO ₂ emitted over a set level.
Income Tax:	New 50% tax band from next year. Perhaps also US-style measures to tax carried interest as income, not a capital gain.
IPEV Guidelines:	New guidelines on calculating portfolio companies' fair value.
Pension Regulator Code of Practice:	New, much lower barrier to the Pensions Regulator issuing a Contribution Notice.
Serious Fraud Office:	More intense scrutiny of the private equity industry.

Of the above measures, only the reform of the Pension Regulators Code of Practice has already been put in place. Yet, if fully implemented, each of the proposed measures will have material consequences for the private equity sector, notably increased costs and reduced returns.

The EU's proposed **Directive on Alternative Investment Fund Managers (AIFM)** will affect marketing of funds and reporting by portfolio companies. Funds will incur a costly administrative burden, with arguably little real benefit to anyone. In addition, the directive

creates an uneven playing field for private-equity-owned businesses compared with businesses owned by other investors, such as individuals or sovereign wealth funds. Under the directive, private equity firms must make extensive disclosures to regulators and investors where the fund holds over 30% of shares in a company that is not a small or medium-sized enterprise.

Under the proposed **Carbon Reduction Commitment** scheme, a private equity fund will be treated as a holding company and all its majority-held portfolio companies will be treated as subsidiaries. If any one portfolio company triggers the Carbon Reduction Commitment, it will apply to all of the majority-held portfolio companies. Electricity use will be calculated as the aggregate of all portfolio companies controlled by the fund. So, if a fund and its majority-controlled portfolio companies spend £500,000 or more on electricity in total, the fund will be required to purchase annual allowances for each tonne of CO₂ emitted.



Executives at private equity funds and portfolio companies are becoming increasingly concerned about **the additional income tax band of 50%**, effective from 6th April 2010. Employees earning more than £150,000 a year can no longer shelter this increased liability through additional pension contributions (see article on page 6). Furthermore, there is concern about whether the UK will follow the US in taxing carried interest as income, rather than capital gains, from 2011. The UK Treasury is awaiting further details on how the US is proposing to do this.

The **International Private Equity and Venture Capital Valuation Board** has proposed a set of guidelines for uniformly calculating the value of portfolio companies across the private equity industry. The guidelines will apply to all funds completing quarterly valuations at 30th September 2009 and all funds reporting at 31st December 2009.

Reform of the Pension Regulators Code of Practice may lead to a rise in portfolio companies' pension obligations, thus reducing the internal rate of return on private equity investments. The reform relates to Contribution Notices (CNs), which force employers to make additional contributions to defined benefit pension schemes. In the past, it was difficult for the regulator to issue CNs, because it had to demonstrate intent on the employer's part to avoid or artificially reduce its obligations to the scheme. Now, it simply needs to show some

form of 'material detriment' to the pension scheme. Material detriment exists wherever some act or failure materially reduces the likelihood of scheme benefits being paid. So, unless the scheme is fully funded on a self-sufficient or insurance market basis, a CN could be issued if anything reduces either the portfolio company's ability to provide funding or the dividend which the pension scheme might receive on the insolvency of the sponsors.

In an effort to counter criticism of its failure to mount more big City cases, the UK's **Serious Fraud Office** has announced a crackdown focused on asset-backed securities, insurance fraud, private equity companies and hedge funds.

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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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