

Private Equity Director

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The Newsletter for Executive Directors of Private Equity Backed Businesses

April 2010

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

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

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This issue covers:

- First quarter 2010 – the return of the larger buy-out (pages 1 & 2)
- Budget update – scant cheer from round one (page 3)

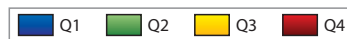
First quarter 2010 – the return of the larger buy-out

Towards the end of 2009, the UK private equity industry became noticeably more optimistic about the prospect of a recovery in deal activity. In the first quarter of 2010, that translated into a definite upturn, but only at the larger end of the deal spectrum. Here, Jim Keeling of corporate finance advisor Corbett Keeling sifts through the data produced by private equity journal Unquote in order to assess whether the upturn will filter down to medium and smaller deals – and concludes that there are grounds for cautious optimism, which will be **good news for those in smaller companies who have been patiently waiting to sell or refinance.**

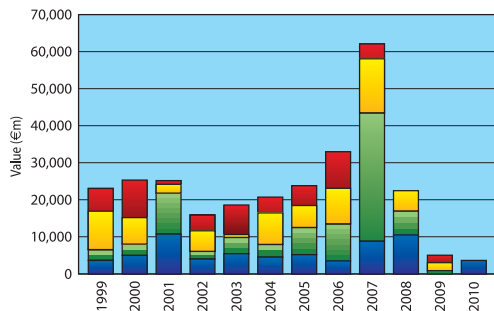
Finally, at the start of 2010, comes some solace for those working in the larger buy-outs market. After a record-breaking weak 2009, funders and advisers alike can draw comfort from a marked upturn in larger deals. Let's look at the facts, as usual examining first larger UK buy-outs of more than €150 million enterprise value, then UK buy-outs of less than €150 million and finally early stage and expansion capital deals.

- It wasn't hard, in the first quarter of 2010, for the statistics for **larger UK buy-outs** (€150 million or above) to beat the comparatives of a year earlier, when there was a highly unusual straight zero. Encouragingly, though, activity has done far better than just beating the zero mark: it has returned to levels seen in the opening quarters for much of the past ten years. Indeed, only three years – 2001, 2007 and 2008 – saw significantly greater volumes and values than 2010. The result for

the first quarter of this year (at nine larger buy-outs with a total value of €3.7 billion) was not only a reasonable performance compared with earlier years' first quarters but is already nudging the comparative figures – by both volume and value – for the whole of 2009.



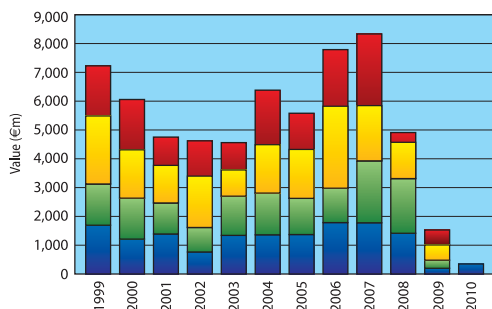
€150m+ Buy-outs by Value



- The first-quarter 2010 result for **smaller UK buy-outs** (below €150 million) was much more pedestrian, coming in at almost exactly the quarterly average level since the downturn at the end of 2008. At the time of writing there had been just 14 deals, with an aggregate value of €350 million. This may seem a reasonable result compared with the number of larger deals, but in a good quarter

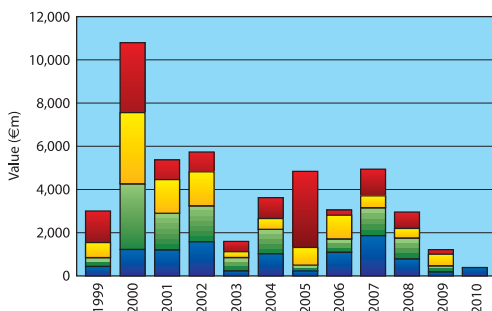
there would normally be far more small deals done than large. So the improvement in larger buy-outs has not yet filtered down to their smaller cousins.

Sub €150m Buy-outs by Value



Likewise, **UK early stage and expansion capital deal** numbers, though not dramatically down compared to recent quarters, fail to provide any excitement for deal-makers. There were 50 early stage or expansion deals in the first quarter of 2010, with an aggregate amount of €390 million. Both statistics are in line with recent weaker years, but a long way below years when activity was high.

Early-Stage/Expansion Deals by Value



So what do we conclude from this? Last quarter, we reported that one larger-deal practitioner’s firm “had not done a deal for 18 months”, and his team was “really hungry to get a transaction over the finishing line”. It appears that he and many of his peers have reacted to that sentiment by pushing hard and finally re-starting the larger-deal machine.

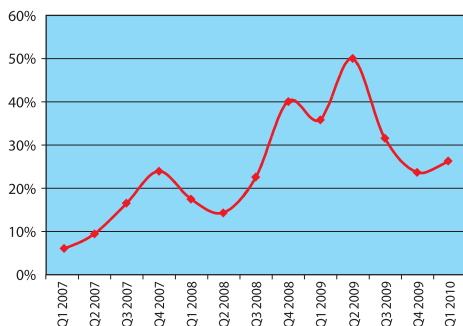
The question is whether, over the coming months, this trend will be sustained for larger buy-outs and then spread to smaller deals, especially given the uncertainty created by the General Election. The survey of future

expectations which, as for the historic data, is produced by Unquote showed some helpful and generally positive pointers:

- While fewer respondents than three months ago thought numbers of larger deals would continue to increase – which is perhaps not surprising, given the larger buy-out result – two thirds of respondents still thought numbers of smaller buy-outs are on the up.
- The proportion who thought prices have fallen far enough to trigger more deal activity is also rising.
- When asked about sources of deal flow, those surveyed indicated a return of the secondary buy-out, with respondents favouring private equity owned businesses as the greatest source of future deals. This perhaps reflects the difficulties that sparsely available debt caused for many private equity backed businesses during 2009, leading many to get into difficulties and so come up for sale in 2010.
- Finally – and this may be little wonder, given Gordon Brown’s last-minute intervention – the world seems split down the middle on the likely impact on private equity of the EU’s Directive on Alternative Investment Fund Managers (AIFM).

The graph of all equity buy-outs to total buy-outs shows the ratio being maintained at just above 20%, providing encouragement that banks are settling back into the buy-out game – and that should be positive for deal-making.

All Equity Funded Buy-outs to All Buy-outs



At the coal-face, activity has certainly increased since last autumn and, as yet, there has been no let up in deal flow. So we are hopeful that, despite the negative impact of the twin uncertainties of the General Election result and the AIFM, we will continue to see increased deal activity – and a fruitful 2010.

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

Budget update – scant cheer from round one

*The Budget delivered in March by Alistair Darling was probably only the first of 2010, as a new one is likely within weeks following the General Election. The first provided **little consolation for the management teams of private equity backed companies**, as Darren Oswick of lawyers Simmons & Simmons explains. And, with the incoming government under intense pressure to address the fiscal deficit, the second is unlikely to offer much more encouragement to the private equity industry.*

The March Budget contained confirmation (if any were needed) that the top rate of income tax will rise to 50% from 6th April 2010 for those earning more than £150,000, with the 1% increase in employer and employee national insurance (NI) contributions taking effect from 6th April 2011. The NI increase may be amended, depending on political developments after the election; the top rate rise will not, at least in the short term.

Further clarity has been provided about the restrictions on higher rate tax relief for pension contributions by those with income in excess of £150,000 a year, which will also take effect from 6th April 2011. Any attempts to circumvent this by increasing pension contributions in the interim were forestalled by the introduction of the “special annual allowance charge” in last year’s Budget. As with the 50% income tax rate, this unfortunately appears to be a measure which will apply for the foreseeable future.

The Labour government has been increasingly alert to tax planning aimed at circumventing both the increased income tax rate and the pension changes. It announced crackdowns on benefits provided by employee benefit trusts and on arrangements designed to get around the pension relief restrictions introduced in 2009. The details of these measures are currently being worked on by the Treasury, so we have little visibility on their scope. We can expect further information and draft legislation in the coming months, but it is likely that, at the very least, the most aggressive forms of bonus planning using employee benefit trusts will cease to work. Nevertheless, some arrangements are still worth considering, as discussed in the July 2009 issue of *Private Equity Director*.

Worrying news for future management buy-outs and buy-ins came with the announcement of a consultation this year on “geared growth” arrangements involving employment-related securities. Under these arrangements,

managers are given equity which has a nil value on award but which has a built-in mechanism designed to make the equity become more valuable over time. Obviously, these managers would pay capital gains on disposal, rather than income tax. It is unclear whether any measures that follow the consultation will target just these sorts of “joint ownership” schemes, which are being widely marketed, or whether they will go further and call into question the tax treatment of managers’ equity arrangements on a typical management buy-out or buy-in. Fortunately, any existing arrangements are likely to be grandfathered.

The rate of capital gains tax remains at 18%. Yet that is likely to be increased in the post-election Budget – whoever is in power – as the differential between this and the 50% top rate of income tax is now too stark. Private equity executives may also be concerned that the UK will follow the US’s lead in seeking to tax carried interest as employment income, which will be appealing to the Treasury if a simple mechanism can be found to achieve it – and if lobbyists on behalf of industry prove to be less persuasive than they have been in the past.

The one bit of good news – and that only for a small minority of management teams – was that the existing £1 million threshold for entrepreneur’s relief (a reduced 10% rate of capital gains tax for individuals who sell 5% plus shareholdings in trading businesses) will be increased to £2 million.



Now that the election is over, we can expect a second Budget in short order. Although this may contain some good news in the shape of a reduction in corporation tax, the current levels of personal taxation appear here to stay, at least for a while, and all that can realistically be expected is a further crackdown on avoidance.

Taxing times indeed.

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