Private Equity Director

Corbett Keeling

Simmons & Simmons

The Newsletter for Executive Directors of Private Equity Backed Businesses July 2010

Dear Reader,

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

This issue marks the start of PE Director's second year. We hope that you have enjoyed the four previous issues and that they have kept you abreast of some of the topics of greatest relevance to directors of private equity backed companies.

The articles in this issue take an in-depth look at the areas we think will dominate the agenda in the second half of 2010:

- the implications for private equity backed companies and their shareholders of the various measures announced in the emergency Budget (pages 2 & 3);
- whether an increased level of deal activity can continue and how that affects you as you get closer to an exit (pages 4 & 5);
- the potential impact of proposed new regulations on your company as a result of it being owned by private equity (pages 6 & 7).

The article on the Budget draws on many of the ideas discussed at the latest seminar hosted by PE Director, which was held at the offices of our legal and tax contributor Simmons & Simmons.

Previous seminars have included:

- managing private equity backed businesses in the credit crunch; and
- how to maximise value on exit from your business.

We are planning to hold more seminars in the autumn, once the summer holiday exodus is over. These events give us a chance to deal with topics in more detail than is possible in the space of a short article. They also provide an opportunity for you to quiz our expert panel and your peers within the industry on the latest developments and emerging trends. We have certainly enjoyed hosting them and hope that you will find them interesting, informative and occasionally even entertaining!

If you have any ideas for topics you particularly want to see covered by future seminars, or if you have any suggestions for ways we can make PE Director more relevant to you, please let us know.

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Finally, PE Director is available by e-mail as a pdf. If you would rather receive it in this format, please register your interest, providing us with your e-mail address using the contact details above.

We look forward to another year of – we hope – providing incisive commentary that is useful in building and realising the value of your private equity backed business.

Megan Peel, *Editor*

A good Budget for PE backed businesses?

After a period of fantasy fiscal politics while the campaigning season lasted, everyone expected the new coalition government's emergency Budget to provide a strong dose of reality – as indeed it did. But how much of the increased tax burden would private equity backed businesses have to share? Darren Oswick of lawyers Simmons & Simmons sifts through the new legislation to shed some light on the subject. His conclusion: it may not be as bad as had been feared, but the Budget still contains pitfalls for unwary directors of private equity backed companies.

In the run-up to the latest Budget, management teams at private equity backed businesses were focused on one aspect of tax only – what changes would be made to the rules for capital gains tax (CGT)?

That was hardly surprising, as an increase in CGT rates had been widely trailed. Quite apart from the usual media briefings by government sources, the Coalition Agreement (published on 20th May 2010) had clearly stated in black and white that "we will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities".

This had led to fears that management shareholdings would be classed as "non-business" assets, which would therefore not fall within whatever exemptions the government planned to introduce. As a result, a number of management teams undertook planning to crystallise existing gains at the prevailing CGT rate of 18%. The view in the market appeared to be that the rate of capital gains tax would go up to 40% but that there would probably be a raft of exemptions – in addition to entrepreneurs' relief – which would benefit management teams, at least those with significant shareholdings.

To the extent that businesses had positive expectations of the Budget, they were based on one of the central planks of the Conservative manifesto, namely a reversal of the "jobs tax" – the 1% rise in employer and employee national insurance contributions introduced by the last government, to take effect from 6th April 2011.

Capital gains

As it turned out, the most significant measure was indeed a rise in capital gains tax. The increase, from 18% to 28%, applies to higher-rate taxpayers only. The cynics will say that the government has done something right when it can raise the rate of capital gains tax overnight by more than half, and yet those affected feel that it could have been so much worse. However, before the government feels too pleased with itself, it should note that, amongst the UK's international competitors, only France now has a higher rate of capital gains tax.

Taxpayers whose income and gains do not exceed the basic rate threshold (£37,400 for 2010/11) will continue to be subject to the 18% capital gains tax rate. In addition, the annual exempt amount (the CGT personal allowance) remains at £10,100. The annual exempt amount, and any capital losses, can be used to minimise any tax due.

Lifetime limit for entrepreneurs raised from £2 million to £5 million

The "generous exemptions for entrepreneurial business activities" promised in the Coalition Agreement amounted to no more than an increase in the lifetime limit of the amount of gains qualifying for entrepreneurs' relief, which was introduced in 2008 to accompany the 18% CGT rate exempting gains on certain types of business assets. The lifetime CGT limit for entrepreneurs was raised from £2 million to £5 million.

But the devil, as always, is in the detail, and not all directors of private equity backed companies will be in a position to benefit from this relief. In order to qualify for entrepreneurs' relief on a management shareholding, two of the conditions which need to be satisfied are that the shareholder must hold at least 5% of the ordinary share capital of the company and must have at least 5% of the voting rights by virtue of that shareholding. Hence, it is only likely to benefit founders or managers who have negotiated sufficiently high individual equity stakes in the business with their private equity backers.

"Jobs tax"

Perhaps not surprisingly, given the state of the public finances, the Chancellor of the Exchequer did not in fact withdraw the proposed 1% employer and employee national insurance contribution increases for 2011. Instead, there was some tinkering around the edges. For example, the threshold above which employer national insurance contributions will apply for 2011 was increased by £21 per week. In addition, exemptions from employer national insurance contributions will be introduced for new businesses setting up in certain parts of

the country (broadly, outside London, the South East and Eastern England) – but only in respect of the first ten employees they hire.

Corporation tax

One bit of good news for businesses was the decrease in the headline rate of corporation tax from 28% to 27% from 1st April 2011, with a further 1% reduction per year to 24% in 2014. The small companies rate is to be cut from 21% to 20%. However, these reductions will be paid for by additional limitations to the capital allowances regime.

The reductions in corporation tax rates are principally intended to increase the UK's competitiveness in international league tables as a place to have businesses' headquarters. They are unlikely to make management teams feel much better about their own tax positions, particularly for those who are now bearing the brunt of the new 50% income tax rate.

Pensions

There may be some light at the end of the tunnel as regards pensions changes. In 2009, the Labour government announced that higher rate tax relief on pension contributions would be withdrawn for those earning in excess of £150,000 from 6th April 2011. In the meantime, it introduced an "anti-forestalling" regime to prevent significant additional pension contributions being made by high earners before the new rules took effect. The 2011 proposals effectively meant that pensions would cease to be a worthwhile investment for high earners.

The Budget announced a reversal of the proposed restrictions on higher rate tax relief. Instead, we are likely to end up with a system where all taxpayers can contribute between £30,000 and £45,000 every year and will receive full tax relief on such contributions. The pensions industry is currently predicting that the limit will be set at around £35,000, in order to meet the necessary revenue-raising targets the changes were supposed to achieve. If implemented, these changes will mean that pensions will continue to be attractive to taxpayers earning six-figure salaries.

The big headline grabber was the increase in the rate of VAT from 17.5% to 20%

VAT

Other than the CGT increases, the other big headline grabber was the increase in the rate of VAT from 17.5% to 20% from 4th January 2011. That will obviously present enormous political difficulties to the Liberal Democrats among the coalition government, given their pre-election warnings of Tory VAT bombshells. However, the Chancellor felt that such a move was "unavoidable".

Trust structures and "geared growth" arrangements

One area we noted in the April 2010 edition of *Private Equity Director* was employee benefit trusts, discretionary trusts set up as tax-efficient ways to remunerate employees. At present, we have nothing further to report on this, as the Treasury has not yet completed its scrutiny of these and similar arrangements. Our view is that employee benefit trusts used for bonus planning are likely to be on the wrong side of the line wherever it ultimately falls, whereas trusts used to provide pension alternatives should escape relatively unscathed.

Nor has the Treasury reported any progress in its review of "geared-growth" employment-related security arrangements, including progress as to what types of arrangement the review is actually going to cover. However, a consultation document has been promised for later in the summer. It is unclear whether management shareholdings in leveraged structures will be targeted. In these structures, the leverage has the effect of making the ordinary share capital far cheaper on acquisition than it might otherwise be and, if the leverage is ultimately repaid, can significantly enhance the returns on such share capital. We will update you on both of these areas in due course.

The way forward

The prevailing view of private equity backed management teams so far appears to be that, although the Budget will overall have a negative impact on them, it could have been far worse. Of course, whether it will lay the foundations for economic recovery, only time will tell. In the meantime, clients are beginning to refocus on incentivisation opportunities as, even with the new top CGT rate of 28%, there is still a stark difference between that and the top rate of income tax, which is now in excess of 50% and will remain so for some time to come.

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Optimism spreading to smaller and early stage deals

After last year's deep freeze in deal-making activity across the private equity industry, we saw some signs in late 2009 of increasing optimism about future investment levels. In the first quarter of 2010, that optimism started to flow through into deal activity, though it was mainly confined to transactions at the larger end of the spectrum.

Here, Jim Keeling of corporate finance advisor Corbett Keeling assesses the latest data to see if this thaw is continuing – and whether it is starting to flow down to medium-sized and smaller deals. He discovers that activity and optimism are holding up, which should provide some comfort at last for long-suffering executives of smaller companies who have been waiting to sell out or refinance.

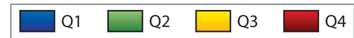
The preliminary statistics are in, and they show that private equity deal-making activity during the second quarter of 2010 held up across the board. These data, produced by private equity journal unquote", are encouragingly corroborated by figures from the Centre for Management Buyout Research (as detailed under *Policing private equity* on page 6).

Of course, with the western economies still in the middle of prolonged de-leveraging, it was not to be expected that the level of investment would return to anything approaching the dizzy heights of 2007. However, it seems there has been enough activity to fuel a more positive mood around the market.

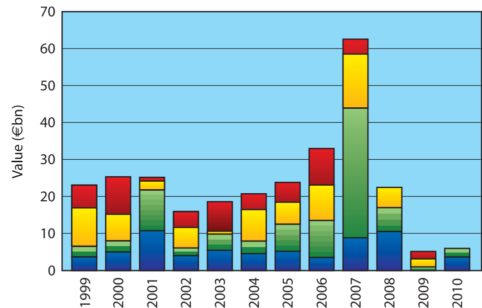
So let's look at the facts. As usual, we will examine first larger UK buy-outs of more than €150 million enterprise value, then UK buy-outs of less than €150 million and finally early stage and expansion capital deals.

Larger deal-makers can take solace that the drought appears to be well and truly over

- After just two quarters of 2010, the total number and aggregate value of **larger UK buy-outs** (€150 million or above) has already outstripped the total for the whole of 2009. The number of deals (at 16) compares with 10 for 2009 in its entirety. In value terms, transactions worth €6 billion have been completed so far in 2010, compared with €5 billion for the whole of last year. So larger deal-makers can continue to take solace that the drought of 2009 appears to be well and truly over.

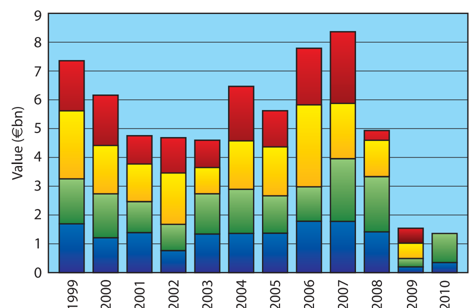


€150m+ Buy-outs by Value



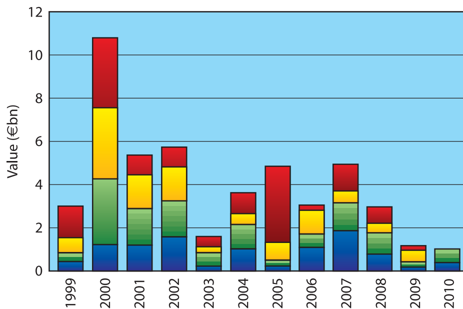
- The drought for **smaller UK buy-outs** (below €150 million) last year was not nearly as severe as for their larger counterparts. Not surprisingly, therefore, the recovery has been commensurately more modest. However, there is some encouragement here too: the aggregate value of smaller deals for the first half of this year is already approaching the total for the whole of last year, at €1.4 billion so far in 2010, compared with €1.5 billion for all of 2009. By comparison, the number of deals is up only a little in the first six months, at 34 completed transactions, versus 29 in the same period of 2009.

Sub €150m Buy-outs by Value



- The picture for smaller buy-outs is mirrored in the statistics for **UK early stage and expansion capital deals:** the value of these deals, at €1 billion after six months, is only just below the €1.2 billion for all of 2009, even though deal numbers – at exactly 100 in the year so far – are not far ahead of the 87 recorded in the first six months of 2009.

Early-Stage/Expansion Deals by Value

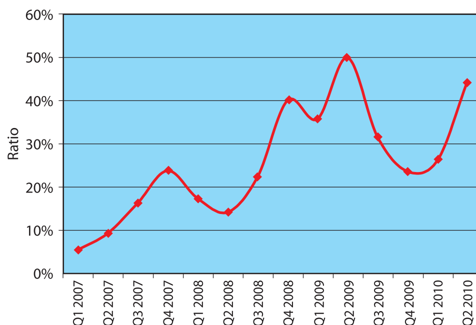


So far, the private equity industry might appear to have sailed through the General Election and the European legislation comparatively unscathed

At the end of the first quarter of 2010, we noted two big sources of uncertainty for the months ahead, namely the General Election and the likely impact of new European legislation on UK fund managers. So far, the private equity industry might appear to have sailed through both comparatively unscathed. Yet two questions remain:

1. Although the election is now behind us, it is still to be seen how much of last quarter's activity was driven by capital gains tax (CGT) considerations, with owners seeking to crystallise any gains before CGT rates were raised, thus simply bringing forward deals rather than creating an underlying increase in activity. There was certainly plenty of chatter in the market that deal-making was in part being driven by tax considerations.
2. Will the devil prove to be in the detail of European legislation – will it yet make a material impact on the UK's competiveness for carrying on private equity activity?

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



Next quarter's data will give us some clue as to the answers to both questions. In the meantime, however, what are market practitioners' views of the future? We can find some helpful pointers in the survey of future expectations provided by unquote".

Most survey respondents feel that sufficient bank debt is available in the market to support transactions

- There is increasing optimism about smaller deals, with 82% of respondents to the survey predicting that activity will rise.
- At the same time, a large majority (94%) thinks that larger deal activity will either increase or be maintained at what is already, at least in terms of deal numbers, a reasonable level.
- Interestingly, while buy-outs funded by all equity have seen a sharp rise (to 45% of all buy-outs, compared with 25% last quarter), most survey respondents feel that sufficient bank debt (leverage) is available in the market to support transactions. At the same time, respondents are split almost exactly 50:50 as to whether, with the Bank of England taking over from the Financial Services Authority, the new regulatory regime will have a detrimental impact on the future availability of debt.

The final pressing question is about the possible impact of the changes to capital gains tax announced in the emergency Budget. Perhaps not surprisingly, a majority of private equity practitioners were in favour of the tax remaining at historic levels. Now, though, everyone must consider whether the increased rate of 28% – which, according to analysis by the British Private Equity and Venture Capital Association, makes Britain's rate the highest but one of its 16 nearest peer nations – will be detrimental to entrepreneurial and investing activity.

Only the coming months – or years – will tell. In the meantime, we will keep watching to see whether the current level of optimism is borne out by deal activity during the summer months, which are traditionally a quieter time.

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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.

Policing private equity

Although we see signs of life returning as deal activity picks up, the private equity industry faces some stiff regulatory headwinds. After the credit crisis, some increase in regulation may have been inevitable. Here, Arthur Stewart of lawyers Simmons & Simmons outlines some of the issues which could have serious implications for the directors of private equity backed companies and discusses whether or not the new regulations amount to a level playing field.

In the first half of 2010, the combined value of private equity deals in the UK has, according to data published recently by the Centre for Management Buyout Research (CMBOR), been almost 50% higher than the total value of private equity deals closed for the whole of 2009. These statistics are broadly corroborated by the latest data from unquote" as reviewed on pages 4 and 5. And, at the time of writing, we remain hopeful that the paranoid optimists in the private equity world will win out over the paranoid pessimists.

However, despite these signs of recovery, the private equity industry as a whole continues to face many challenges, some of which will directly affect many companies that receive private equity investment. In the table below, we summarise two examples of UK legislation specifically aimed at private equity which will have an impact on these portfolio companies:

Regulation	Conditions for regulation to apply	Impact on private equity portfolio and investment companies
Carbon Reduction Commitment Scheme (CRC):	■ Portfolio company "controlled" by PE firm. ■ One company in the group had a half-hourly electricity meter in 2008. ■ Aggregate electricity consumption of group in 2008 was greater than 6,000 MWh.	Requirement to purchase carbon credits based on aggregate emissions of the portfolio companies grouped within the private equity fund, with each portfolio company jointly liable for non-compliance.
AIFM Directive:	■ PE firm has at least a 10% stake in the company. ■ Company has more than 50 employees.	Wide-ranging regular public disclosures may be required of small and medium-sized companies in receipt of private equity investment, whereas other similar companies that do not receive private equity investment may not.

The CRC Scheme – a group effort

The inefficiently named Carbon Reduction Commitment Energy Efficiency Scheme (CRC) took effect from April 2010. It will apply to companies in the UK based on the electricity supplied to them in 2008. The scheme will affect conglomerates or groups of companies, defined in terms of parent and subsidiary company under the Companies Act 2006.

Despite the concerted efforts of lobbyists from the private equity industry, the government has stuck to the view that this scheme should apply to private equity firms and their portfolio companies too. Where a portfolio company is under the control of a private equity firm, the portfolio and investment companies are considered to be part of the same corporate group for the purposes of the legislation. So, if only one of the portfolio companies of a PE firm falls within the scope of the scheme, all the portfolio companies of that firm that are considered to be part of the same group will have to comply with the scheme's regulations.

Only companies that had a settled half-hourly electricity meter in 2008 fall within the scope of the scheme and must register for it. The scheme applies:

- partially to companies with total electricity consumption of between 3,000 and 6,000 megawatt hours (MWh), which have to provide details of their electricity consumption;
- fully to companies with a total usage of more than 6,000 MWh, which must purchase carbon allowances from the government per tonne of emission and must participate in a carbon allowance trading scheme.

Crucially for directors of portfolio companies, where the scheme applies to groups of companies, the electricity consumption in 2008 is measured on the basis of the aggregate consumption of the group. So a portfolio company will have to comply with the CRC regulations if it is controlled by a PE firm which controls any other company that falls within the scope of the scheme. The extent to which the company will be bound by the scheme will then depend on the total electricity consumption of the group as a whole.

As a result, many small and medium-sized portfolio companies, which would not on their own be big enough to be subject to the scheme, will now fall within the scope of the legislation simply because they are owned by private equity backers or have received private equity investment. In addition, all portfolio companies of a PE house will then be jointly and severally liable for non-compliance by any one of them.

The scheme comes with stringent penalties – including fines and criminal punishment

Although the CRC scheme has an admirable purpose, this application of the scheme to private equity structures in an aggregate manner is questionable. While private equity portfolio companies may technically fall within the scheme's definition of group companies, in practice they are operated not as part of a group but as individual entities. Nevertheless, the scheme comes with stringent penalties – including fines and ultimately criminal punishment – for non-compliance. So the provision of joint liability for group companies could have serious consequences for PE-backed companies and their directors.

Not so private equity – AIFM Disclosures and Walker Guidelines

The draft EU Alternate Investment Fund Managers (AIFM) Directive has similarly thrown up issues for private equity firms, especially the proposed disclosure requirements. The final form of the directive is currently being negotiated in so-called trialogue meetings between the EU Parliament, the Council of Ministers and the European Commission. But both the Parliament's and the Council's versions of the directive contain increased disclosure requirements for portfolio companies within the EU.

The draft directive proposes that a company over which a private equity firm has a "controlling influence" – defined as a 10% or higher stake – will have to make bi-annual disclosures of its finances, management and planning information.

Disclosures will need to be made to the competent authorities of the AIFM and the EU member state where the company is established, as well as to the shareholders and employee representatives of the company. Each time a private equity firm comes to hold 10%, 20%, 30%, 40% or 50% of a company, the PE firm will be required to disclose this level of acquisition. The draft also proposes that PE funds make disclosures about their plans for investments in individual portfolio companies; any significant divestment in assets; and even any policy with regard to employees. The requirement for disclosure in so many circumstances and to so many different parties would mean a widespread public dissemination of information about PE backed companies.

Such disclosures could make these companies uncompetitive . . . the private equity industry is not accepting these proposals without a fight

Previously, the regulations which applied to private equity backed portfolio companies in the UK have sought to keep the disclosure requirements for such companies in line with the disclosures required of companies that were not backed by private equity. The Walker Guidelines sought to regulate only those PE backed companies that were of the same size as FTSE 350 companies and exempted companies below a certain threshold size.

By contrast, the EU Parliament's version of the draft AIFM Directive proposes disclosure requirements based solely on receipt of PE investment, with no concession to size (other than an exclusion for companies with fewer than 50 employees and private equity investment of less than 10%). Small PE backed companies would therefore be required to make excessive disclosures, far beyond those

continued

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required of similar-sized companies backed by more traditional financing sources. Such disclosures could make these companies uncompetitive, forcing them to reveal financial, strategic and operational information to their better-established competitors.

The private equity industry is not accepting these proposals without a fight. Several representatives of the sector, such as the British Venture Capital Association, are still working to try and mitigate the level of the disclosure obligations, and they may succeed to an extent. However, private equity backed firms are certain to face at least some increase in their disclosure obligations.

The new legislation being drafted clearly demonstrates that, in the aftermath of the financial crisis, the private equity industry will inevitably suffer a real rise in the burden of regulation. Yet it remains to be seen to what extent the industry can succeed in its efforts to avoid over-regulation and how it will manage to cope with whatever regulation is finally passed into law. The directors of private equity backed portfolio companies will need to keep a wary eye on the direction the regulation takes – and may have to take a wider interest in the other companies within their backers' portfolios.

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Corbett Keeling is a corporate finance advisory firm focused on:

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