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RESTRUCTURING AND FINANCING ISSUES OF THE GERMAN PRIVATE EQUITY MARKET IN 2010

THROUGHOUT most of 2010, the private equity market in Germany was still affected by the financial crisis. Many German portfolio companies of private equity funds were compelled to go through restructuring processes due to the high leverage imposed in the years 2006 to 2008. Financial covenants were breached and lenders took the opportunity to reduce their exposure, even if the economic performance of a portfolio company improved in the meantime. After disappointing first and second quarters, deal activity increased during the second half of the year and has now reached about the level of 2002/2003. Leverage in buy-out transactions generally did not exceed 50% of the purchase price. Lenders remained rather cautious and mostly preferred club deals to syndication processes.

Especially in the automotive sector, which had been a key target industry for PE investors, many portfolio companies suffered from the crisis and breached their financial covenants in 2009. Due to the high number of breaches, the arranging banks were only able to restructure those companies in 2009 that were suffering most. Although the automotive sector benefited from the growing economy in Germany in 2010 and improved its profits, many lenders did not want to miss the opportunity in 2010 to reduce their risks and strengthen their position by restructuring.

From the lenders' point of view, the most favorable restructuring instrument is usually the contribution of "fresh money" by the equity sponsor by way of additional shareholder loans. Shareholder loans are, however, subject to statutory subordination in case of insolvency and rank behind any claim of any other creditor. Equity sponsors are therefore often willing to contribute fresh money only if their repayment claim is not subordinated. With a view to the statutory subordination of shareholder loans, the equity sponsor and third party lenders have therefore often agreed on so-called "super shareholder loans". This means that the third party lenders and the equity sponsor define a waterfall in the intercreditor agreement under which

the equity sponsor participates up to the amount of the super shareholder loan before any payments to other lenders are made. Technically, this is implemented by way of an undertaking on the part of the lenders to purchase the shareholder loan from the equity sponsor upon exit/liquidation. The precise features of a super shareholder loan, such as time limits, limitation to liquidation proceeds or inclusion of exit proceeds, exact ranking, etc., are at the discretion of the parties. The super shareholder loan does not technically lose its subordinated status following a transfer to third party lenders; so the parties technically achieve a reallocation of proceeds from the banks to the equity sponsor.

In case the equity sponsor is not willing to contribute fresh money, the lenders are usually equally unwilling to do so. Often the amount of the outstanding facilities is not fully covered by the value of the collateral; in this case, the acceleration of the facilities is not the best choice for the lenders. With respect to liability risks under statutory law, as well as risks of statutory subordination of their remaining claims, lenders are usually not interested in acquiring an equity stake in the borrower. Moreover, lenders typically want to avoid a consolidation of the company on their balance sheets. In this situation, the lenders therefore often choose a so-called trust structure (Treuhandlösung), i.e. the banks cause the equity sponsor to voluntarily transfer its shares to an independent third party (often a specialized lawyer) who shall then act as trustee and initiate an exit process as soon as practicable. Any sales proceeds received by the trustee shall then serve primarily to repay any outstanding facilities. Only exit proceeds exceeding the outstanding facilities are distributed to the shareholders. In order to convince equity sponsors to consent to a trust structure, lenders are often prepared to adjust the order of distribution of proceeds in favour of the shareholders by way of ratchet formulae, depending on the amount of total proceeds achieved in the sales process. In particular,



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this occurs if cooperation of the shareholders (especially managing shareholders) is required for a commercially successful sales process.

The sale of distressed companies was made more difficult by the decision of the European Commission of February 24, 2010 regarding the privileged treatment of German tax loss carry forwards of distressed companies.

Purchasers of a distressed company are, of course, interested in maintaining any tax loss carry forwards of the company. In order to incentivize the acquisition of distressed companies, the German legislator had eased the restrictions on tax loss carry forwards in 2009. Under the revised law, the statutory rule according to which a transfer of more than 25% of the shares would have caused the expiration of all or part of the unused tax loss carry forwards had been abolished for cases in which the share transfer was part of a restructuring and some further requirements were met (Sanierungsprivileg). According to the European Commission, this privileged treatment of distressed companies violates European law. With effect as of April 30, 2010, the privilege was revoked. Today, in cases of transfers of 25.1% to 50% of the shares in a company, a corresponding percentage of unused tax loss carry forwards expires and in cases of a transfer of more than 50% of shares, all unused tax loss carry forwards expire (unless certain narrow exceptions apply).

In addition to a steady flow of restructuring cases, traditional leveraged buy-out activity has increased - not to the level of the 2006/2007 pre-crisis environment but approximately to the level of 2002/2003. Banks in Germany were again offering leveraged finance but they acted far more cautiously than before the crisis. Facilities were no longer granted on a "covenant lite" basis, but financial covenants were recognized by the lenders as an essential instrument of risk management. The leverage ratios usually did not exceed 50% of the purchase price and the banks preferred club deals to syndications. For a purchaser, a club deal is a greater challenge. The purchaser has to negotiate the facility agreement with several banks and must obtain all banks' agreement to the terms and conditions. Accordingly, the duration of transaction processes continues to be significantly longer than in the pre-crisis environment.

Consequently, sellers also became more cautious with respect to the ability of purchasers to meet their payment obligations. Since the purchaser in leveraged transactions usually is a NewCo with a minimal nominal capital, sellers typically request adequate comfort upon signing that funding is assured. Before the credit



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crunch, signed term sheets or facility agreements were mostly regarded as sufficient. In the crisis environment, banks tended to introduce an increasing number of conditions precedent to funding, most notably "material adverse change" clauses. Therefore, even a signed facility agreement often did not give adequate comfort to sellers. As a result, industrial

bidders or bidders with all-equity financing have gained substantial competitive advantages in auction processes.

After disappointing first and second quarters, the increasing number of deals in the second half of 2010 is encouraging for the German private equity markets in 2011. There are a high number of portfolio companies that are mature for an exit and, with leverage more easily available, private equity funds are becoming increasingly active on the buy-side as well. Secondary transactions could therefore be seen more often in 2011. While some industries such as renewable energies may show first signs of "over-heating", others such as automotive suppliers continue to be characterized by restructuring and industry consolidation rather than leveraged buy-out activity. In summary, the private equity industry in Germany is cautiously optimistic for 2011. ■

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