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PRIVATE EQUITY INTERNATIONAL

APRIL 2011 | privateequityinternational.com

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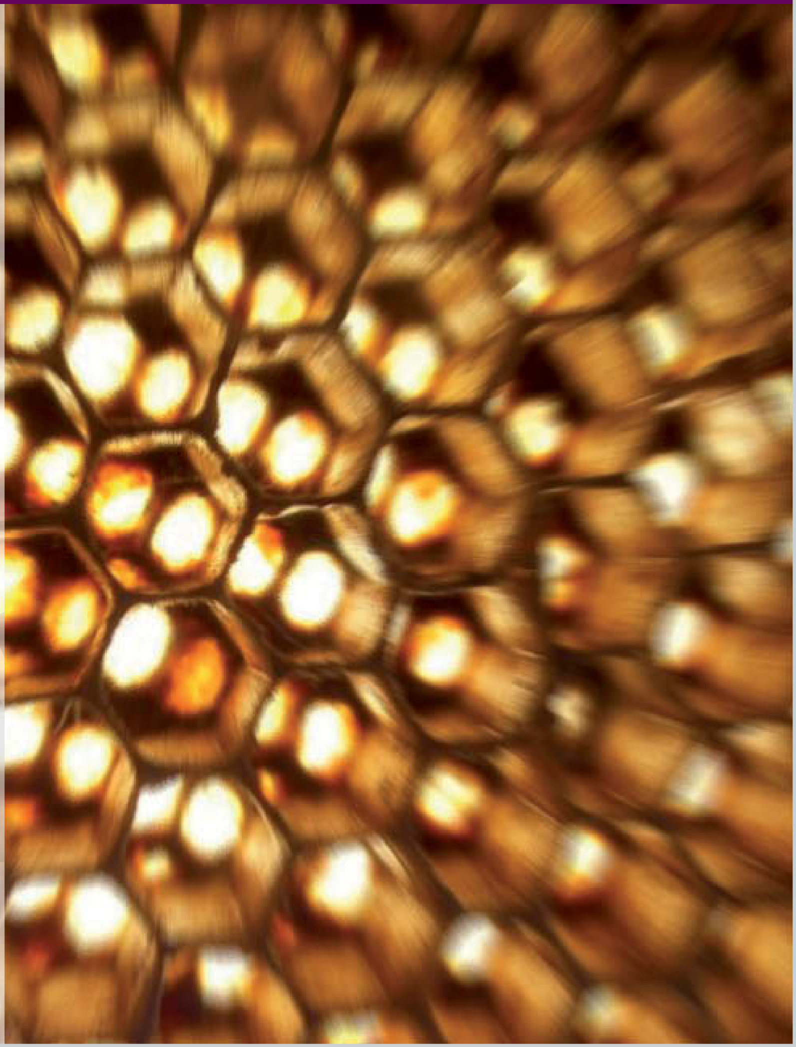

EXPERT COMMENTARY **P+P PÖLLATH + PARTNERS**

Germany's encouraging outlook

The German Private Equity and Venture Capital Association in March published its annual review of private equity activities in Germany in 2010 together with the prospects for 2011. Andreas Rodin *of P+P Pöllath + Partners examines some of the findings*

As a consequence of the financial crisis, the total amount of private equity invested in 2009 dropped to €2.78 billion from € 9.18 billion in 2008. Because Germany's economy recovered much faster than expected the total amount invested in 2010 increased by approximately 60 percent to €4.44 billion in the aggregate and 1,300 companies had obtained private equity financing. Thirty percent of the investments had been consummated by non-German private equity firms and the remaining balance of 70 percent by German players.


Rodin: *growth on horizon*

Indeed, €2.52 billion representing 57 percent of the 2010 volume had been invested in buyout transactions, where majority positions in portfolio companies had been acquired. Also, €1.26 billion representing 28 percent had been invested in growth financings, replacements and turnaround situations involving minority positions in portfolio companies. Venture capital investment activities remained low with little increase in 2010 overall as €0.66 billion had been invested in this segment. Seed and early stage financings of €0.37 billion in 2010 are even lower by 11 percent compared to the 2009 level. Later stage venture capital investments of €0.29 billion, however, increased by 25 percent *vis-à-vis* 2009.

Projections for 2011

Because of the positive economic environment and the continuing upward trend in Germany, 75 percent of all private equity firms anticipate further growth of the investment activities in 2011. The buyout industry is more optimistic (86 percent have a positive view) than the venture capital firms (68 percent anticipate an increase). Firms participating in the interviews had stated that they intend to consummate more syndicated investments in the future despite of the upward trend in the German economy. While it is common that several venture capital firms provide capital in financing rounds, it is interesting to note that also more than 50 percent of the other private equity firms projected for 2011 an increase of co-investments with other investors.

While enterprise valuations had remained stable in 2010, only one-third of all private equity firms believe that this will not change, but more than 50 percent assume an increase in 2011 and 8 percent believe that the increase will be significant.

It is expected that in 2011 investment opportunities can be derived mainly from the following sources: secondary buyouts, spin-offs, growth capital and minority investments in family owned enterprises and majority investments in family owned companies. Divestments by banks, buyouts of distressed companies as well as investments in publicly listed companies are expected to be insignificant.

The private equity firms' view on the most attractive industry branches has not changed. The main emphasis is on companies engaging in renewable energies, water and environmental technologies. The venture capital firms are still focusing on software, information technology, internet as well as biotechnology, pharmaceutical, medical technology. Private equity firms consummating buyout transactions of mid-sized companies indicated a preference for traditional industry segments, including mechanical engineering, plant construction and consumer goods.

The most interesting question related to acquisition financing. Just 42 percent of all private equity firms are optimistic that the amount of equity capital required for a buy-out transaction will be lower than in 2010 and 2009, but still one third even assumes an increase. Debt capital/EBITDA multiples are generally expected by the majority of all firms interviewed to increase.

Private equity divestment

Exit transactions have become a major challenge for private equity firms during the last years. Industry players had more or less stopped to acquire enterprises in order to grow, but had put emphasis on stabilizing their own business during the financial crisis, and the German and international stock markets had little capacity for initial public offerings. But private equity firms are optimistic that the exit environment will improve in 2011 and 80 percent anticipates an increase of exit transactions. Indeed, 75 percent of all firms expect trade sales to become more important because strategic investors have sufficient cash available for acquisitions and want to grow again.

Private equity fundraising

Fundraising continues to be very difficult also in Germany. Only €930 m had been raised in 2010 representing a decrease by 13 percent against the already frustrating level of 2009 with €1.07 billion. The vast majority of the German private equity firms had very successful fund closings in 2007 with €5.66 billion in the aggregate. Thirty-nine firms stated in interviews that they already started fundraising again or are about to do so in 2011 and 2012. The objective is to raise a total amount of €4.22 billion during these years, €1.68 billion for venture capital and €2.54 billion for buyout/growth capital.

In light of the positive analysis of the investment and divestment activities and the environment for exits the prospects for fundraising should be viewed similarly positive. But all private equity firms had expressed in their interviews concerns about the success of the fundraising efforts. They anticipate increasing competition among themselves and realized that institutional investors are still hesitant to increase their private equity exposure again. Moreover, the German private equity industry suffers from the poor basic conditions in Germany and these conditions may become even more relevant following the implementation of the EU's Alternative Investment Fund Managers (AIFM) directive.

Fund structuring developments

When setting up new funds private equity firms have to take into consideration a large number of new regulatory and tax aspects that will have an impact on structuring. They affect the managers, the investors, marketing of funds and the investment activities. These new rules are summarised below:

AIFM directive

Timetable. The AIFM directive was adopted on the European level in November 2010. It will enter into force once it has been translated into the languages of the member countries (expected in April/May 2011). The member countries have to transpose the directive into national law within two years following the effective date on the European level.

While the directive itself now contains with binding effect the basic principles governing the new regulation it refers to implementing rules with respect to approximately 100 items that are important from a practical perspective. These implementing rules will be developed by ESMA, the new European regulatory authority, by September/October 2011 and will be submitted to the European Commission which will adopt them. ESMA directed a "call of evidence" to the relevant market participants to get more information on alternative investment funds operating in the EU, to determine the legal format for the delegated acts and to quantify the financial impacts associated with the directive.

ESMA has established four working groups to deal with the delegated acts efficiently. The German regulatory authority (BaFin) is responsible for the authorisation provisions and operating conditions, the French regulatory authority (AMF) for the rules on the depositary and the UK regulatory authority (FSA) for the rules on transparency, leverage, risk management and delegation. The fourth working group shall deal with the third country rules. BaFin has directed a "call of evidence" to practitioners, including the German Private Equity and Venture Capital Association, to provide to it as much practical information as possible thereby enabling BaFin and ESMA to make proposals that consider the characteristics of the funds and their managers. It is important for the private equity industry to interact with BaFin and ESMA closely during the next following months in order to achieve that the implementing rules are consistent with the basic features characterising private equity funds.

Transitional provisions. While the directive immediately applies to all managers falling within the scope of its application once the 2-year period for the national transposition has expired (i.e. as of April/May 2013), the directive contains special provisions on its application to funds that are existing as of such date. Closed-ended funds that do not consummate investments anymore following the final transposition date (i.e. April/May 2013) can be operated by their managers without authorisation under the directive. The same applies to closed-ended funds whose subscription period expired on or before the final transposition date and that are constituted for a period of time that expires on or before the third anniversary of the final transposition date; provided, however, that in such cases the provisions of the directive regarding the annual report as well as the provisions regarding funds that acquire control of a non-listed company shall apply.

Third-country rules. The directive also applies to an international set of facts. Two different situations have to be distinguished:

EU AIFM marketing and/or managing a non-EU AIF. In case of management without marketing the EU AIFM requires authorisation from its national authority and has to comply itself with the directive except of the provisions regarding the depositary and the annual report; in addition, the member country of the AIFM and the third country must have entered into an agreement on the cooperation between their regulatory authorities. In case the AIFM (also) markets a non-EU AIF using the EU passport for marketing, the EU AIFM requires authorization, shall fully comply with all provisions of the directive and shall observe specific notification procedures; in addition, the third country must have entered into a cooperation agreement on regulatory matters, must have agreed on exchange of tax information in accordance with the OECD tax convention model, and must not be listed by the EU as a non-cooperative country for anti-money laundering purposes. In case a non-EU AIF shall be marketed without passport, the notification procedures do not apply.

Non-EU AIFM. In case a non-EU AIFM intends to manage an EU-AIF, such none-EU AIFM must generally fully comply with the directive and must obtain authorization from the so-called member country of reference (which is generally the country of residence of the EU-AIF); in addition, the non-EU AIFM's home country must have entered into an agreement on the cooperation between the respective regulatory authorities and on the exchange of tax information and must not be listed as a non-cooperative country for anti-money laundering purposes. If a non-EU AIFM intends to (also) market in the EU a non-EU AIF or an EU-AIF the requirements that have to be met depend on whether such funds shall be marketed with or without the passport. In the former case, the non-EU AIFM shall fulfill the requirements for managing an EU-AIF and specific notification procedures have to be observed. Simplified rules apply to marketing of funds without using the passport. Marketing activities are limited to private placements subject to national regimes and delegated acts by the European Commission and ESMA. While for marketing without passport no authorisation or legal representative in the European Union is required, compliance with the reporting disclosure requirements is required.

Areas of regulation. The important areas of regulation, including authorisation, initial capital of AIFMs, operating conditions for AIFMs, risk management, valuation, depositary, transparency requirements, annual reports, disclosure to investors, reports to the regulatory authorities, had already been set out in our article in the 2010 Fund Structuring Supplement to which we may refer. The following briefly explains specific obligations for AIFMs of funds that acquire control over non-listed companies. These requirements apply if one or more AIF managed by the same AIFM or if several AIF managed by different AIFMs cooperate with the objective that they acquire control over non-listed companies other than micro, small and medium sized enterprises and other than real estate holding companies. For the purposes of the directive control means more than 50 percent of the voting rights.

In case control was acquired by an AIF, individually or jointly, the AIFM of such AIF shall notify thereof the non-listed company, its shareholders and the regulatory authority of the member country of the AIFM. The notification shall include information about the policy for preventing conflicts of interests, the specific safeguards established to ensure that transactions between the company and the AIFM/AIF shall be at arms' length, the intentions with regard to the future business of the non-listed company and the likely repercussions on employment, including any material change in the conditions of employment. All such information shall be disclosed by the board of directors of the non-listed company to the workers' council or, in its absence, to the employees themselves.

In its annual report for an AIF exercising control the AIFM shall present a fair review of the development of the company's business at fiscal year-end and shall give an indication of any important events that have occurred since the end of the fiscal year, the company's likely future development as well as information concerning acquisition by the company of own shares. As an alternative, the AIFM shall use its best efforts to make sure that the annual report of the company itself contains this information. In addition, such company related report shall be disclosed to the workers' council or, in its absence, to the employees themselves.

In order to protect the capital of a non-listed company controlled by one or more AIF the directive includes specific provisions against asset stripping. Before the second anniversary of the date when control was acquired the AIFM shall not allow any distribution, capital reduction, share redemption or acquisition of own shares if, as a consequence of such action, the company's net assets would become lower than the amount of the subscribed capital plus mandatory reserves, or if an amount exceeding the company's annual surplus plus profits brought forward was paid to the shareholders.

Transposition into national law. The European directive only contains provisions regarding the regulation of managers of AIF and addresses product related regulation only to the extent necessary to achieve efficient manager regulation. The directive therefore does not prevent the member countries from adopting national requirements in respect of fund structures or the composition of the portfolios. Given the fact that the private equity market is international and likely competitive the German private equity industry strongly supports that Germany does not introduce specific fund structuring or investment related regulatory restrictions into domestic law when transposing the directive.

VAT on management fee

Management of private equity funds established in Germany after 1 January 2008 is subject to value added tax (VAT). This is unprecedented in Europe. The European rules provide for an exemption of management of investment funds. In our judgment, the administrative practice of the German revenue service violates the European rules as interpreted by the European Court of Justice. The transposition of the AIFM directive into national law is an excellent opportunity for the German revenue service to reconsider the scope of application of the VAT exemption under the EU rules and it appears that such exemption could now be extended to private equity funds.

Insurance companies, pension funds

Investments by insurance companies and pension funds in private equity funds are typically allocated to their so-called equity basket. The regulatory provisions governing such basket have been amended in June 2010. Investments in funds are only eligible for the equity basket if the fund pursues a "business model": Pursuant to the official reasoning private equity funds should not be adversely affected by such new requirement because their investments are exposed to entrepreneurial risks.

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