Private Equity: Law and Practice

Third Edition

Darryl J Cooke

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To my lovely wife Pam and my two wonderful boys
Ashley and Hayden

Foreword

Private equity and venture capital are a significant force in the UK economy. The industry is a major contributor to the UK's financial services sector, to the economy as a whole, and to the UK's competitiveness. Over the last five years, the BVCA's members have produced £55bn of investment, backed companies whose generated total sales were £424bn, and whose exports were £48bn. The United Kingdom is the hub of private equity activity in Europe, accounting for over 50 per cent of the European market.

The industry invests at all stages in a company's development, from initial seeds to grand oak trees. There are currently around 8,000 private equity/venture capital-backed businesses in the United Kingdom, and as an industry, our aim with each one of these is to create a better business. The relationship with management teams and their advisers is crucial to our long-term success. Central to that is ensuring all parties have a clear understanding of both their needs and objectives, and of the processes involved in making investments.

The success of this book, now in its third edition, demonstrates the value of providing that education to practitioners, management teams and entrepreneurs. The BVCA hopes this edition will continue to assist those in the industry by providing a very useful update on private equity law and practice.

Wol Kolade
Chairman
BVCA, The British Private Equity and Venture Capital Association

Preface to Third Edition

"Entrepreneurship is a way of thinking that can be applied to all avenues in life. It is a way of looking at the world, a mindset that is sharpened and improved by experience."

Sir Ronald Cohen, Apax Partners

Over the past three years private equity has emerged as a huge, powerful and influential force in the economy and the workplace. In 2006, the value of global private equity deals was nearly £380 billion—five times the figure for 2003. The British private equity industry is believed to have invested more than £75 billion in businesses around the world, second only to the USA. In 2006, investments were made by UK private equity houses alone in over 1,600 companies. It should not need further statistics to show the benefits that accrue in the wider economy, whether in the billions of pounds of taxes generated, the vast number of jobs created or the millions of pensioners who benefit from investing in private equity. The availability of private equity and associated finance avenues combined with the downsizing of major respected companies, and in some cases their disappearance, has led to a transformation of attitudes towards enterprise.

Economies have moved away from a reliance on smokestack industries to technology and services with an accompanying move away from job security in such companies and a gravitation towards entrepreneurship. It is estimated in the USA that over 60 million jobs have been created by new firms in the last 30 years while 50 million jobs have been lost by established companies. At the same time many millionaires have been created by the entrepreneurial skill, passion and determination of a new breed of risktakers; a new breed drawn from across the class divide, drawn not from private schools but from the school of belief, enthusiasm and persistence, realising the private equity dream of growing companies, job creation, entrepreneurial reward, secure pensions and the generation of more government taxes.

But the reality is not this perception and this year for the first time a social debate has developed around class divisions as city financiers bank billions of pounds in bonuses while ordinary workers struggle. Private equity has become so powerful that a handful of firms own businesses that employ one in every five workers in the private sector in Britain. These

firms are seen to be secretive, rarely giving interviews and failing to disclose who invests in their funds.

The debate has focused upon taxation. In 1998, Gordon Brown had created a tax system "for those who build up businesses or stake their own hard-earned money in them". Unwittingly, he also created a system that would benefit private equity executives.

But the debate on taxation only serves to highlight the image problems currently facing private equity, manipulated cleverly by the trade unions. Private equity is still a young and maturing industry. It is an asset class that is not going to go away but the industry's senior executives need to assume the mantle of responsibility that is coming their way. They must play their part in the political arena and become institutional figures serving the arts, music and sport, meeting and working closely with the trade unions and their trade bodies; and not from the comfort of their offices but from the corridors of power to the industrial marketplace and to their regional bases, playing a major role that befits their place in both the economy and their contribution to the growth of the country.

I am grateful to my contributors: James Dow of Dow Schofield Watts, Andrew Burrows of the Centre for Management Buy-out Research (CMBOR), Paul Quinn of The Quinn Partnership and Julie Wood and her knowledge management team at DLA Piper. Thank you also to my secretary Caroline Ashworth.

The law is as at 1 October 2007.

Darryl Cooke
November 2007

Contributors

Darryl Cooke

Darryl Cooke is the head of private equity at Hill Dickinson. Prior to that he was head of private equity for EMEA at DLA Piper. Darryl is the author of *Management Buy-Outs, Due Diligence: A Practical Guide* and contributor to a number of publications. He has been involved in over 100 buy-outs and has won numerous awards.

James Dow

James is a founding partner of the corporate finance boutique, Dow Schofield Watts. Prior to its formation he was the corporate finance partner in charge of the North West Region for KPMG Corporate Finance. In total James has spent 18 years specialising in advising companies, shareholders and funds in the private equity arena. He has particular expertise in deal and debt structuring, recognised as such as the best accountant in the EN Deals of the Year Awards 2001 and as Dealmaker of the Year 2006 in the Insider Deal Awards.

Andrew Burrows

Andrew Burrows is Director of the Centre for Management Buy-Out Research (CMBOR), the leading provider of analysis and information in the UK and European buy-out markets. Founded in 1986 at Nottingham University Business School by Barclays Private Equity and Deloitte, CMBOR now has a detailed database of over 25,000 deals, which provides the only complete set of statistics on management buy-outs and buy-ins in the UK and Continental Europe.

Paul Quinn

Paul has worked with a wide range of private equity investors. Since establishing The Quinn Partnership, Paul has asset management teams on deals across a broad raft of sectors and a range of transaction structures with a combined deal value of over £4 billion.

Buy-out Market Development and Latest Trends

Andrew Burrows, Centre for Management Buy-out Research (CMBOR)

Introduction

Since the development of highly leveraged transactions involving listed companies in the US in the late 1970s, management buy-outs have become an international phenomenon. In Europe, the UK led the way with activity levels growing rapidly in the early 1980s. The Continental European buy-out market first saw growth later in the decade in Western Europe, with France and the Netherlands in particular seeing considerable buy-out activity. Initially buy-out activity in Germany was slower to develop but has recently become much more important, with parts of southern Europe also now experiencing significant increases in market value.

Buy-outs have also been an important feature of the privatisation of state assets during the transition from communism to a market economy in Central and Eastern Europe since the beginning of the 1990s. Further privatisation and restructuring activity has seen the spread of buy-outs to Africa, whilst the need for major restructuring in Japan and Korea has given an impetus to buy-outs in the Far East, with buy-outs now spreading in significant numbers to Asia.

Definitions and types of buy-outs

Management buy-outs are a major subset in the range of corporate restructuring and involve simultaneous changes in ownership, financial structure and incentive systems of firms. In general, buy-outs involve the creation of a new independent entity in which ownership is concentrated in the hands of management and private equity firms, if present, with substantial funding also provided by banks. Management buy-outs or buy-ins may take a number of forms dependent on the level or scale of

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involvement of management, private equity providers and other participants.

Management buy-outs (MBOs) usually involve the acquisition of either a divested division/subsidiary or a private family owned firm by a new company in which the incumbent management takes a substantial proportion of the equity. The purchase price is generally met by a private equity/venture capital firm providing significant amounts of equity and/or banks providing debt. The former parent may retain an equity stake, perhaps to support a continuing trading relationship. Private equity firms become active investors, generally taking board seats and specifying contractual restrictions on the behaviour of management which include detailed reporting requirements.

In smaller transactions management are likely to obtain a majority of the voting equity. MBOs typically involve a small group of senior managers as equity-holders but depending on circumstances equity-holding may be extended to other management and employees creating a management-employee buy-out (MEBO). MEBOs may occur, for example, where it is important to tie in the specific human capital of the employees or on privatisation where there is a need to encourage trade unions to support the transfer of ownership.

Management buy-ins (MBIs) are a similar form of transaction but differ in that the entrepreneurs leading the transaction come from outside the company. Although superficially similar to MBOs, MBIs carry greater risks as incoming management do not have the benefits of the insiders' knowledge of the operation of the business. A hybrid buy-in/management buy-out (BIMBO) combines the benefits of existing internal management and the contribution of external entrepreneurs; these transactions have developed to address the shortcomings of pure MBIs where asymmetric information problems faced by outsiders contributed to significantly higher failure rates than for MBOs in early deals.

Leveraged buy-outs (LBOs) generally involve the acquisition of a publicly quoted corporation or a large division of group by a specialist LBO association. These mostly occur in the USA, where the resulting private company is typically controlled by a small board of directors representing the LBO association, with the CEO usually the only insider on the board. As the name suggests, these deals are generally highly leveraged with the LBO Association acquiring a significant equity stake. Incumbent management may play a marginal role in putting LBO transactions together, have only a small equity holding and may even be replaced.

Similar to LBOs, investor-led buy-outs (IBOs) are a form of MBI, which involves the acquisition of a whole company or a division of a larger group in a transaction led by a private equity firm. The private equity firm will typically either retain existing management to run the company or bring in new management to do so, or employ some combination of internal and external management. Incumbent manage-

ment may receive a small equity stake or may receive stock options. IBOs, which are also referred to as institutional buy-outs, developed in the late 1990s when private equity firms were searching for attractive deals in an increasingly competitive market and where corporate vendors or large divisions were seeking to sell them through auctions rather than giving preference to incumbent managers. As the names suggest, IBOs tend to have lower leverage than LBOs and may be expected to create value through developing the company, not just through efficiency improvements.

The initial buy-out transaction may be used as a platform for further acquisitions, a so-called buy-and-build or leveraged-build-up (LBU) strategy. Such deals are typically aimed at consolidating fragmented industries. LBUs developed as private equity firms sought new means of generating returns from buy-out type investments and tend to be attractive in fragmented industries with strong demand prospects. The potential problems with LBUs relate to the identification, purchase and subsequent integration of suitable acquisition candidates.

Factors influencing the development of a private equity based buy-out market

Twenty-five years ago, the private equity industry in Western Europe was still in its infancy. The US buy-out market had developed during the mid 1970s but in Western Europe, only the Netherlands showed any significant activity outside the UK in 1982. Contrast this with the picture today where private equity markets in many other Western European countries have become well established.

Deal value across Western Europe was negligible in 1982 but two decades later stood at over €60 billion. Although the market remained relatively flat from 1999 to 2003 the last three years have seen massive increases in value driven by a growing number of multi-billion Euro deals lifting the total European market value to €167 billion in 2006 (Figure 1).

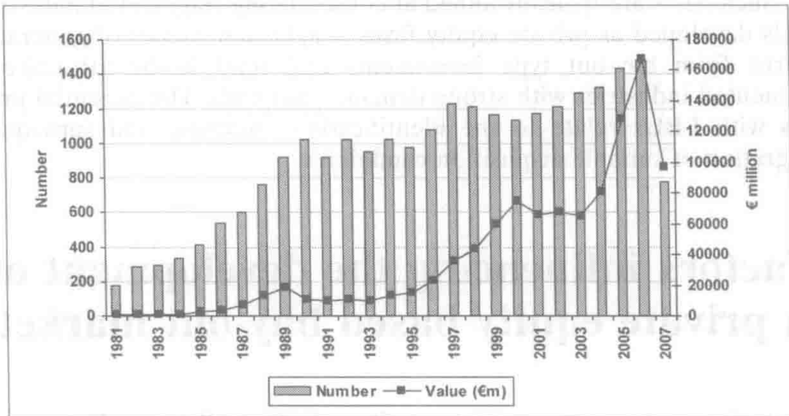
The total number of deals across Western Europe quadrupled from just over 300 in the mid 1980s to reach 1224 in 1997. There were a record 1,476 buy-outs in 2006, continuing the general upward trend seen since the slight dip in activity observed from 1998 to 2000. Within these totals, the UK and France in particular have made the major contribution, whilst Germany has become much more important of late.

Despite this rapid growth, the factors driving these changes are not well understood. There is a need to identify the common features of the growth in different buy-out markets as well as the country-specific aspects influencing their emergence. The impetus behind the development of the European buy-out market can be reviewed by referring to a framework of

analysis developed by CMBOR, which identifies the following key elements influencing the differential development of management buy-out markets:

- supply of deal opportunities
- demand for private equity
- infrastructure to complete deals
- opportunities to realise gains.

Fig 1: European Buy-outs Trends, 1981–2007



Source: CMBOR/Barclays Private Equity/Deloitte
*** Year 2007 figures are for first 6 months only**

Changes in these factors illustrate how significant markets for private equity may emerge. This framework has also successfully been adapted to analyse the potential development of later stage private equity markets in the EU Accession States of Central and Eastern Europe and in Asia.

A number of key structural developments have driven the development of the private equity market in the principal European countries over the past 25 years. These include privatisation programmes and the need for restructurings to create opportunities, improved tax and fiscal incentives for equity investment to attract capital and improve returns, the development of debt markets to provide leverage and scale, increased financial intermediation to assist companies in accessing private equity, and the increasing harmonisation of the business landscape across the EU, which gave rise to opportunities for pan-European private equity.

Supply of deal opportunities

The recession of the early 1980s together with a strengthening of global competitive forces placed widespread pressure on UK firms to restructure

and created a major source of buy-out deals. Many diversified groups began to divest under-performing divisions and those that no longer fitted the new strategic direction of the parent.

Beginning in the mid 1990s, the UK saw a second boom in buy-outs. Until the mid 1990s, divestment via management buy-out from corporations was the single largest source of deals. Since then, investor-led buy-outs have emerged as corporations, under greater pressure to maximise shareholder value in an environment of greater attention to corporate governance, have increasingly sold unwanted larger divisions through an auction process.

Although there had been some public to private transactions in the 1980s, the end of the 1990s saw major growth in this transaction type as many small to mid-cap listed companies fell out of favour with institutional investors. By 2000, some seven per cent of UK buy-outs were from this source. As the average size of these transactions increased, a total of €15 billion worth of public to private transactions were completed, accounting for almost two-fifths of market value.

Throughout much of the period, the UK government's privatisation programme of 1982–1997 produced large numbers of management-employee buy-outs, many of which generated substantial returns for investors when they were subsequently sold or taken to market. Buy-outs of private businesses have also become more important in the UK over the last 25 years.

In France, deal opportunities initially arose from a need to sell businesses by the owners of family firms facing succession problems. Early studies showed that owners of French family firms saw buy-outs as a potentially important means of dealing with succession problems. Succession and portfolio reorganisation issues in the large number of family controlled listed companies in France also contributed to a marked growth in buy-outs from this source.

After having been less important than buy-outs of family firms, divestments from corporations have now become a major part of the French private equity market. This development is closely associated with growing competitive pressures on French industry arising from efforts by the EU to introduce greater flexibility to market structures and the recent growth of interest in corporate governance and shareholder value.

In contrast, the conditions for development of private equity in Germany emerged much later. Although there was a widely held perception that a vast swathe of privately held small and medium-sized firms would generate significant deal opportunities, reluctance on the part of founders both to let go and to sell to private equity firms restricted market growth. This perspective also persists in some other countries of Western Europe such as Spain and Italy. As a result, the mid-market in Germany and elsewhere has been slow to develop, with divestments and secondary deals being the most important sources of buy-outs in these countries.

From being slow to develop as a deal source, corporate restructuring and the generation of buy-outs of divested activities have become more evident since the mid 1990s in Germany as a result of increased pressure from macro-economic factors and belated improving corporate governance and more active institutional investors. The restricted stock market produced little scope for public to private transactions until the late 1990s, since when a modest number have taken place.

In CEE, the transition from communism has been the main source of opportunities as many state-owned firms were privatised, though these volumes have steadily declined in recent years. The overall Continental European market for PTP transactions is still small, in part because these countries have far fewer listed companies in the first place. Culture may also play a role in this, with managers in some countries apparently expressing such pride in their listings to even consider going private.

Demand for private equity

In a climate of a weak takeover market in the early 1980s, incumbent management in unwanted subsidiaries in the UK, provided they had the capability to run the firm as an independent entity, were often in a strong position to acquire and turnaround their businesses. At the same time, the notion of entrepreneurship again became acceptable, leading to increased demand for opportunities.

In France, the entrepreneurial culture became more positive towards buy-outs from the late 1980s. Later in the 1990s, studies also showed that 70 per cent of senior managers of French corporations would be interested in buying out their companies. Unlike the UK and France, the willingness of German managers to undertake buy-outs has traditionally been low. However, the recent growth of corporate restructuring has significantly reduced managerial security of tenure in large corporations and contributed to a more positive approach to buy-outs.

Infrastructure to complete deals

The notable legal development that helped facilitate the development of buy-outs in the UK was the relaxation of the prohibition on firms providing financial assistance to purchase its own shares in 1981. This change helped reduce the barriers for lenders to obtain security for the funds they advanced. The advent of specialist private equity and mezzanine funds together with entry by US banks from the mid 1980s opened the door to the first boom in market development involving larger deals.

Experienced private equity firms have become highly proactive since the mid 1990s in seeking out and leading buy-outs in the form of IBOs. Also around this time a number of financial developments contributed to the growth in activity. Major US investors returned to the market, a European subordinated high yield debt market emerged from 1997, and substantial amounts have been raised in private equity funds specifically targeted at buy-outs.

In France, the introduction of fiscal incentives in 1984 to encourage managers to buy family businesses facing succession problems helped kick-start the buy-out market. Management typically needed to obtain majority stakes in order to obtain the fiscal benefits. Although it served a purpose in getting activity started, this initial procedure was very bureaucratic and cumbersome.

The introduction of fiscal consolidation in 1988 paved the way for larger transactions where incumbent management held minority stakes. The French private equity industry grew rapidly from the mid 1980s, including entry by foreign players, with lawyers particularly playing an important role in the diffusion of the buy-out concept. Government support in the form of loans on favourable terms also provided some initial impetus to the buy-out market.

The infrastructure to complete German deals was for a long time less than favourable; with few intermediaries, an under-developed private equity market and high rates of taxation. Many of these restrictions did not begin to ease until the mid 1990s, when, for example, the country's punitive capital gains tax regime relating to share disposals began to be relaxed.

Opportunities to realise gains

The UK stock market and general M&A takeover markets have traditionally been well-developed and have provided scope for the realisation of buy-out investments over the last two decades. The most common exit route has been through sales to other corporations but over the past 25 years there has also been extensive exit through IPO, with over 500 buy-outs obtaining a market listing. However it should be recognised that even highly developed stock markets provide limited exit opportunities for all but larger, fastest-growing businesses.

Exit via IPO was generally the second most common form of exit throughout the 1980s but even exceeded sales to corporate buyers in 1986. With stock market conditions more difficult in recent years, flotations became relatively scarce especially for modest sized buy-outs in more traditional sectors, although there has been some recovery in the last few years as stock market values have increased. Corporate buyers also became less active as acquirers of buy-outs at the start of this decade; consequently

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