Private Equity

in 33 jurisdictions worldwide

Contributing editor: Casey Cogut

2011

Published by
Getting The Deal Through
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Advokatfirmaet Steenstrup Stordrange DA
Advokatfirman Delphi
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Contributing editor:
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Simpson Thacher & Bartlett LLP

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Sarah Walsh

Marketing assistants
Alice Hazard
William Bentley

Subscriptions manager
Nadine Radcliffe
Subscriptions@GettingTheDealThrough.com

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Production editor
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Chloe Harries
Davet Hyland

Editor-in-chief
Callum Campbell

Publisher
Richard Davey

Private Equity 2011
Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 7908 1188
Fax: +44 20 7229 6910
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ISSN 1746-5524

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Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

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Global Overview

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Simpson Thacher & Bartlett LLP

Rebound year for M&A and private equity

Few predicted a turnaround in M&A activity in 2010. However, following the dismal year of 2009, year 2010 saw a marked increase in global M&A activity overall. Financial sponsor deal activity increased even more than global M&A markets as a whole (Thomson Reuters). Debt financing re-emerged as a key driver for much of the activity of many financial sponsors. In addition, financial sponsors saw many of their portfolio companies begin to realise significant operational gains following the prevalence of restructurings that occurred over the course of the previous few years. Carrying over from the momentum in 2009, there was a continued rise in initial public offerings of portfolio companies in 2010, with many financial sponsors retaining large stakes. In addition, there was a significant increase in private equity sponsor exits from their investments, with financial sponsors realising the highest median prices on exits in 2010 compared to any previous year (Pitchbook).

Global announced M&A deals in 2010 totalled approximately US$2.4 trillion, which was an increase of 22.9 per cent from 2009 totals. Interestingly, there were over 40,000 announced deals worldwide in 2010, representing just a 3 per cent increase from 2009, and for the third consecutive year there was a notable spike in transaction volume in the fourth quarter. Worldwide announced M&A transactions during the fourth quarter of 2010 totalled approximately US$716.2 billion, which was the largest quarterly total since the third quarter of 2008 and a 21.2 per cent increase from the fourth quarter of 2009. Financial sponsor buyouts totalled US$225.4 billion worldwide in 2010, representing an 89.2 per cent increase over 2009. As a result, financial sponsors accounted for approximately 9 per cent of announced M&A transactions worldwide during 2010 compared with approximately 6 per cent in 2009 (all of the above statistics supplied by Thomson Reuters).

Americas

Announced M&A deal volume in 2010 in the Americas totalled approximately US$1.13 trillion, which was an approximately 23.3 per cent increase in announced M&A deal volume in the Americas in 2009 (Thomson Reuters). In particular, M&A deal volume in Brazil was up almost 50 per cent in 2010 – through the end of November, there were 1,221 M&A transactions representing US$244.6 billion in Brazil alone (LatinFinance). US-based LBO transactions accounted for almost 15 per cent of the total value of all M&A transactions in the Americas, which represented the highest percentage of LBO transactions since 2007 (Thomson Reuters). In addition, larger private equity M&A transactions were more prevalent in 2010. Of the US private equity M&A transactions with disclosed purchase prices in 2010, 26 per cent had total purchase prices of more than US$250 million, compared to 13 per cent in 2009, and 12 per cent were valued between US$500 million and US$1 billion (Pitchbook).

Europe

European announced M&A deal volume reached approximately US$641 billion in 2010, which represented a 10.3 per cent increase in European announced M&A deal volume in 2009. Cross-border M&A activity involving European companies totalled US$716.1 billion in 2010, representing a 35.8 per cent increase from the levels in 2009. Private equity acquisitions of European targets totalled 1,517 announced transactions representing approximately US$80 billion, which was an 83.6 per cent increase from the levels in 2009. Financial sponsor activity represented approximately 12.5 per cent of all European M&A activity in 2010 as compared to 7.5 per cent in 2009. Notable European private equity transactions in 2010 included the approximately US$4.6 billion acquisition of Tomkins plc by affiliates of Onex Corp and Canada Pension Plan Investment Board; the approximately US$3.7 billion purchase of a minority investment in Abertis Infraestructuras SA by affiliates of CVC Capital Partners and Actividades de Construcciones y Servicios, SA; and the agreement by affiliates of 3i Infrastructure plc, Morgan Stanley Infrastructure Partners and STAR Capital Partners to acquire Eversholt Rail Group for approximately US$3.4 billion (all of the above statistics supplied by Thomson Reuters).

Asia-Pacific, Middle East and Africa

Announced M&A deal volume in Asia-Pacific, the Middle East and Africa increased to approximately US$656 billion in 2010, which represented a 49 per cent increase from deal volume in 2009 (Thomson Reuters). M&A activity in Asia alone reached a recorded high of US$474.6 billion, which represents a 48.2 per cent increase from the US$380.2 billion of M&A activity in Asia in 2009, and a 10.9 per cent increase from the previous record for M&A activity in Asia, which was set at the peak of the M&A boom in 2007. In particular, as many M&A practitioners had predicted, Chinese cross-border M&A activity increased greatly in 2010, totalling US$80.7 billion, which represents a 21.2 per cent increase from the US$63.6 billion of Chinese cross-border M&A activity in 2009. Notably, M&A activity in Australia accounted for US$164.4 billion, which is more than twice the activity level of US$68.8 billion in 2009 and is the highest level recorded for Australian M&A activity since 2007 (all of the above statistics supplied by Thomson Reuters). In the first half of 2010, the number of private equity investments in Asia grew to 588 as compared to 498 in the same period in 2009 (Asian Venture Capital Journal).

Post-economic crisis regulatory reform

In an attempt to avoid a repeat of the recent economic crisis, in 2010 President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Dodd-Frank Act is a comprehensive set of reforms representing the most sweeping set of changes to the US financial regulatory system since the Great Depression. Included in the Dodd-Frank Act are new registration and reporting requirements for investment advisers of private equity

funds and modifications to certain exemptions from registration that many private equity funds previously used. Private equity and hedge fund advisers whose advisee funds and other client accounts have US$150 million in assets or more under management are required to register with the US Securities Exchange Commission (SEC), and in connection therewith, be subject to additional reporting obligations and recordkeeping obligations (including with respect to side arrangements or side letters, whereby certain investors in a fund obtain more favourable rights or entitlements than other investors) and periodic and special examinations by the SEC. Advisers solely to 'venture capital funds' (irrespective of their size) are not required to register with the SEC, although they are subject to certain reporting requirements. The registration, reporting and recordkeeping obligations will become effective in 2011. In addition, the Dodd-Frank Act includes what is commonly referred to as the 'Volcker Rule', which, among other things, restricts the ability of 'banking entities' and their affiliates to invest in and sponsor private funds (subject to a transition period and limited exceptions). Although non-bank financial companies are not subject to the Volcker Rule on its face, the Dodd-Frank Act requires regulators to impose on non-bank financial institutions that qualify as 'systemically important non-bank financial companies' additional capital and quantitative limits on such activities covered by the Volcker Rule.

The Dodd-Frank Act establishes an incomplete framework for heightened regulation of the private funds industry (and in some cases, intentionally so), and the United States Congress has authorised the SEC and other financial regulators to complete the gaps through further analytical review, rulemaking and interpretation. This administrative process will dictate important aspects of the reform and the ways in which the new law will affect private funds and their advisors, thereby delaying the known and measurable impacts of the regulatory reform on the private funds industry.

Notable transactions and increasing deal volume

Financial sponsors once again garnered headlines for significant going-private transactions in 2010, resulting in many cautious predictions of the resurgence of private equity M&A in the deal landscape. The increased volume was partially driven by a number of multi-billion LBOs in the third and fourth quarters of 2010. In the third quarter of 2010:

- affiliates of Onex Corp and the Canada Pension Plan Investment Board agreed to acquire Tomkins plc for approximately US$4.6 billion;
- affiliates of 3G Capital Partners entered into an agreement to acquire Burger King Holdings, Inc for approximately US$3.9 billion;
- affiliates of The Carlyle Group agreed to the US$3.8 billion acquisition of NBTY Inc;
- Welsh, Carson, Anderson & Stowe and The Carlyle Group agreed to the sale of MultiPlan, Inc to affiliates of BC Partners and Silver Lake for approximately US$3.1 billion; and
- a consortium comprised of affiliates of TPG Capital and The Carlyle Group agreed to the approximately US$2.35 billion acquisition of the Australian hospital operator Healthscope Ltd.

In the fourth quarter of 2010:

- a consortium comprised of affiliates of Kohlberg Kravis Roberts & Co, Vestar Capital Partners and Centerview Partners Management announced an agreement to acquire Del Monte Foods Co for approximately US$5.3 billion;
- affiliates of The Carlyle Group agreed to the US$3.7 billion acquisition of CommScope Inc and the US$2.6 billion acquisition of Syniverse Technologies Inc;
- a consortium comprised of affiliates of Leonard Green & Partners and TPG Capital entered into an agreement to acquire J Crew Group Inc for approximately US$2.7 billion; and
- affiliates of Bain Capital Partners agreed to the approximately US$1.8 billion acquisition of Gymboree Corp.

Portfolio company add-on activity

One trend of note was the prevalence of portfolio company add-on activity in 2010. Private equity firms continued to consolidate investment opportunities in 2010 by growing their portfolio companies through add-ons of similar and complementary new businesses. Private equity portfolio company add-on transactions accounted for 41.4 per cent of all US buyouts in 2010, and marked the sixth consecutive year there had been an increase in add-on activity. Private equity sponsors completed 442 portfolio company add-on transactions in 2010, which represented the fifth highest yearly total, and had an aggregate value of over US$9.5 billion. The median value of add-on transactions increased from approximately US$25 million in 2009 to approximately US$51.5 million in 2010 (all of the above statistics supplied by Pitchbook).

Private equity sponsor exits

There was a significant increase in private equity sponsor exits in 2010 – there were 323 exits as of 14 December 2010, as compared to 206 for all of 2009 (Buyouts). The US private equity industry saw a steady increase in the number of exits, which were up 3.8 times from a low of 39 during the first quarter of 2009 to 148 during the fourth quarter of 2010 (Pitchbook). Sales of portfolio companies from one private equity sponsor to another private equity sponsor increased three-fold in 2010 as compared to 2009, and represented 28 per cent of all financial sponsor exits in 2010 (Pitchbook). Portfolio companies sold in the US to strategic acquirers fetched a median sale price of US$211 million, which is 2.6 times more than the median sale price in 2009 (Pitchbook). According to Buyouts, The Carlyle Group and Platinum Equity were the most active in consummating exits in 2010, with The Carlyle Group completing 12 sale transactions and Platinum Equity completing 10 transactions (Buyouts). Even more notable was the US$382 million median sale price of portfolio companies to other private equity sponsors, which is the highest median sale price of portfolio companies from one financial sponsor to another (Pitchbook). Significant exits that either were announced or closed in 2010 include:

- the closing of the sale of Alltel Corp by GS Capital Partners and TPG Capital to Verizon Wireless for approximately US$28.1 billion;
- Cerberus Capital Management's agreement to sell its portfolio company, Chrysler Financial Services Americas, LLC, to The Toronto-Dominion Bank for US$6.3 billion;
- Lone Star Fund's agreement to sell its approximately US$4.1 billion controlling stake in Korea Exchange Bank to Hana Financial Group;
- TPG Capital's sale of its ownership stake in Shenzhen Development Bank to Ping An Insurance (Group) Co of China Ltd for approximately US$2.4 billion;
- MBK Partners' agreement to sell China Network Systems to a consortium of Taiwanese investors for approximately US$2 billion; and
- the sale by Thomas H Lee Partners of Michael Foods Inc to GS Capital Partners for approximately US$1.7 billion (with Thomas H Lee Partners retaining a 20 per cent interest in the company post-closing).

In addition, The Carlyle Group has sold shares of its investment in the publicly listed China Pacific Insurance (Group) Co for an aggregate of approximately US$2.6 billion since late December 2010, and it still maintains an 8.1 per cent interest in the company worth an estimated US$2.6 billion.

Portfolio company IPOs

Continuing the trend from 2009, there was an increase in portfolio company initial public offerings in 2010. As of 14 December 2010, 25 financial sponsor portfolio companies completed IPOs in the United States in 2010 (Buyouts). This is contrasted with 16 private equity sponsored companies that went public in the United States in 2009 (Thomson Reuters). Only four private equity-backed companies went public during the first quarter of 2010, while seven companies completed IPOs in each of the remaining quarters of 2010 (as of mid-December). The largest offering was the IPO of EnCap Investment LP's Oasis Petroleum Inc in mid-June 2010. The offering raised approximately US$588 million through the sale of 42 million shares at US$14 per share, which included the sale by the existing stockholders of approximately 11.6 million shares in the offering. The offering proceeds received by the company were used to repay existing debt and fund its exploration and development programme. NXP Semiconductors NV, which is backed by Koninklijke Philips Electronics NV and a consortium of private equity firms comprised of AlpInvest Partners, Apax Partners, Bain Capital Partners, Kohlberg Kravis Roberts & Co and Silver Lake, had the highest post-offer value of approximately US$3.49 billion among the 25 LBO-sponsor companies that went public in 2010. NXP raised US$476 million by selling 34 million shares at US$14 per share in its initial public offering in August 2010. As in the case of the Oasis Petroleum IPO, the offering proceeds to NXP were used to repay existing debt (all of the above statistics supplied by Buyouts).

Private equity sponsors' ability to successfully IPO portfolio companies in 2010 varied by region. For example, buyout firms listed 43 Chinese portfolio companies on exchanges in mainland China and Hong Kong (Dealogic). According to Citigroup, approximately 30 per cent of all IPOs in Asia (excluding Japan) in 2010 had a private equity firm behind them. In comparison, notwithstanding the increase in portfolio company IPOs in the US, in 2010, private equity firms withdrew 19 US companies from the listing queue after registering with the SEC (Dealogic). One factor may have been lower than expected valuations in light of US investor reaction to a proposed use of proceeds to repay debt rather than fund operational growth or acquisitions by the issuer. However, there remain a large number of companies controlled by private equity sponsors that have filed registration statements for IPOs that are being brought to market, and it remains to be seen whether this activity will persist into 2011. As of the middle of February 2011, a consortium of private equity firms comprised of affiliates of The Blackstone Group, The Carlyle Group, Centerbridge Partners and WL Ross & Co completed an initial public offering of BankUnited, Inc, which raised approximately US$783 million; Nielsen Holdings NV, a portfolio company held by a consortium of private equity firms comprised of affiliates of AlpInvest Partners, The Blackstone Group, The Carlyle Group, Hellman & Friedman, Kohlberg Kravis Roberts & Co and Thomas H Lee Partners raised approximately US$1.64 billion pursuant to an initial public offering; and a consortium of private equity firms comprised of affiliates of The Carlyle Group, Goldman, Sachs & Co, Highstar Capital and Riverstone Holdings completed an initial public offering of Kinder Morgan, Inc, which raised approximately US$2.86 billion and which is the largest IPO of a private equity-backed company in US history.

Focus on Asia

Global private equity funds have continued to increase their focus on Asia and raise funds that are targeted specifically to Asia or specific Asian countries, such as China or India. In addition, large local funds are becoming significant competitors to global private equity sponsors in many Asian jurisdictions. The primary investment focus of most private equity sponsors in Asia has been China and India, although Southeast Asia (including Singapore, Thailand, Malaysia, Indonesia and Vietnam) is an area of increasing interest for buyout firms. In Asia, 107 funds raised US$17.7 billion in the first half of the year (Asia Venture Capital Journal). Of this number, approximately US$4.2 billion went to just six buyout groups, which may reflect a desire by limited partners to invest with only the most experienced and credible teams (Asia Venture Capital Journal).

Since 2005, private equity firms have raised more than US$57 billion for investment in China (Preqin), and as of November 2010, China-focused funds accounted for more than 9 per cent of global fundraising (Thomson Reuters). In January 2011, the Shanghai government announced the launch of a pilot scheme entitled the 'Qualified Foreign Limited Partner' programme, which will allow foreign private equity firms to directly invest in the People's Republic of China (PRC). Under the trial programme, certain types of foreign investors can apply to convert foreign currency into renminbi, which can be directly invested in private equity funds based in Shanghai. China's foreign exchange regulator has granted Shanghai a US$3 billion initial quota for the project, which has been allocated to various private equity funds including The Blackstone Group, The Carlyle Group and First Eastern Investment Group. The extent to which programmes of this type will encourage further investment in China remains to be seen, particularly in light of the uncertain status of such PRC legislation and ongoing investment restrictions applicable to certain industries.

In Asia, the private equity model is different than the mega-LBOs seen in the United States. Particularly in China and India, private equity investments involve much less (if any) debt and are often limited to non-controlling stakes. In India, minority investments dominate and buyout or control transactions are limited, resulting in part from constraints on the use of debt and the desire of many large family-owned businesses to keep control with the family. The same considerations apply to investments in China where a typical Chinese private equity investment is a non-controlling stake of 15 to 40 per cent in an operating company, with the money intended to be used as growth capital. In addition, private equity investors in China and other Asian countries are required to navigate through a complicated governmental approval process in which many industries are not open for investment by foreign entities. Given the smaller average deal size in Asia (for example, approximately US$31 million in India according to Bain Consulting Research), many investors and private equity managers are concerned about their ability to source multiple investments that will generate the level of returns expected by investors for growth investments in emerging markets. In addition, the competition for quality investments is fierce, and valuations often run high compared to other emerging markets. In Southeast Asia, many sponsors are attracted to the significant opportunities in the manufacturing, natural resources and consumer products sectors, particularly in light of the growing middle class populations and domestic consumption rates in countries such as Malaysia, Vietnam and Indonesia. However, investors remain wary of the stability of these economies and potential for sustained growth. In addition, the legal framework for executing acquisitions and obtaining effective governance rights in these countries is frequently sparse and untested. In this environment, thorough due diligence and navigation of the regulatory landscape is critical to successfully executing transactions.

Private equity fundraising reaches new lows

The downward trend in private equity fundraising that began in 2008 continued through 2010. A total of 484 private equity funds completed a final close in 2010, raising US$225 billion, which is the lowest aggregate amount raised in a single year in six years. Furthermore, funds that had a final closing in 2010 spent an average of 20.4 months fundraising, which is up from an average of 9.6 months in 2004. Only 122 European-focused funds closed in 2010, raising an aggregate of US$50.2 billion, while 118 Asia and rest-of-world-focused funds accounted for US$41.1 billion with US$134.6 billion being raised by 242 North America-focused funds. Venture funds were the most prolific, with 102 reaching a final close in 2010 and raising an aggregate of US$20.4 billion. Buyout funds accounted

for the largest proportion of the aggregate capital raised with US$68.5 billion collected by 88 such funds that closed in 2010. Although many private equity fundraising practitioners predicted a recovery in the fourth quarter of 2010, only US$32 billion was raised by 92 funds that completed a final close in the fourth quarter, which is the lowest fundraising quarter since the third quarter of 2003 (all of the above statistics supplied by Preqin). In the United States, private equity fundraising declined further, with US$86.3 billion being raised by 336 funds, which represented a 16 per cent decline from the US$102.2 billion raised by 366 funds in 2009 (Dow Jones). One positive trend in 2010 was found in fundraising for 'middle-market funds', which are those funds that are less than US$1 billion in size. Middle-market funds raised approximately US$15.2 billion in 2010 as compared to US$10.1 billion in 2009 (Dow Jones). As a corollary, 'mega-funds', which are categorised as US$6 billion or more in size, continued to find the private equity fundraising markets difficult in 2010 – only one US fund, Blackstone Capital Partners VI LP, reached this mega-fund threshold by raising US$14 billion (Dow Jones).

The difficult fundraising conditions in 2010 continued to place pressure on private equity sponsors to readjust the pricing of the terms of private equity funds. In connection with fundraising in 2010, certain institutional limited partners negotiated preferential terms, including preferential return hurdles for such limited partners prior to profit distributions to the general partner, discounted management fees and carried interest, customised structuring and priority co-invest rights. Notwithstanding these difficult fundraising conditions in 2010, based on interviews conducted by Preqin with over 100 leading investors in private equity funds, there are some signs for optimism regarding fundraising in 2011. According to Preqin, 62 per cent of investors interviewed expect to make new fund commitments in 2011 and a further 30 per cent have yet to finalise their plans for the year. In addition, 54 per cent of those interviewed expect to commit more capital to funds in 2011 than in 2010, and 90 per cent of investors interviewed intend to increase or maintain their private equity allocations over the next three to five years. Key areas of interest for investors in 2011 include small to middle-market buyout funds and distressed private equity, which are seen as attractive by 55 per cent and 20 per cent of investors interviewed by Preqin, respectively, with 70 per cent of interviewees currently invested in or considering investing in emerging markets.

Outlook for 2011

Many practitioners and industry participants expect that mergers and acquisitions activity in 2011 will equal or surpass the levels achieved in 2010, and that the trend of multi-billion dollar LBOs seen in late 2010 will continue. In the previous two years, many corporations primarily focused their M&A activity on improving synergies and cost structures in an effort to survive the economic downturn; however, many expect that they will begin to shift their focus to improve top-line growth, including via an increase in merger activity. In addition, companies comprising the S&P 500 have an estimated US$1 trillion in cash, which can be used to fuel M&A activity, and as valuations have rebounded many corporations may look to re-evaluate their corporate portfolios and begin to execute strategic reorganisations and divestitures (the above statistics supplied by PricewaterhouseCoopers). All of these factors may contribute to fuel private equity sponsor activity in 2011. Specifically, the energy and power sector is widely considered to present opportunities for M&A activity by strategic companies and private equity sponsors alike in 2011. Financial sponsors completed 28 energy and power deals in the fourth quarter of 2010, which represented a 33 per cent increase from the previous quarter and a 64.7 per cent increase from the low of 17 deals completed in the second quarter of 2009 (Pitchbook). The energy and power sector totalled 20.6 per cent of global M&A activity in 2010, and with increasing global commodities prices, many expect this sector to remain one of the most active areas for mergers and acquisitions activity in 2011 (Thomson Reuters).

Despite the bullish views of many M&A practitioners, few industry participants expect that global M&A activity and private equity deals will return to the levels seen in 2006 and 2007. However, a robust level of M&A activity is certainly plausible, and we expect that a variety of factors may drive private equity deal activity in 2011. First, many are expecting that cross-border opportunities and M&A activity involving emerging markets, particularly in Brazil, Russia, India and China, will expand in the near term. Private equity investment in emerging markets rose 30 per cent in 2010 to US$28.8 billion, driven by an increase in deal volume and a slight increase in transaction size (Emerging Markets Private Equity Association). Any continued increase in activity will depend, in part, on private equity sponsors' abilities to source quality target assets in these jurisdictions, sustained economic growth in such emerging markets and a more open regulatory framework with respect to foreign investments.

Second, the continued availability of attractive financing terms will be another factor that will have a significant impact on private equity M&A activity (although debt financing is less relevant for certain emerging markets jurisdictions such as India and China). Global M&A-related leveraged loan volume reached approximately US$85 billion in 2010, which was nearly five times the US$18 billion level in 2009 (Standard & Poor's Leveraged Commentary and Data). In a positive sign for private equity sponsors in 2011, more than 25 per cent of first-lien loans issued in 2011 have 'covenant-lite' structures, which represents a higher percentage than in 2007, and nearly US$4 billion of covenant-lite loans have been issued in January, which represents 40 per cent of all covenant-lite issuances in 2010 (Standard & Poor's Leveraged Commentary and Data). Such LBO covenant-lite financings include the approximately US$2.7 billion financing for the pending US$5.3 billion LBO of Del Monte Foods Co and the approximately US$1.2 billion financing for the pending US$2.7 billion LBO of J Crew Group Inc. On the equity side, LBOs in 2010 were funded with an average equity contribution of 41 per cent, which is the highest on record next to 46 per cent in 2009 (Standard & Poor's Leveraged Commentary and Data). We would expect that equity contribution requirements for new LBOs will be another factor that will influence private equity deal-making in 2011 as sponsors continue attempts to decrease the level of equity necessary to win deals in an effort to boost returns to investors.

Finally, there is no question that private equity firms continue to be under pressure to exit investments in order to return capital to investors and establish positive track records for future fundraising. Private equity sponsors owned nearly 6,000 companies in the US at the end of 2010, which is the highest number on record. This investment 'overhang' has occurred due to the fact that investments have outpaced exits over the previous decade (Pitchbook). We would expect to see an ongoing focus on private equity sponsor exits from investments in 2011, continuing the trend of an increasing number of sponsor exits in 2010. In any event, in order for private equity activity to maintain or improve upon the levels seen in 2010, capital markets must continue to remain stable with an ongoing availability of debt financing on attractive terms, and financial sponsors must continue to find avenues to return capital to their limited partners by consummating exits and effecting portfolio company IPOs.

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 ISSN 1746-5524