GETTING THE DEAL THROUGH

Private Equity

in 33 jurisdictions worldwide

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Global Overview

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Bleak year for private equity

After the global financial turmoil and private equity drought that prevailed throughout 2008, few were optimistic about the prospects for private equity M&A activity in 2009. Even those who predicted a continued low level of financial sponsor activity in 2009, however, may not have expected the type of year that many participants in the private equity industry would like to forget. In conjunction with a continued significant decline in global M&A activity, financial sponsor buyouts worldwide suffered another sharp fall-off, declining to their lowest level since 2002. Debt financing was extremely scarce, and many financial sponsors were forced to utilise any such available debt to address issues at existing portfolio companies rather than financing for new acquisitions. Financial sponsors continued to struggle with portfolio company distress and defaults as operating performance declined and substantial debt loads with looming maturities placed heavy burdens on cash-strapped companies. In addition, in light of public criticism of the financial and investment industries, many regulators (as well as the public) have increased their scrutiny of the private equity industry, and various regulatory agencies in the United States and the European Union have proposed new regulations that could significantly impact financial sponsors. Notwithstanding all of the issues faced by financial sponsors in 2009 and the overall bleak environment for private equity that prevailed throughout most of the year, an opening of the capital markets, an increased number of initial public offerings of portfolio companies and several multi-billion dollar LBOs in late 2009 may be grounds for some cautious optimism for 2010.

Continued decline in worldwide transaction activity

Global announced M&A deals in 2009 totalled approximately US$2.1 trillion, which was a decrease of 28.2 per cent from 2008 totals and the lowest level for annual deal activity since 2004. A significant portion of this decreased level of activity was comprised of investments by governments and government entities, representing 16.6 per cent of total global M&A activity during 2009, which was the highest percentage on record. On a positive note, there were over 38,000 announced deals worldwide in 2009, down just 6.6 per cent from 2008, and there was a notable spike in transaction volume in the fourth quarter of 2009. Worldwide announced M&A transactions during the fourth quarter of 2009 totalled approximately US$625.4 billion, which was the largest quarterly total since the third quarter of 2008 and a 12.5 per cent increase from the fourth quarter of 2008. Financial sponsor buyouts amounted to only US$133.8 billion worldwide in 2009, which was the lowest level since 2002 and represented a 43.5 per cent decline over 2008. As a result, financial sponsors accounted for just over 6 per cent of announced M&A transactions worldwide during 2009, compared with approximately 8 per cent in 2008 and approximately 19 per cent in 2007. In addition, with the exception of certain multi-billion dollar LBOs in the later part of 2009, noted below, smaller private equity M&A transactions were much more prevalent in 2009. Of the private equity M&A transactions with disclosed purchase prices that closed in 2009, 81 per cent had total purchase prices of less than US$250 million, compared to 66 per cent in 2008 and 47 per cent in 2007. Conversely, only 5 per cent of 2009's disclosed deals were valued above US$1 billion, compared with 13 per cent in 2008 and 23 per cent in 2007 (all of the above statistics supplied by Thomson Reuters).

Americas

US-based financial sponsors closed 530 control-stake deals in 2008 for a disclosed value of US$34.7 billion. Those figures represent a 39 per cent decrease compared to 2008's LBO deal count of 872 and a precipitous 75 per cent drop from 2008's US$137 billion of disclosed deal volume in the United States. The closed-deal count of 98 US transactions in the fourth quarter of 2009 represents a quarter-over-quarter drop of more than 32 per cent from the closed-deal count of 144 deals in the third quarter of 2009 and a 31 per cent drop from the 142 deals consummated in the fourth quarter of 2008. However, the total deal volume of US LBOs in the fourth quarter of 2009 was US$20.2 billion, which represented an enormous increase of 432 per cent compared to the total US LBO deal volume of US$3.8 billion in the third quarter of 2009 and an increase of 185 per cent compared to the total US LBO deal volume of US$7.1 billion in the fourth quarter of 2008 (all of the above statistics supplied by Buyouts). Private equity-sponsored deals in Canada accounted for only 2.5 per cent of all Canadian M&A deals and amounted to only C$3.2 billion of the C$129 billion worth of Canadian M&A deals in 2009, which represented a 92 per cent decline in private equity deal volume involving Canadian companies from 2007 (KPMG LLP). Private equity M&A activity in Latin America also plummeted as deal volume in that region decreased from US$7.0 billion in 2008 to US$0.6 billion in 2009, representing over a 91 per cent year-over-year fall-off (Dealogic).

Europe

European private equity M&A activity dropped 75.5 per cent from a total volume of US$89.9 billion in 2008 to US$22.0 billion in 2009, which was the lowest total since 1996. The number of deals fell to 463 from 857 (Dealogic). One bright note from Europe, similar to the trend in the United States, is that US$8.9 billion of private equity deals were announced in the fourth quarter of 2009, which reflected an increase of 50 per cent from both the third quarter of 2009 and the fourth quarter of 2008.

Asia-Pacific, Middle East and Africa

Financial sponsor activity in Asia declined to US$12.5 billion in 2009 from US$26.5 billion in 2008 (Dealogic). Financial sponsor activity in the Middle East declined to US$1.0 billion in 2009 from US$3.4 billion in 2008, and financial sponsor activity in Africa declined to US$1.0 billion in 2009 from US$2.9 billion in 2008

(Dealogic). Notwithstanding the decline in financial sponsor activity in Asia in 2009, many industry participants have voiced expectations that private equity activity will continually increase in the Asia-Pacific region, particularly in China, with some predicting that the Asian private equity market will ultimately overtake the US market (Dow Jones Private Equity Analyst).

Increased regulatory scrutiny and proposed legislation

Against a backdrop of economic crisis in many regions worldwide, financial sponsors were faced with mounting scrutiny of the financial and investment industry and increased calls for additional regulation. In June 2009, US President Obama released a reform proposal that would require the registration of all managers of private equity funds, hedge funds, venture funds and other private pools of capital to register as investment advisers with the US Securities and Exchange Commission. In addition, President Obama's reform proposal may subject certain private equity funds to regulation and supervision by the US Federal Reserve. In December 2009, the US House of Representatives passed a bill requiring registration, but exempting venture capital firms, small business investment companies and investment firms with less than US$150 million of assets under management. The bill would impose on investment fund advisers record-keeping, SEC reporting and disclosure requirements regarding the funds. In addition, all records of funds maintained by a registered adviser would be subject to examination by the SEC. It remains unclear whether the US Senate will adopt a similar bill and whether any legislation which is ultimately adopted will cover such a broad range of investment fund advisers or include the same degree of substantive regulations and reporting requirements.

Increased regulatory scrutiny of the investing industry was also a notable development in Europe in 2009. In April 2009, the European Commission proposed a draft Directive on Alternative Investment Fund Managers. The draft directive would require the authorisation of persons established in the European Union who provide management services to alternative investment funds and would prohibit unauthorised persons from providing any management services to alternative investment funds in the EU or marketing alternative investment funds in the EU. Under the draft directive, authorised managers would be subject to minimum capital requirements and conduct of business rules, in addition to a variety of other substantive requirements. Significantly, the draft directive also contemplates potential limits on the maximum amount of leverage that may be used by alternative investment funds and required disclosures by a fund manager regarding the amount of leverage used by the fund. A more recent addition to the draft directive would limit compensation earned by the alternative investment fund managers. One of the more controversial aspects of the draft directive is a proposed requirement that, before any alternative investment fund outside of the EU may be marketed in the EU, the country of domicile of such fund must enter into a tax information-sharing agreement with any EU member states in which the fund is marketed. It would also require non-EU general partners to demonstrate that the regulatory regime in their home country has similar safeguards to the ones Europe is considering. Not surprisingly, the draft EU directive has generated a substantial amount of comment as well as criticism from those within and outside of the private equity and hedge fund industries. Several amendments have been proposed which would soften the adverse impact of the draft directive on private equity firms, but it is unclear what, if any, final legislation will ultimately be adopted by the European Parliament and the Council of the European Union.

Another area which has been the focus of regulation in the United States has been taxation of carried interest. In December 2009, the US House of Representatives passed a bill providing, among other things, that 'carried interest' earned by investment fund managers would be taxed at ordinary income rates, rather than capital gains tax rates which (at least currently) are significantly lower. The bill would also create an expansive reporting and withholding tax regime that would require 'foreign financial institutions', including any non-US investment fund vehicles, to obtain detailed information regarding the identity and ownership of account holders and investors, including non-US investors. Although many of the proposed regulations in the United States and Europe may undergo significant amendments prior to their adoption (or may not be adopted at all), financial sponsors and their counsel should be aware of the potential implications of proposed registration, disclosure and other substantive requirements as well as potential changes in tax laws.

Positive signs of increased deal volume

A potentially positive sign for financial sponsors was the significant increase in deal volume in the later part of 2009. This increased volume was primarily driven by a number of multi-billion LBOs in the third and fourth quarters. Elliott Management and Silver Point Capital closed their approximately US$11 billion acquisition of Delphi Corp out of bankruptcy in October 2009. In addition, The Blackstone Group closed its US$2.7 billion acquisition of Busch Entertainment Corp from Anheuser-Busch InBev in December 2009, and a consortium led by Silver Lake and Canada Pension Plan Investment Board closed their approximately US$2 billion acquisition of Skype Technologies SA from eBay in November 2009. Other multi-billion LBOs closing in late 2009 included the approximately US$1.8 billion acquisition of Oriental Brewery Co Ltd by Kohlberg Kravis Roberts & Co and Affinity Equity Partners in the third quarter of 2009, the approximately US$1.8 billion acquisition of half of British Land Co PLC's stake in the Broadgate Office Complex by The Blackstone Group in the fourth quarter of 2009, and the approximately US$1.3 billion acquisition of Birds Eye Foods Inc by Pinnacle Brands Corp, a portfolio company of The Blackstone Group, in the fourth quarter of 2009.

In addition, a number of multi-billion LBOs were announced in the fourth quarter. The largest was the approximately US$5 billion acquisition of IMS Health Inc by TPG Capital LP and the Canada Pension Plan Investment Board, which was announced in November 2009. Notably, the debt financing for this transaction was provided by only one lender, Goldman Sachs Group Inc. Other notable multi-billion LBOs announced in the fourth quarter of 2009 included Apollo Management LP's agreement in December 2009 to acquire Cedar Fair LP for approximately US$2.3 billion, General Atlantic LLC and Kohlberg Kravis Roberts & Co's agreement in November 2009 to acquire TASC Inc for approximately US$1.7 billion, and Apax Partners LP's agreement to acquire Marken Ltd.

Based on the few large LBOs disclosed in 2009, it appears that financial sponsors continued to be able to utilise a reverse break-up fee structure in acquisition agreements to address financing risk. In at least three recent multi-billion dollar LBOs of US companies, the acquisition agreements provided for a payment of a reverse break-up fee by the buyer, which also functioned as a cap on the buyer's damages following a termination of the transaction in the event that the conditions to closing were (or would have been) satisfied and the transaction did not close. However, in each such agreement, the target company had the right to a limited form of specific performance by the buyer, which reflected increasing pressure by sellers and target stockholders to obtain more deal certainty and protect against the buyer's financing risks. In these transactions, the target company had the right to seek specific performance against the buyer to cause the buyer to draw down and fund its equity financing if, among other requirements, the debt financing had funded or was available to be drawn down by the buyer. Note that there were a number of smaller LBOs in which financial sponsors funded the purchase with only equity and agreed to provide the seller or target company with full specific performance remedies against the private equity fund. However, it does not seem likely that this will be the standard model for large private equity transactions going forward in light of, among other factors, the potential inefficiencies in the pro forma capital structure, the adverse impact on returns (and thus valuation) and fund concentration limits included in fund partnership agreements. In any event, it appears that conditionality and financing risk will continue to be critical issues for financial sponsors and their counsel (and target companies and their counsel) in any LBOs going forward.

Dealing with debt

In 2009, as more companies defaulted on debt, engaged in restructurings (in and out of bankruptcy proceedings) or otherwise struggled in a challenging economic environment, financial sponsors and the investment industry have been subject to particular criticism for saddling companies with substantial amounts of debt incurred in connection with record LBO prices paid in 2006 and 2007. However, in a report published by Moody's Global Corporate Finance in November 2009, based on a study of 186 private equity leveraged buy-out deals with an aggregate value of approximately US$640 billion, Moody's reached several conclusions that indicate that private equity firms may have been overly criticised for their role in corporate defaults in 2009. Moody's reported that defaults have been roughly as common among 186 LBO deals as among similarly rated companies which are not owned by financial sponsors. In addition, Moody's noted that among the 186 private equity deals analysed, sponsors took out dividends on 44 LBOs, yet this group of deals included only six defaults (a 13.6 per cent rate), which was lower than the rate for all 186 LBOs (19.4 per cent) and for other similarly rated companies which are not owned by financial sponsors (18.6 per cent). However, the Moody's study noted that, of the 10 'mega-deals' (all in excess of US$13 billion), four of the 10 have already defaulted and several others appear to be in distress (with a credit rating of B3 (negative outlook) or lower). Club deals, in which at least two of the top 14 private equity firms participated, generated a default rate of 15.6 per cent, but excluding three mega-deals the default rate was 8.3 per cent, significantly lower than the 18.6 per cent default rate for similarly rated companies, even though the large club deals took dividends during the first year of ownership at nearly twice the rate of the rest of the Moody's study group (14.6 per cent compared to 7.5 per cent). The Moody's study further noted that, notwithstanding the 'covenant-lite' features of many debt issuances of the companies analysed, approximately 20 per cent of the deals had a rating of B3 (negative outlook) or lower, compared with 14 per cent of similarly rated issuers. The Moody's study concluded that one of the primary risks with respect to the transactions analysed is the risk of refinancing with a substantial amount of revolving credit facilities as well as term loan debt scheduled to mature in 2011 and 2012.

There is no doubt that refinancing risks must be at the forefront of concerns for most financial sponsors with respect to many of their current portfolio investments. Much to the relief of private equity industry participants the capital markets opened somewhat in 2009, which provided certain financial sponsors the opportunity to refinance some existing portfolio company debt and, to a lesser extent, obtain new debt for acquisitions. In the US high-yield bond market, US$151 billion of bonds were issued in 2009, which is triple the level in 2008 of US$50.2 billion (Dow Jones Private Equity Analyst). Approximately three-quarters of the high-yield bond issuance was utilised to pay down existing bonds or loans in 2009, compared with less than half in 2008 (Dow Jones Private Equity Analyst). Spreads on high-yield bonds were at their lowest levels in nearly two years, at approximately 600 basis points above Treasury in December 2009, and leveraged loan spreads also decreased, albeit at a more moderate pace (Dow Jones Private Equity Analyst). As of 11 December 2009, the amount of outstanding leveraged loans due in 2012 and 2013 decreased to US$58 billion and US$127 billion in 2009 respectively, compared with US$77 billion and US$174 billion in 2008 (Standard & Poor's Leveraged Commentary and Data). However, leveraged loans remained depressed as banks were less willing to hold debt on their own balance sheets with year-to-date volume of half of 2008's level, at US$75 billion versus US$150 billion (Standard & Poor's Leveraged Commentary and Data).

Perhaps the most notable example of issuing new debt to repay existing debt was the completed issuance of US$2.5 billion of new bonds (originally slated to be only US$750 million) by a subsidiary of Clear Channel Communications Inc in December 2009. The proceeds from the bond issuance were used to repay US$2 billion of debt owed by the subsidiary to its parent company, which in turn used such proceeds to repay some of its existing bank debt. Earlier in the year, in February 2009, Freescale Semiconductor Holdings I Ltd, which is owned by The Blackstone Group, Texas Pacific Group, The Carlyle Group and Permira Advisors, announced exchange offers for approximately US$4 billion in notes for up to US$1 billion in a new term loan. When the offers closed in March 2009, Freescale had reduced its debt by almost US$2 billion. Following on the heels of Freescale, at the end of March 2009, NXP BV, a portfolio company of Kohlberg Kravis Roberts & Co, Apax, AlpInvest Partners, Bain Capital and Silver Lake Partners, launched an exchange offer that valued some of its bonds at between 17 per cent and 32 per cent of face value (Dow Jones Private Equity Analyst). Through this exchange offer, NXP reduced its debt by US$465 million and related interest expense by approximately US$30 million. Later in July 2009, NXP further reduced its debtload by approximately US$504.2 million and the related interest expense by approximately US$31.8 million pursuant to a cash tender offer for outstanding debt.

Portfolio company IPOs

Another bright spot for financial sponsors in 2009 was the increase in portfolio company initial public offerings, particularly in the fourth quarter of 2009. The number of financial sponsor portfolio companies that completed IPOs in 2009 more than doubled the number in 2008 (Buyouts). In 2009, 16 companies with LBO sponsors went public (Thomson Reuters). Only two LBO-backed companies went public during the first half of 2009, while the remaining 14 companies completed IPOs in the fourth quarter of 2009. The largest offering was the IPO of Cerberus Capital Management LP's Talecris Biotherapeutics Inc in October 2009. The offering raised approximately US$950 million by selling 50 million shares at US$19 per share, which included the sale by Cerberus of approximately 21 million shares in the offering. The offering proceeds to the company were used to repay existing debt. Dollar General Corp, which had the highest post-offer value of approximately US$7.15 billion among the 16 LBO-sponsor companies that went public in 2009, completed its initial public offering in November 2009. Dollar General raised US$716.1 million by selling 34.1 million shares at US$21 per share in November 2009. As in the case of the Talecris Biotherapeutics IPO, the offering proceeds to Dollar General were used to repay existing debt. An investment vehicle owned by a consortium of sponsors led by Kohlberg Kravis Roberts & Co, which includes GS Capital Partners, LP, Citigroup Capital Partners, Canada Pension Plan Investment Board and Wellington Management Company, sold 11.4 million shares out of the total of 34.1 million shares sold in the offering.

Two other large IPOs of sponsor-owned companies in 2009 included the initial public offerings of Cobalt International Energy Inc and Avago Technologies Inc. Cobalt International Energy Inc, a portfolio company of The Carlyle Group, First Reserve Corporation and Goldman Sachs & Co went public in December 2009. The offering raised approximately US$851 million by selling 63 million shares at US$13.50 per share. None of the sponsors sold shares in the IPO and the company disclosed that the proceeds from the IPO would be used for capital expenditures, related operating expenses and general corporate purposes. Avago Technologies Inc, a portfolio company of Kohlberg Kravis Roberts & Co and Silver Lake, went public in August 2009. The offering raised approximately US$648 million by selling 43.2 million shares at US$15 per share. The proceeds to the company were used to repay existing debt and pay a specified amount to the sponsors in connection with the termination of their advisory agreement with the company. The sponsors sold approximately 21.7 million shares in the IPO. Thereafter, on 28 January 2010, the sponsors filed a prospectus to sell 25 million shares at US$17.41 per share. It remains to be seen whether the number of portfolio company IPOs will continue to grow in 2010, but after the almost total unavailability of the public markets as a viable exit for financial sponsors in the past two years, the opening of the IPO market was a welcome opportunity for financial sponsors seeking to partially realise investments and make some long-awaited distributions to their limited partners.

Private Equity Fundraising Declines

Continuing a downward trend that began with the global credit crisis, the collapse of Lehman Brothers and other events following September 2008 and the widespread downturn in financial markets, 2009 proved to be a very challenging year for managers seeking to raise new private equity funds. Fundraising totals globally again showed sharp declines in 2009. The marketplace, especially in the earlier part of 2009, was marked by the illiquidity of many investors, which put pressure on some general partners to defer drawdowns, created the need for expedited secondary transactions, and caused defaults by some limited partners (although less than originally anticipated).

These conditions resulted in an imbalance between supply and demand forces in the marketplace, putting pressure on sponsors to readjust the pricing of the terms of private equity funds, broadly considered. Limited partners have refocused not just on the straightforward economics of funds such as the management fee, carried interest formula and management fee offset, but also on non-economic terms and remedies. In response to a perceived shift in negotiating leverage, groups of institutional investors have disseminated what they perceive as best practices for private equity fund terms and operations. To a large extent, these guidelines aggregate many of the items that the investor community has been trying to obtain in negotiations over many years.

Out of this environment, sovereign wealth funds, government agencies and other investors with liquidity have emerged as significant sources of capital for fund sponsors. Increasingly, these investors are flexing their financial muscle to drive more bespoke terms and structures to which they can make disproportionately large capital commitments on an expedited basis relative to other more traditional sources of capital. With many of these investors being located in the Middle East and Asia, more institutionalised sponsors are finding that their global footprints, profiles and prior experience with fundraising or investing in those geographies are helpful in securing outsized commitments in the current environment.

Outlook for 2010

It is unclear whether the multi-billion dollar LBOs seen in late 2009 will continue into 2010 and lead to a surge in private equity activity. Similarly, it remains to be seen whether the capital markets will remain viable for refinancing or raising new debt and whether the IPO market will remain open as an attractive option for portfolio companies and financial sponsor exits. Many note that IPOs in late 2009 increasingly priced at the lower end of (or below) their initial per share ranges and highlight the fact that several sponsors sold no shares or a limited percentage of their stakes in portfolio company IPOs, potentially reflecting a concern that public investors would be scared away by a more significant exit by the controlling financial sponsors. Undoubtedly, a continued upswing and stabilisation of public markets and the economy in general will make IPOs a more feasible exit for financial sponsors, particularly to the extent that sponsor exits via M&A transactions remain at low levels. In addition, notwithstanding the opening of the capital markets in 2009 (at least compared to the prior two years), some note that debt financing for new acquisitions was still relatively unavailable in 2009 and that banks were only willing to extend debt financing on attractive terms for blue-chip companies or smaller acquisitions with low debt multiples. Certainly, one of the most significant factors that will impact private equity in 2010 will be financial sponsors' continuing challenges in securing debt financing on reasonable terms. In light of current economic conditions, many practitioners and industry participants certainly would not have expected the number of large, public company LBOs in the fourth quarter of 2009. In a positive sign that increased financial sponsor activity may continue, Kohlberg Kravis Roberts & Co announced its agreement to acquire UK retailer Pets at Home Ltd from Bridgepoint Capital Ltd on 27 January 2010, and SkillSoft Plc, an Irish comapny which provides electronic education services, announced on 12 February 2010 its agreement to be sold to a consortium comprised of Berkshire Partners LLC, Advent International Corporation and Bain Capital Partners for US$1.1 billion in cash.

Although few have any expectations that private equity acquisitions will soon return to the magnitude and rate seen in 2006 and the first half of 2007, there are several factors that may create continued momentum for financial sponsor activity in 2010. It is clear that private equity firms have substantial amounts of capital to invest over the next few years, with some estimates placing the current overhang of committed capital to buyout firms at between US$500 billion and US$1 trillion globally (Dow Jones Private Equity Analyst). Financial sponsors are incentivised to deploy this enormous amount of capital promptly (albeit prudently) following the drought of acquisitions and investments in 2008 and 2009, particularly if they believe that the window for increased capital markets activity may be fleeting. On the other side of the equation, financial sponsors are also being pressured to achieve some successful realisations on their portfolio investments as limited partners, who have suffered from a dearth of distributions in the past two years, are anxiously awaiting proceeds from sales or other dispositions of existing investments. In addition, some predict that potential changes in tax laws could motivate both sellers and buyers to move more quickly to take advantage of current capital gains rates and the current tax treatment of carried interest. Given the uncertainty regarding proposed legislation that would impact financial sponsors, it is difficult to predict whether the increased regulatory focus on the private equity industry will result in any chill in activity.

The fundraising environment for 2010 appears poised to pick up some momentum. More sponsors may launch new fundraisings in 2010, driven by a need to replenish available capital commitments or a desire to act upon investment opportunities created by perceived mispricings of companies under current market conditions. Benchmark funds offered by quality sponsors that were launched in 2009 are finalising negotiations and helping to set the market for terms. Large capital commitments are expected to continue to flow from sovereign wealth funds and other entities with liquidity and a continuing appetite for alternative investments. Successfully closing investors will likely require a more differentiated product offering, enhanced and protracted diligence and more extensive negotiations of terms. In any event, in light of the relatively positive factors outlined above, and given the extremely low levels of financial sponsor deal volume and fundraising activity in 2009, one would hope that private equity activity has nowhere to go but up in 2010.

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