



Private equity



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### ORGANISATION GLOSSARY

## FORUM

# Creating value through private equity in today's market

FW moderates a discussion on value creation in the private equity market between Antonio Cabral at The Riverside Company, Craig E. Marcus at Ropes & Gray LLP, and Kevin Kester at Siguler Guff & Company, LP.

## THE PANELLISTS



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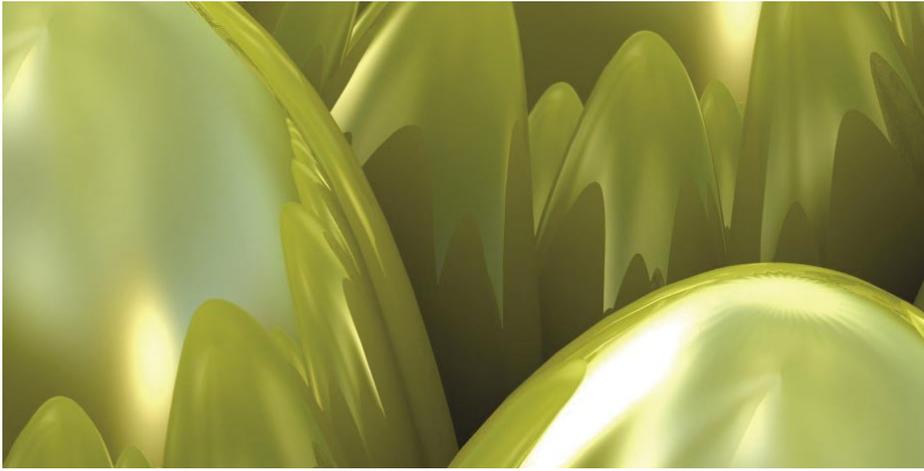
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Antonio Cabral joined Riverside in 2000. As Fund Manager, he leads the Riverside Europe fund family in the acquisition, growth and sale of portfolio companies, as well as in the development of the funds' strategic direction.



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Mr Kester is a senior member of Siguler Guff's investment staff and oversees the firm's Small Buyout Opportunities Fund, where he has responsibility for designing and implementing fund strategy, screening and selecting investment managers, negotiating terms and conditions, identifying and executing direct investments and co-investments, and monitoring investment portfolios. Mr Kester has over 17 years of experience investing and managing institutional portfolios in alternative investments.



**FW:** *What is the general mood or attitude of general partners, and their limited partners, towards PE investing? How is the economic outlook influencing these attitudes?*

**Cabral:** As a general partner (GP), we are cautiously optimistic. We are cautious because of the financing environment and current economic situation in parts of Europe, but we are also optimistic in terms of some great buying opportunities that we see. Much of the continent is facing economic uncertainty and there are significant dislocations in the availability of capital for certain companies. This type of environment always creates some compelling investment opportunities. In Europe we are seeing the highest level of deal flow in our history, although we are being more selective and prudent to ensure we invest only in the best companies.

**Marcus:** GPs continue to look for deal opportunities in an environment of more sponsors chasing fewer deals. Limited partners (LPs) continue to exercise their increasing leverage in negotiating improved fund terms for new commitments. While the economic outlook has made new investments as well as exit opportunities scarcer, GPs have increased the flow of distributions to LPs over the last year or two. In addition, PE portfolio valuations have rebounded significantly from the lows that were seen at the height of the recession. As a result, while the market remains somewhat volatile, I think both GPs and LPs anticipate improved market opportunities over the course of the next few years.

**Kester:** Within the US small and lower middle-market – companies with \$10m to \$100m in revenue – we think that GPs are generally positive about the current investment and M&A environment. Overall M&A activity has been slow this year, but in the smaller end of the market we are seeing activity, both on the buy-side and the sell-side. On the other hand,

LPs still seem to be pretty bearish on PE. There does seem to be a bit of disconnect between what we're seeing on the GP side versus the LP side. With respect to the economic environment, the economic uncertainty both in the US and globally is having an impact on M&A. There has been a significant slowdown in the first two quarters of this year, even though expectations were that M&A activity would pick up. On a year-to-date basis through May, the global M&A transaction total was down 6.7 percent and reported dollar volume dropped 16.2 percent compared to the same period in 2011. Despite the global slowdown in M&A activity, we are seeing quite a bit of activity in the US small and lower middle-market.

**FW:** *How would you describe recent deal activity involving private equity firms across the globe? Which key sectors are PE firms targeting, and why?*

**Marcus:** Recent deal activity has been somewhat volatile with concerns over how the European debt crisis will ultimately be resolved, but transactions continue to get done – in some cases with larger equity investments or reduced pricing. While volume hasn't rebounded to levels seen in the more robust years, there is still a significant flow of transactions. PE firms have continued to invest across many industries, with some sponsors focusing on particular industry niches, but we have seen an increased focus on healthcare companies, with the US healthcare market primed for some changes in light of the new US healthcare law, as well as a focus on newer geographies that offer significant growth opportunities, such as China.

**Kester:** Overall, in the second quarter, business products and services was the most active industry for private equity investment, accounting for a 33 percent share of the activity, followed by consumer products and services which represented 18 percent of deal flow. The greatest increases in activity from Q1 to Q2

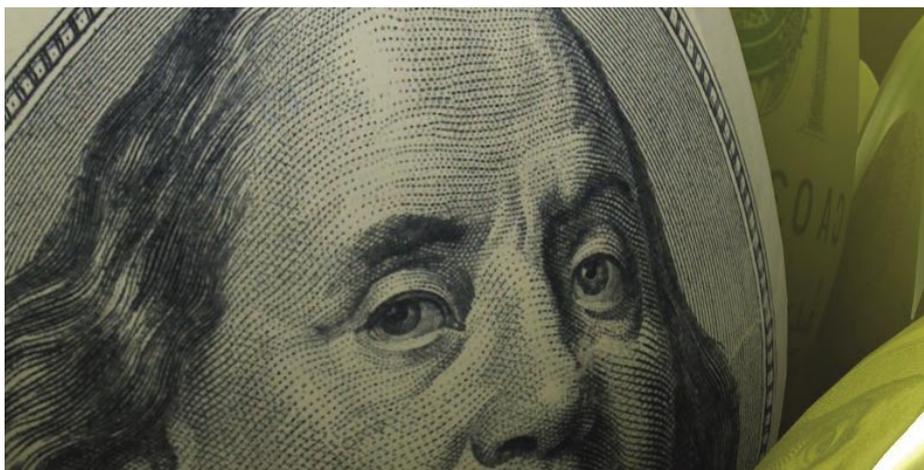
were in the healthcare and IT industries. Anecdotally, we are seeing strong M&A activity in the energy services sector, particularly around oil field services in the US, which is a considerable growth opportunity. We have also seen activity in the commercial aerospace markets, in the logistics and transportation sectors, and in IT. Industrial goods and services remains active and has been a strong part of the market since the beginning of the recovery. There is this manufacturing renaissance theme in the US which ties into low energy costs, moderate labour costs and high productivity. Investors' mindsets are more focused on cyclical sectors that benefit recovery, rather than more defensive sectors that would likely be the focus if they feared a double dip recession.

**Cabral:** In general, in the US and the Asia-Pacific region we are seeing more growth-oriented investment – there is more growth in the US so you see people paying more for it. The capital markets are also more open and pricing is perhaps better than would be the case if the economy were stronger. In Europe we are seeing more value-oriented investment. However, we are still seeing companies with great growth profiles that achieve high multiples. Low-cyclicality companies with good upside are always attractive. However, we are being very particular, looking for good companies at good prices with exceptional growth profiles and picking only the best.

**FW:** *What strategies are PE players utilizing to create value in today's market? How important is good portfolio management, and what essential elements does this entail?*

**Kester:** Good portfolio management is and always has been critical. One of the most important elements of good portfolio management is the ability to help facilitate improvements in investee companies. Those improvements are typically operational, organisational and/or financial in nature. As PE has become a more efficient asset class, where companies and assets are priced more efficiently, there is an even greater need for investors to add value to help generate investment returns. As always, though, the best strategy for creating value is to not overpay for assets.

**Cabral:** More than ever, LPs are looking for GPs with the internal resources to help their companies grow, especially through an economic downturn. We have always focused on the fundamentals – driving value through organic growth, selecting and integrating the right add-on acquisitions and leveraging operating expertise. We believe that the trend towards in-house operating capabilities will continue to get stronger. Moving forward, it ►



will be more difficult for private equity firms, particularly in the middle market, to produce returns for investors if they are not able to actively participate in setting the strategy and working with the management team.

**Marcus:** Sponsors are more focused on operational improvements for portfolio companies and implementing new operating strategies in order to improve portfolio company performance and generate returns – as opposed to seeking returns through financial engineering. In addition, some sponsors are looking to leverage the scale of their portfolios to enable portfolio companies to benefit from group purchasing arrangements for items such as insurance, healthcare or other services. Due to the more limited exit opportunities and refinancing alternatives, sponsors are keenly focused on debt maturities and operating covenants contained in financing agreements, to ensure that portfolio companies maintain a comfortable runway through an anticipated exit date that might be beyond the initially modelled exit date.

**FW:** *How difficult is it to achieve PE exits in the current climate? What options are available to overcome these challenges?*

**Cabral:** When you have high quality assets for sale that are attractive to a financial buyer or synergistic with a strategic acquirer, good exits are always possible. That said, it can be challenging if you are exiting a company in a country or a region that is being heavily impacted by a weak economic environment. In those situations, illiquid or closed debt markets make it difficult to finance deals, and if local PE firms have been hard-hit or are fundless, it can be difficult to find buyers.

**Marcus:** Given the volatility in the credit markets and the public equity markets, successfully exiting an investment can be challenging but good transactions are still getting

done. While the after-effects of the Facebook IPO chilled the US equity market for a time the flow of IPOs has started to resume and there is a healthy pipeline of PE sponsored companies gearing up to go public in the second half of this year. Sponsors are also seeking returns through dividend recapitalisations, which while subject to the volatility of the credit markets have been used successfully in a number of companies. In addition, sponsors have become more receptive to retaining a minority stake in a business that is sold to another PE sponsor through a rollover of a portion of its existing interest.

**Kester:** In our part of the market, it is actually an excellent time to be exiting investments. There is a tremendous amount of buyers out there. There is also a large capital overhang – \$368.5bn in dry powder globally and a lot of cash on strategic investors' balance sheets. Financial buyers are more active than strategic buyers right now; we are seeing financial buyers often outbid strategics today. It is important to have different exit avenues available – for example, selling to a financial investor, selling to a portfolio company of a financial investor, or selling to an outright strategic investor. You don't want your only exit opportunity to be taking a company public – that is a pretty limited option.

**FW:** *What is your view of the latest legal and regulatory issues shaping the industry? What impact will such developments have going forward?*

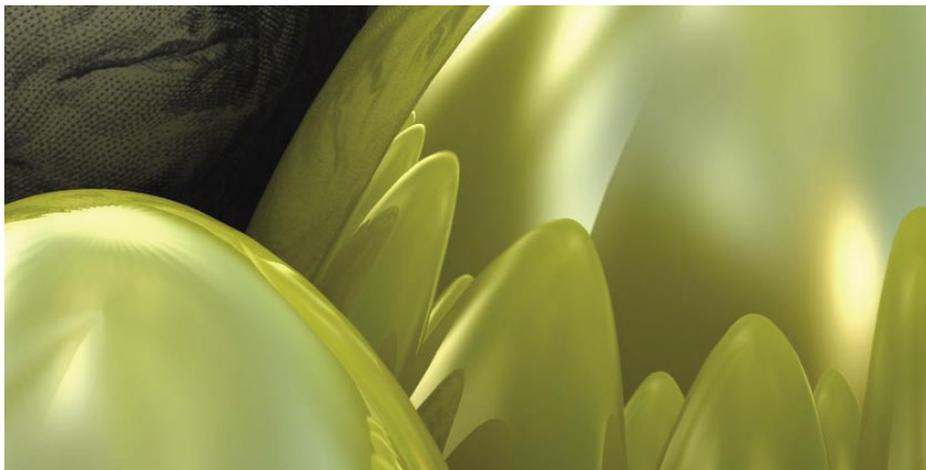
**Marcus:** The regulatory focus on the private equity industry has intensified and is unlikely to subside anytime soon. From adviser registration requirements, to governmental agency inquiries and investigations into valuation practices, and management fee offset provisions and other features of the private equity industry, regulators are keenly focused on understanding the private equity business and

identifying areas that might provide an opportunity for regulation or enforcement. In addition, taxation of carried interest as capital gain versus ordinary income is likely to remain a hot topic and, depending on the outcome of the upcoming US election, may result in changes to the US tax laws. The increased regulation and scrutiny will inevitably increase the costs of operating a private equity business.

**Kester:** There is a lot of uncertainty about laws and regulations and greater uncertainty is not conducive to a strong investment environment. Good investors can deal with all types of legal and regulatory constraints. In fact, the best investors are able to use these constraints to their advantage; however, it is difficult for anyone to navigate the unknown. One thing we do know is that new laws and regulations will always have unintended consequences. For instance, rules requiring private equity firms, even very small ones, to register as investment advisers will likely create barriers to entry in a part of the capital markets that I would think policymakers would want to encourage and grow.

**Cabral:** A tremendous amount of new financial regulation has been introduced over the past few years, both in Europe and in the US. It will raise costs and require process and disclosure changes, but by and large, it will be manageable. If not planned carefully, regulation has the risk of limiting the amount of capital available for growing businesses. However, it also offers a number of potential positives. It may, over time, make our industry more institutional, as general partners build up the infrastructure necessary for compliance. Additionally, as a regulated, more transparent industry, private equity will have an opportunity to become a much stronger and more accepted participant in economic discourse, allowing the industry to shed some of the stereotypical misperceptions and position itself as a constructive partner across a wide range of issues, including growth, corporate governance, and responsible investment. Private equity is also likely to be affected by the regulation of the financial sector, which reduces the ability of banks, insurance companies and pension funds to invest in the industry. These new rules may make fundraising more difficult for PE firms. We have already noticed LPs being more selective and favouring general partners that have real operating capabilities and can deliver growth and improvement in portfolio companies.

**FW:** *In terms of fundraising, where are limited partners committing their funds? What characteristics does a PE firm need to attract investment?*



**Kester:** Limited partners are continuing to have interest in emerging and developing economies. Within Europe, there is a lot of interest in the distressed debt opportunity. In the US, the focus seems to be more on the middle-market and lower middle-market, as investors have had less than satisfactory experiences with large and mega-sized funds. As funds have grown exponentially in size, not only has their performance suffered, but their alignment of interests with their investors has also been negatively impacted. As investors look at smaller, more aligned funds, they tend to focus on managers with sector or industry expertise – managers with the ability to source compelling and attractive deal flow and then add value to companies.

**Cabral:** We see capital flows moving from emerging markets back to developed markets. Investors are looking for fund managers with deep experience, stable teams and unique market niches that are generating realisations. Investors are more excited about the lower end of the middle market. They recognise the opportunity to generate strong returns through a hands-on approach to adding value to the tremendous number of high-quality smaller

European businesses. So firms with proven histories in the lower end of the middle market are seeing increased interest from investors. We're also seeing some of the more traditional larger firms coming down to the middle market in the hopes of meeting some of that investor demand. In addition, limited partners are insisting on seeing operating partners who are actively involved in portfolio companies. That is increasingly becoming a prerequisite for fund investment. We have practiced this for a long time and see it as a positive shift for the industry.

**Marcus:** As was always the case, raising a first time fund is difficult – LPs generally look to funds with a history of successful performance. In addition, LPs are consolidating their GP relationships so recent performance is critical for GPs to maintain their commitments from LPs. In addition, fund terms have trended more LP friendly over the past few years, and in some cases GPs now offer a menu of choices for different combinations of management fee, carried interest/hurdle rate, and transaction fee sharing in order to attract LPs with different requirements. We are also seeing an increase in the use of managed accounts by larger in-

vestors, which allows the investor to cut its own deal with the GP on terms.

**FW:** *What trends do you expect to see in private equity through 2012, and beyond?*

**Cabral:** The role of the operating partner and active ownership will continue to grow in importance as the industry continues to move toward adding value as the primary means of achieving returns. Additionally, the top private equity firms will continue to become better-rounded, more professional organisations with an increased variety of skill sets. This will make them better owners and smarter investors. The industry will continue to prove its merit as a valuable asset class that is able to generate returns in excess of public indices. The trend towards increased transparency and making private equity less 'private' will help to demonstrate this value to public audiences.

**Marcus:** With many funds chasing fewer available transactions, the competition for quality deals is likely to continue into the foreseeable future. In addition, until the global credit markets reach some level of equilibrium, the availability of debt financing is likely to remain more limited and subject to the volatility of the credit market swings. These factors are also likely to result in fewer 'megadeals' being completed.

**Kester:** I think that you will start to see limited partners increase their allocations to private equity. I think that it will become more evident to limited partners that private equity is still one of the best investment categories where significant alpha can be generated. Another trend that I think we will see through the remainder of this year and into next year is a robust exit environment for smaller companies based on the amount of capital that larger PE funds and strategic buyers have available to invest. ■

## OPINIONS ARTICLES

### Outlooks may dim, but the sun never sets on venture investing

BY MARK HEESEN

Over the past 30 years, US venture capitalists have earned a reputation around the globe as a fairly confident lot. This year, for the first time, the National Venture Capital Association and Deloitte & Touche tried explicitly to measure that confidence – and that of other

global VCs – in our annual global venture survey.

In hindsight, we may have picked the wrong year to debut our measure: On a scale of 1 to 5, with 5 being the most confident, responses from VCs across the globe averaged below 4

in most subject areas. That is a low number for an industry known for its optimism, but it may provide more insight into future trends than a higher average might have.

The fact that specific issues in individual markets like Europe and the US have dark- ▶

ened the entire global outlook speaks to how globally interconnected venture investing has become. Clearly, we now live in a global economy where the ramifications of economic struggles in one country impact the economies of other countries in significant ways. Even the US venture capital industry – once envied as a splendid exception among economic growth generators – is no longer immune to events in Europe, the Middle East and Asia.

Has the US venture model fallen victim to its own success? Probably not. However, venture performance in past decades has drawn significant interest from international investors – thus globalising US venture's base of limited partners. On the flipside, US venture investors have actively exported the venture model in search of new markets poised for explosive growth. In the process, they've shown US limited partners how to seek out opportunities overseas. These trends have made venture investing a permanently global game.

#### A light at the exits

Of course, any venture ecosystem – whether global or local – requires healthy and robust exit markets. While the market for initial public offerings in the US has been tepid, acquisitions have held steady. Yet, both markets must maintain momentum and uphold quality in order to draw more investment from limited partners in the coming years. Anecdotally, we're starting to see many LPs once again becoming interested in venture. However, market conditions will dictate how much money LPs put into venture

and what firms they choose to work with.

In the US, we expect that the JOBS Act of 2012 will have a tremendous impact on the entrepreneurial community. This law makes it easier for emerging growth companies to go public, and could help revive the sluggish US IPO market. While it is by no means a panacea, the JOBS Act has spurred a resurgence of interest by entrepreneurs in taking their companies public with many filing confidentially under the newly enacted provisions. That is a step in the right direction, even though we won't be able to measure the law's impact precisely in the short term.

#### IT shines brightly

In terms of sector outlooks, information technology offers the brightest outlook for US venture investing. Capital requirements and investment horizons are still favourable in IT. Within this sector, cloud computing and software generated the highest confidence among VCs in our survey. Facebook's rocky IPO has not blunted excitement and enthusiasm within this sector.

Contrary to the picture often painted by the media, the US clean energy space remains an important sector for venture investing. This sector will continue to fluctuate with changes in the policy environment, global political developments, and the markets for incumbent energy sources and technologies. But the persistent global demand for innovation in this space over the long run will make it a winner for VCs and their investors, as well as for energy con-

sumers worldwide.

#### Spotlight on policy

The connection between what occurs in Washington, DC and other capitals, and what the venture community invests in, has never been tighter. One of the clearest examples of this has been the recent flight of US medical innovation to foreign countries where the approval pathway for new drugs and devices is more predictable. However, improving communication and recent FDA legislation that focuses on preserving medical innovation in the US has the promise to change this.

Similarly, a government's view of its role in advocating for alternative forms of energy has played a major role in global clean energy leadership – as demonstrated by the different policy approaches pursued by China, Germany and the US, respectively. Looking forward, major US government initiatives in cyber security and immigration could create opportunities for new companies in these sectors. All of these factors will impact a venture firm's decision whether to invest in a particular emerging enterprise.

Amid the pessimism and uncertainty, however, one constant remains: a laser-like focus on exponential growth. Come hell or high water, venture capital will continue to flow globally and domestically, through regions, sectors and subsectors, in pursuit of it. ■

Mark Heesen is president of the National Venture Capital Association (NVCA).

## Expansion PE in Australia – an engine for growth

BY DR KATHERINE WOODTHORPE

Private equity in Australia, like the rest of the world, comprises a spectrum that ranges from early stage venture capital to global leveraged buyout funds. If you use the words 'private equity' in Australia the average business person will conjure up visions of the large leveraged buyout deals by global mega funds of companies that are household names. But the reality of private equity in Australia is very different from the perceptions that people might have.

The greatest number of funds in Australia lie in that part of the spectrum that we call growth or expansion capital funds. These are defined by AVCAL in the Australian context as being funds that are investing in established businesses (i.e., not VC) ranging in investment/equity value from A\$10-50m. They invest with

little or no leverage and may or may not take a majority position. They are sector-agnostic and might invest in industries such as mining services, retail, manufacturing and building products.

There are around 35 active funds defined this way in Australia, approximately 60 percent of the total number of funds resident here. They have a total of A\$6bn funds under management and own approximately 200 companies.

Such funds provide a substantial capital injection into the economy, which is invaluable. They help owners and entrepreneurs to monetise all or part of their position and the capital injected into the companies enables them to fulfil their growth potential and develop into valuable contributors to the economy.

There are a range of strategies employed

by fund managers in this segment and they often adopt a specialised approach. The largest number of acquisitions tend to be in succession planning opportunities, where family owned companies, with no natural successor, use a transition step of PE ownership to grow and develop the company into one suitable for listing or acquisition. With over 11,000 family owned businesses in Australia turning over more than A\$10m there are many such opportunities available for investment.

Of those companies, over two thirds are owned by baby boomers who often want to retire and have no succession plan in place. Most of those companies are not in a position to be attractive to acquirers; they don't want to sell to their fierce competitors and they are not suitable for listing. Many such owners find it ►►

## Australian expansion funds offer a strong opportunity for investors seeking alpha in these difficult economic times.

is the expertise of the PE managers, who put into place governance processes and recruit new senior staff, that they value as much as the additional capital injection.

Other expansion capital funds invest into rapidly growing entrepreneur-owned businesses that have capital constraints on their growth. Some of these can be household names even outside Australia, such as Aesop skin care which has flagship stores all over the world or Skins sportswear which is internationally renowned.

Some fund managers may have turnaround expertise or favour roll-up strategies to build critical mass from a number of small companies.

The expansion funds segment is good for investors too. While the listed equities market has been languishing in the doldrums, or worse, over the last four years, private equity has continued to be a good investment for

pension and endowment funds, and other investors. It has provided the only significant growth that such investors have seen in their portfolios, comprising most of their alpha. In Australia, private equity investment has been a strong performer over all time horizons over the last 10 years. Within the PE spectrum, expansion funds have been particularly good performers and AVCAL, in conjunction with Cambridge Associates, has developed an Australian PE Growth Index. The performance has been positive over every time horizon, in contrast to the local stock exchange index the S&P/ASX 300. As at 30 September 2011, growth funds returned 3.72 percent over one year (-8.7 percent for the ASX 300); 0.38 percent over three years (-0.1 percent); 7.8 percent over five years (-0.7 percent) and 17.1 percent over 10 years (7.3 percent). Looking at the figures from a different angle, more than nine percent of the companies exited by ex-

pansion funds in the last decade generated a money multiple of more than 5x.

Australian expansion funds offer a strong opportunity for investors seeking alpha in these difficult economic times. To date they have been largely funded from Australian domestic investors such as superannuation funds. However, with a combination of the super funds either reducing their programs in PE or globalising them, the Australian expansion funds have to turn to offshore investors for the first time. And those investors have proved to have a healthy appetite for the group. For example, CHAMP Ventures, which till now has been entirely domestically funded, has just closed its latest fund with over 50 percent of the subscription coming from overseas. Similarly Archer Growth has just raised a new A\$300m fund with 40 percent of offshore investors.

Australia offers growth opportunities akin to neighbouring emerging markets, while enjoying the mature and stable regulatory climate of a developed economy. This confluence of circumstances will continue to underpin the performance of the expansion funds segment of the PE market. ■

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## A framework for a global private equity industry

BY JENNIFER CHOI AND HOLLY FREEDMAN

Today's private equity industry is a multi-polar, global industry with an increasingly diverse array of players, strategies and markets. As investors worldwide search for growth stories, and regulators open their doors to investment, PE's expansion into new markets will continue to accelerate. Cross-border initiatives underway will create the frameworks necessary to increase efficiencies and encourage regulatory environments more conducive to private investment.

Private equity's push into new markets is happening on multiple levels. International PE firms are now competing with fast-growing national industries. China's explosion of fund managers in recent years is even challenging regulators to establish a local definition of what constitutes a private equity fund. Increased competition has encouraged firms to go deeper into regions where the industry's footprint is still nascent, but attractive investment opportunities exist. In Latin America,

international and regional firms are setting up offices in Colombia and Peru, in addition to the ones they already have in Brazil. The Asia PE landscape now encompasses more fully the Southeast Asian markets, including Indonesia, Vietnam and Thailand. In recent months, even markets entirely new to private capital such as Namibia, Malawi and Myanmar have gained watchful interest.

The growth of the global PE industry has been fuelled by an expanding investor base. Local fund managers have proliferated in part due to their ability to tap new, local sources of capital. Regulators in Latin American and Sub-Saharan African markets have made it possible for national pension funds to invest in the asset class and support the development of the local industry. Furthermore, a greater number of investors in developed markets are expanding their PE allocations to emerging markets. A recent survey of investors across developed and developing countries released by the Emerging

Markets Private Equity Association (EMPEA) in April 2012 found that 75 percent were expecting to increase their PE commitments to emerging markets over the next two years, compared with only 25 percent who anticipated an increase to developed markets. Limited partners are also increasing their investment activity through co-investment and direct investments, even setting up local offices in emerging markets.

Meanwhile, policymakers are opening their doors to investors believing in the transformative power of private equity to support economic growth and tackle unemployment. At the 2012 Global Private Equity Conference in Washington, DC, former President of the World Bank Robert Zoellick remarked in his opening address "I've seen from my discussions with our clients in developing countries around the world, just how important they consider the capital and expertise that private equity brings in helping their countries grow and raise stan- ▶▶

## It will be crucial to develop frameworks that strike the right balance between consistency and adaptability.

dards.” Emerging markets officials are looking across borders for legislative frameworks that are conducive to attracting investment, while providing adequate protections for investors, entrepreneurs and national interests.

In response to increasing engagement from policymakers and growing calls for guidance on international practices for regulating the asset class, EMPEA has worked with legal

counsel, fund managers and other industry stakeholders to develop the EMPEA Legal & Regulatory Guidelines. The Guidelines are aimed at arming investment professionals and regulators with a resource for a more structured and productive dialogue around legal and regulatory issues. This framework includes key elements proven to help develop a robust PE industry, including principles such as con-

formity to international standards of business and anti-corruption. The asset class needs tools like this one to enhance the quality of discourse between regulators and industry players within and across borders.

As the markets and investors continue to diversify, it will be crucial to develop frameworks that strike the right balance between consistency and adaptability. If executed successfully, these tools will shape an investment climate that better aligns the interest of all stakeholders in a multi-polar, global industry. ■

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## Private equity activity in Latin America

BY CATE AMBROSE

Surging interest in Latin America among global investors has driven historic fundraising by the region’s private equity managers in recent years, contributing to an environment that has come to be perceived by some as overheated. While capital is abundant and competition for deals intense in 2012, in the major economies of Brazil, Mexico, Colombia, Peru and Chile private equity investment as a percentage of GDP is still a fraction of that in developed and other emerging markets such as Asia.

There is a large stock of mid-sized, often family-owned businesses that are poised to serve expanding domestic demand for a wide range of goods and services. Real estate investors are seeking to address an undersupply in housing, commercial, office, and tourism space, and infrastructure funds have been raised to finance a wide range of projects, from energy to transport, water and sanitation.

With the exception of 2009, fundraising for Latin American private equity has increased every year since 2005. According to proprietary LAVCA data, in 2011 a total of \$10.3bn was raised for the region, surpassing the previous year’s record of \$8.1bn. In 2010, two Latin American fundraising powerhouses, Advent International and Southern Cross Group, closed the largest-ever regional funds at \$1.65bn and \$1.68bn respectively.

But in 2011 Brazilian asset managers dominated, with four firms raising \$7.3bn for five funds, and an additional \$800m committed to smaller funds. It would be easy to interpret the dominance of Brazil in 2011 fundraising as a

reflection of investor’s appetite for increased exposure to the world’s sixth largest economy. In fact the \$8.1bn of committed capital is more likely a vote of confidence in the track records of Brazilian asset managers, and the right-sized matching of \$1bn+ funds with global institutional investors looking to put larger sums to work in a single fund.

The influx of international institutional investors into Latin America since 2006 has occurred in tandem with the expansion of the region’s pension funds as LPs in private equity funds. Today, assets under management at private and public pension funds in Brazil, Mexico, Chile, Peru, and Colombia total \$785bn, and by one estimate medium-term potential investments in PE could total \$20-25bn.

Increasingly, local pension funds are playing a critical role in the development of the PE industry in Latin America. In Brazil, Colombia and Peru, local managers that got their start by raising first funds from local sources have now set out to raise capital internationally. In Mexico, the local pension funds have been active investors in local PE since 2009, backing over 20 vehicles dedicated to private equity, infrastructure and real estate.

New PE/VC investments realised in 2011 totalled \$6.5bn, a decrease from the 2010 total of \$7.3bn. The decrease may reflect a certain discipline on the part of veteran managers who resisted overpaying for assets while valuations were high and currencies strong. Of the total, about two-thirds, or \$4.2bn, was invested in Brazil, while Colombia and Mexico were represented with 9 percent and 13 percent of total

deals respectively.

Deals closed in 2011 reflected investment themes that have dominated in recent years, with a majority of dollars committed to transactions in energy, logistics and distribution, and sectors targeting consumer demand, especially for services. Investments in companies poised to capitalise on expanding consumer credit were popular targets, as well as in health care, and there were several large deals in regional fast food franchises.

One noteworthy trend over the last three years has been an increase in technology investing, ranging from investments in large data centres and software developers to internet start-ups and online gaming businesses – 46 of the 173 deals reported to LAVCA in 2011 were in the technology sector. Other sectors represented include manufacturing and agribusiness.

Perhaps the most important development revealed by 2011 LAVCA data was the remarkable number of exits realised. A historic record of \$10.6bn was raised through 37 divestments with financials disclosed, with another 16 exits reported without financial information. Latin American business and family groups and multinational firms seeking a foothold in the region were ready buyers of PE-backed assets. Exits in 2011 also included a total of seven initial public offerings on regional and global exchanges.

However, IPOs were concentrated in the first half of 2011, and the market has slowed significantly since then, with no new PE-backed IPOs in H1 2012. The volatility prevalent across global equity markets has reached Bra- ►►

zil and the rest of Latin America, making it increasingly difficult for private equity investors looking for exits on local exchanges.

Looking forward, the universe of institutional investors seeking exposure to Latin America as part of a broader emerging market strategy is likely to expand from what is still a relatively small base today.

However, anyone investing on the ground in Latin America today will quickly identify the greatest constraint to the success of the in-

dustry facing PE investors in the short- to mid-term as human capital.

In 2012, there is still a relatively small pool of PE managers with established track records of raising, investing, and exiting funds and delivering solid returns to investors. Competition to form investment teams and staff portfolio companies in Brazil and Colombia, in particular, is intense, with compensation surpassing that of many developed markets.

Fortunately, this reality is driving a new gen-

eration of Latin Americans to pursue careers in their home countries, often after they complete MBAs in the United States and Europe, creating a new pool of talented professionals who combine a global business perspective with deep local networks. ■

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## Non-EU private equity managers and the AIFMD

BY DONNACHA O'CONNOR

The European Directive on Alternative Investment Fund Managers (Directive 2011/1/EC) (AIFMD) is now high up on the agendas of most managers. It will become national law across the EU by 22 July 2013 and it is certainly time to hone in on the provisions of this new law. Managers based outside of the EU (non-EU AIFM) should not assume they can continue to privately place their non-UCITS funds (AIF) to EU investors as they have always done and that they will not be impacted in any other way by this new law.

### Marketing into Europe

The marketing passport under the AIFMD will only be available to EU AIFM and their EU AIF initially. By October 2015, the European Commission will decide whether EU AIFM will be permitted (but not required) to market non-EU AIF under the marketing passport. Non-EU AIFM which manage EU AIF may be required to register at this point. Non-EU AIFM which only market non-EU AIF into the EU will continue to be able to do so until at least October 2018. Around that time, the Commission will decide whether non-EU AIF can continue to be marketed in the EU using national private placement rules or whether they can only be marketed using the EU marketing passport.

From no later than 22 July 2013, each Member State is permitted, but not obliged, to allow non-EU AIFM to market AIF to professional investors in that Member State under the Member State's own national private placement rules, without the marketing passport, provided that: (i) the manager complies with the AIFMD's transparency requirements of Article 22 (see 'Annual Report' below), 23 (see 'Disclosure to investors' below) and 24 (see 'Obligations to report to EU regulators' below) in respect of each AIF marketed by the manager in this way and with Section 2

of Chapter V of the Directive where an AIF marketed in this way acquires control of an EU registered non-listed company (see 'Obligations when acquiring control of non-listed companies' below); (ii) there is a cooperation arrangement for the purpose of systemic risk oversight between the regulators of the EU Member States where the AIF is marketed, between those Member States and the home jurisdiction of the AIFM, and between those Member States and the home jurisdiction of the AIF; and (iii) the country where the AIF is established is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

There are a number of important considerations here. Firstly, the Directive allows, but does not require, Member States to allow private placement, so the marketing of AIF without the marketing passport will need to continue to be looked at on a Member State by Member State basis as is currently the case. Secondly, while the Directive recognises the private placement rules of each Member State, it only permits Member States to allow non-EU managers to market to 'professional investors' as defined in Annex II to Directive 2004/39/EC (the EU's Markets in Financial Instruments Directive) and may impose stricter requirements on AIFM marketing to retail investors: what this means is that in certain EU Member States, the type of investor to whom a non-EU manager may be permitted to market post-AIFMD and the conditions under which it may market to such investors may potentially be more restrictive than is currently the case. Thirdly, the Directive also explicitly permits Member States to impose stricter rules on non-EU AIFM and non-EU AIF than on EU AIFM and EU AIF marketing in their territories. Finally, substantial transparency requirements and portfolio level requirements

apply as set out below.

### Transparency requirements

#### Annual Report

Article 22 will require non-EU AIFM to cause each AIF which it markets in the EU to be audited annually. These audited financials must be provided to investors upon request and must be made available to the national regulator of each EU country in which the AIF is marketed, in each case no later than six months from the AIF's financial year end. The accounting information included in those financials must be prepared in accordance with the standards of the third country where the AIF is established. The audited financials must contain a number of what might be regarded as standard features of annual reports, but must also disclose the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries, and, where relevant, carried interest paid by the AIF. Much of the detail regarding the content and format of the report will be set by the European Commission in its Regulation supplementing the AIFMD (the Level 2 Regulation).

#### Disclosure to investors

Compliance with Article 23 requires the manager to make available to investors certain information before they invest in the AIF and upon any material change to that information. The disclosure requirements under Article 23 include many matters which might be regarded as standard. It also requires a description of the AIF's liquidity risk management, a description of preferential treatment (for example by way of a side letter) or the right to obtain preferential treatment that an investor has obtained, the type of investors who obtain such preferential treatment. Financial data ►►

## The transposition deadline for the AIFMD is fast approaching and non-EU managers need to focus their attention on the practical impact of its provisions.

such as the latest net asset value and the historic performance of the AIF, where available, as well as a description of its valuation procedures and pricing methodology must also be made available to investors prior to investing. The AIFMD must periodically disclose to investors the current risk profile of the AIF, the risk system operated by the AIFM, any new arrangements made for the management of liquidity risk in the AIF, the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature (such as side pockets) and the total amount of leverage employed by the AIF and any changes to the maximum level of leverage which the AIF may employ. The content of disclosures to investors regarding liquidity, risk management and leverage will be set out in the Level 2 Regulation.

### *Obligations to report to EU regulators*

Article 24 provides that the AIFM must regularly report to each Member State in which the AIF is marketed, on the principal markets and instruments in which it trades on behalf of the AIF, the main instruments in which it is trading, its principal exposures and most important concentrations. This Article also requires the AIFM to provide to each such Member State the information which Article 23 requires the AIFM to disclose periodically to investors. Importantly, Article 24 provides that where necessary for the effective monitoring of systemic risk, each Member State in which the AIF is marketed may require more

information on a periodic as well as an ad hoc basis. In addition, in exceptional circumstances, the European Securities Markets Authority may request a Member State to impose additional reporting requirements. The content, frequency and format of the reporting will be set out in the Level 2 Regulation.

### **Obligations when acquiring control of EU non-listed companies**

Article 26(1) provides that AIF which either individually or jointly, on the basis of an agreement aim at acquiring control, acquire control (i.e., more than 50 percent of the voting rights of the company with anti-avoidance provisions included to aggregate shares held by related entities) of a non-listed company domiciled in the EU (subject to limited exceptions for small and medium sized companies), are required to comply with Articles 26 to 30.

Article 27 provides that when an AIF acquires, disposes of or holds shares of a non-listed EU registered company, the AIFM must notify the competent EU Member State regulator of the proportion of voting rights of the company held by the AIF when that proportion reaches, exceeds or falls below the thresholds of 10, 20, 30, 50 and 75 percent.

Articles 27 and 28 require greater transparency around portfolio transactions, for example, AIF bidders will be required to disclose to the target company and the shareholders of the company (of which the identities and addresses are available to the AIFM) their intentions with regard to the future business of the

target and the likely effect the transaction will have on employment, including conditions of employment. In addition, the AIFM must use its best efforts to ensure that this information is provided to the company's employee representatives or, where there are none, the employees themselves. The AIFM must also provide the relevant EU Member State regulatory authority and the investors in the AIF with information regarding the financing of the transaction.

Article 29 provides that where an AIF acquires control either the target's annual report or the AIF's annual report must include a fair review of the development of the target's business over the relevant period, the target's likely future development and other matters.

Article 30 contains the AIFMD's asset stripping rules. It provides that once an AIF acquires control of a target company, it must, for a period of 24 months, not facilitate, support or instruct, not vote in favour of and use its best efforts to prevent, any distribution, dividend, capital reduction, share redemption and/or acquisition of its own shares by the target where as at the company's last financial year end the target's net assets are, or, following the distribution, would be, lower than the target's subscribed and called capital, plus any reserves that may not legally be distributed, or, the amount of the distribution would exceed the target's profits from its last financial year plus any profits brought forward and reserves available for distribution, less any losses brought forward and sums legally required to be placed in reserve.

### **Conclusion**

The transposition deadline for the AIFMD is fast approaching and non-EU managers need to focus their attention on the practical impact of its provisions to ensure that how they market AIF in the EU and how they structure their acquisitions of non-listed EU registered companies are adjusted accordingly. ■

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## Private equity in Germany: a promising outlook for 2013

BY PETER MEMMINGER

The private equity market in Germany can now be considered a mature market with a number of international and local players operating in an established en-

vironment and focusing on various market sectors. While this statement would have needed to be qualified by various caveats 10 or 15 years ago, the PE industry has since

developed further, weathered difficult market conditions such as the post 2007 crisis and the locust debate initiated by German politicians, and is today in a shape where ►►

## A number of medium sized exits in the €300-500m range are currently prepared by private equity players to enter the market in Q4 2012 or Q1 2013, assuming that market conditions will have improved by then.

success is not generally available to all market participants, but rather to those with an established brand, a high specialisation and a high level of sophistication. While this has led to the withdrawal or slow demise of a number of market participants, this should not be seen as a negative sign, but rather as proof that the market in Germany is now also mature, though the number of private equity related transactions when measured against the size of the German economy remains below comparable levels in the UK and US.

### The general market environment

The market environment for private equity in Germany is positive overall. Private equity transactions can be negotiated on the back of a developed and reliable legal system which does not disadvantage private equity transactions, but rather treats them in the same manner as every other transaction. While some changes in the tax system in recent years have limited the possibility of offsetting financing expenses in a leveraged deal with the positive cash flow of the target company, such a mechanism is *per se* recognised and available in Germany, and the legal certainty around it has actually increased due to specific changes in corporate law. Likewise, public takeovers can be undertaken on the basis of a takeover code that has proven its functionality in numerous transactions. Further, there are no changes in corporate or tax laws currently being discussed which may have a major impact on private equity transactions (apart from the AIFMD directive which has an impact on the administrative burden of the general partner of a private equity fund, but not on the transactions contemplated by them as such), so that the above mentioned reliability and stability of the legal environment will continue in the foreseeable future.

The same applies to other factors such as sophistication levels of intermediaries, service providers, financing banks and general market perception. There is by now a well-developed private equity industry in Ger-

many, consisting of a number of banks, law firms, accountants and other intermediaries and service providers with dedicated private equity teams located in Germany, available for both existing and new players. While a good market reputation and proven track record of a private equity firm does certainly help in getting the 'right' transaction being presented or debt financing being offered, Germany is by no means a closed market which would preclude committed, new players from entering.

### The players

As the market has become more mature and partially also due to the severe crisis that hit the market in 2007 and thereafter, one can see (not only in Germany) a consolidation process among private equity players. This can be explained by the fact that, as a result of the more challenging market conditions post 2007, which has led to decreasing returns for investors in private equity funds and generally a higher sophistication and experience level among them, existing and potential new investors now more closely monitor the performance of the respective private equity fund and commit capital only to those funds that have an established track record of either above average return rates or of a reliable business model. As a result, fundraising for less successful funds or new market participants has become increasingly difficult. Yet, there is still a large number of both international and national private equity players focusing on the small, medium or large deal segment and following either a general or a more sector specific approach. Further, one can find funds with a situation-specific investment focus, such as venture capital, distressed investments, minority stakes or active investments in publicly listed companies. When comparing this with the market environment in established markets such as the US or the UK, one sees that the German market has by now attracted the same wide diversity of private equity firms, although the absolute number of players in each of these segments is lower than in the

aforementioned countries.

### Current market condition and outlook

The private equity industry, much like the general M&A industry, had been significantly impacted by the 2007 crisis and its aftershocks. Deal volumes and numbers significantly dropped – in certain segments, such as large deals, by over 50 percent – compared to before 2007, along with an increase in the number of distressed investments. While the market had thereafter stabilised and even improved over Q4 2011 and Q1 2012, with a number of small and medium sized transactions, and even one multi-billion euro transaction, the euro crisis with all of its implications for the economy, business prospects of companies and availability of debt financing, has slowed down the recovery in Q2 2012.

Again, sufficient availability of debt financing, particularly for large transactions or businesses with a more cyclical cash flow profile, has become a topic, together with a mismatch of purchase price expectations between sellers and buyers due to uncertainty around business development over the coming months and years as a consequence of the ongoing euro crisis. However, there is significant appetite for transactions among investors as soon as these uncertainties diminish, and in fact a number of medium sized exits in the €300-500m range are currently prepared by private equity players to enter the market in Q4 2012 or Q1 2013, assuming that market conditions will have improved by then.

Hence, the overall outlook for the private equity industry in 2013 looks promising – but there is one factor still missing before we can expect a huge uptick in dealflow for private equity buyers: willingness among owners of the so-called 'Mittelstand' companies to sell their businesses. This trend, due to the age profile of the owners of such companies, has been forecasted to happen for some years, but has not yet occurred. It may be that these businesses are in excellent shape, with cash flows available to the owners that exceed what they could achieve elsewhere if they were to invest the otherwise received purchase price. Whether this will change soon remains to be seen, but other developments, such as, for example, an increase in outsourcing transactions between large corporates and portfolio companies of private equity players, look promising for 2013. ■

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# Luxembourg legislative changes to approach AIFMD compliance

BY JOHAN TERBLANCHE

As the largest fund domicile in the European Union and the second largest in the world, Luxembourg has traditionally been at the forefront of developments in relation to regulated collective investment funds. Asset managers, investors, practitioners and even regulatory authorities have been overwhelmed by the recent wave of regulatory changes across the globe. For professionals engaged in alternative investments in Europe or with a European connection, the most significant of these developments has been the adoption of Directive 2011/61/EU on Alternative Investment Fund Managers (the AIFMD).

Shortly after the adoption of the AIFMD and even before finalisation of the level 2 measures, the Luxembourg legislature took the opportunity to overhaul and improve the highly popular specialised investment fund (SIF) regime by introducing amendments which were aimed at aligning the regime applicable to SIFs with the main provisions of the AIFMD whilst integrating recent developments introduced for other types of Luxembourg funds and finally consolidating regulatory practice as applied by the Luxembourg regulator for the financial sector (the CSSF).

## Changes to align to AIFMD provisions

The law of 26 March 2012, which entered into force on 1 April this year (the Amendment Law), amended the law of 13 February 2007 on specialised investment funds (the SIF Law) and introduced a number of provisions which apply to all SIFs, regardless of whether or not they fall within scope of the AIFMD. These changes, which can be informally grouped as 'conduct of business' rules, aim at establishing best practice for all alternative investment funds to which the SIF regime applies.

It is now required that all SIFs implement appropriate risk management systems to allow the detection, measurement and management of risks associated with portfolio positions and their contribution to the overall risk profile of the portfolio. SIFs will also need to ensure that they are structured in a manner that minimises potential conflicts of interest. A short grandfathering period, which expired on the last day of June, was introduced to allow existing approved SIFs to comply with the new requirements in relation to the implementation of risk management policies and to ensure that potential conflicts of interest are minimised. In practice, existing SIFs have adopted and implemented both risk management

## It is now required that all SIFs implement appropriate risk management systems to allow the detection, measurement and management of risks associated with portfolio positions and their contribution to the overall risk profile of the portfolio.

and conflicts of interest policies and communicated these to the CSSF. New SIFs communicate their risk management policy and organisational measures to minimise conflicts of interest to the CSSF as part of their application to be authorised as specialised investment funds.

In addition to the requirements in relation to risk management and conflicts of interest, new SIFs will also need to meet specific requirements in instances where certain functions are delegated to third parties. In cases where portfolio management is delegated, a qualitative test has been introduced. Any delegatee must be authorised or registered for the purpose of asset management and subject to prudential supervision. If the delegatee is a third country (i.e., non-EU) manager, a cooperation agreement must be in place between Luxembourg and the relevant other country. If the delegatee is not authorised or registered, or no cooperation agreement is in place, the delegatee must be approved by the CSSF for the purpose of delegation of asset management, before it may act as investment manager. In addition, a specific prohibition on delegation of investment management functions to the depositary has been introduced. For existing approved SIFs, a longer grandfathering period (expiring on 30 June 2013) applies in relation to delegations.

## Changes to align with rules applying to other fund regimes in Luxembourg

Following on from recent amendments introduced in the law of 17 December 2010 on Undertakings for Collective Investment (the Fund Law), the Amendment Law introduced a number of other adjustments. Most notable of these is the possibility for a sub-fund of an SIF structured as an umbrella fund to invest in other sub-funds of the same SIF. In the case of SIFs, there is much less restriction in this context than applies to other fund

regimes in a similar situation. This opens myriad possibilities, for example in the context of tailoring platform funds to specific investors' needs with specific allocations (in a dedicated sub-fund) to the various primary strategies (housed in other sub-funds of the same fund).

Other improvements include the removal of the requirement to translate English language articles of incorporation into one of Luxembourg's official languages and the removal of the requirement to attach the annual report to the notice convening the annual general meeting of shareholders.

## Changes to align with CSSF practice

The legislature also took the opportunity to codify certain elements of regulatory practice. A few examples are: it is now a strict requirement that an SIF obtains CSSF approval before it is launched; any relevant changes to the offering document requires prior approval by the CSSF; and the CSSF's authority to request further documentation and information, to conduct on-site visits and to take other measures in order to exercise its functions has been significantly extended.

The Amendment Law also provides clarification on one or two aspects where a measure of uncertainty prevailed.

## Conclusion

The changes to the SIF regime have been largely welcomed by industry and have further improved the attractiveness of the specialised investment fund as the fund of choice for alternative assets when there is a European connection (be that investor location, asset location or the location of the manager). It is expected that from next year onwards, investors in alternative investment funds will have essentially two options in terms of investing either in funds which are subject to harmonised ►

pan-European regulation or in funds which are not. Luxembourg SIFs are ideal vehicles for both situations, with best-practice standards in relation to risk and conflicts management as well as delegations applying to SIFs whether they (and their managers) fall within or outside of the scope of application of the AIFMD.

While the recently introduced changes are seen as the first step in the process, the full

AIFMD 'legislative package' (which will apply to managers who fall inside of the scope of the AIFMD) will be implemented in Luxembourg before the end of the year and a new Anglo-Saxon style limited partnership will be introduced. SIFs and their managers which fall inside the scope of AIFMD and which comply with the provisions of the SIF Law (as amended) may be required to make some

limited adaptations to fully comply with the post-AIFMD regulatory environment but, by complying with the recent changes, they can ensure that any future adaptation will be minimal. ■

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## Private equity in India: still an emerging story

BY HIMANSHU NARAYAN AND AMARTA ROY

Having contributed to nearly 40 percent of all foreign direct investment received by India over the past decade, notwithstanding 'quarter on quarter' reports, private equity continues to be an influential participant in India's growth story. While on sheer numbers PE activity in the country may not appear as robust as in the heydays of the Indian economy in 2007, it is premature to draw adverse inferences as to PE interest in the country.

Publicly available information suggests that in the first quarter of 2012, India received US\$1.8bn worth of PE investments in 91 deals. While in number terms there has been a decrease in the number of deals since the previous quarter, the amount of PE investment received actually increased by over 50 percent, with five deals in the quarter in excess of US\$100m. In a similar trend, while June 2012 saw only a 10 percent increase in the number of PE deals announced, deal value was the highest in the past 12 months, with three transactions over US\$50m.

These numbers perhaps provide a good aperture view of the PE environment in India today. For the attendant economic problems (in the world in general), and concerns about government action in India notwithstanding, the PE establishment bias in favour of India's potential for growth and demand for capital remains. Thus, the greater caution being shown by PE and Indian promoters before finalising an investment today relates in many ways to the lessons learnt from experiences in 2006-08. Exiguous return prospects from a few of the investments made in the eagerness to become a part of the India story in 2006-08 have crystallised the need for enhanced diligence and circumspection in agreeing valuations of a potential target. This is perhaps more true of mid cap investments between US\$10m and US\$50m – a substantial portion of which were earlier made into family controlled businesses. Thus, each of the venture

### In the second quarter of 2011, PE funds seeking money from investors reached an all time high and PE firms raised between US\$10bn and US\$12bn to be deployed in India.

capital deals (usually less than US\$10m) for start-up ventures with high growth potential and high cap investments (above US\$50m) have not witnessed any significant change in PE investment patterns and are staple of the aggregate PE investments in India presently.

Significantly, the greater emphasis on ascertaining the valuation, whilst perhaps increasing the time from termsheet to investment, has not dampened the appetite for PE investment in India. In fact, in the second quarter of 2011, PE funds seeking money from investors reached an all time high and PE firms raised between US\$10bn and US\$12bn to be deployed in India. Further, most funds based out of India are well capitalised at present and PE firms are presently focusing on deploying these funds in sectors which service some of the Indian economy's strongest facets and are, relatively, agnostic to economic slowdowns.

With the capital markets presently being an unpopular choice among Indian promoters looking to raise finances, promoters are increasingly turning to PE firms to raise finances for their respective companies. Secondly, while IPOs are not being undertaken at present, there are a host of good IPOs expected to hit the market once sentiment improves, giving further fillip to the market. In the interim, the recent history of exits via secondary or strategic sales continues to repeat itself, and

there have been multiple instances of exits via these routes. Interestingly, given that many of the companies from which existing PE investors are exiting have not yet achieved their full growth potential, there are increasing instances of secondary sales where the new PE firm not only acquires but also subscribes further in the Indian company. The recently changing dollar to rupee equation has put pressure on exit valuation discussions, but in a positive sense has also facilitated PE entry discussions. Of the US\$31.5bn invested by private equity funds from 2006 to 2008, less than 10 percent had exited by the end of 2011. With the average PE investment cycle (for investments of this vintage) coming to an end now, the exit environment for PEs continues to be progressively robust.

As an additive to the PE ecosystem in India, market participants are less discomforted today by the previous concerns on options and are adjusting to the legal regime relative to public market takeover transactions. Certain changes introduced in the recent budget have the effect of impeding earnout type transactions, and market participants will have to assess how to factor these into transactions.

Changing economic conditions have merited an evolution in the sectors receiving PE interest. Broadly, PE firms are increasingly focused on sectors servicing the demands of Indian ►►

consumers for essential goods and services which PE firms believe will not be adversely affected by economic slowdown. Thus, in recent quarters, along with certain traditional PE favourites, sectors which are not capital intensive yet promise high volumes and reasonable value businesses, such as education, hospitality and food and beverage (cooked food or branded food), are witnessing increasing attention. The philosophy is rooted in India's ability to absorb large amounts of capital in these sectors, as they service almost unparalleled levels of demand in the domestic market – this is further reflected in the significant increase in deal activity in the healthcare sector, with hospitals and other healthcare companies as beneficiaries. This shift in approach has also removed shackles of geographic confinement for PE firms; as these sectors look to service pan Indian demand, the horizon for PE invest-

ments has expanded from the metropolitans to tier II and tier III cities.

That said, IT and IT services, BFSI and the energy sector continue to experience PE interest and investment. The financial services space has been experiencing a significant uptick both in number of deals, and deal sizes. The real estate sector is benefitting from renewed PE interest, despite a slowdown in home and office sales across cities, with the first quarter of 2012 actually seeing a near 100 percent increase in both the number of deals and the average deal size.

Summarising the PE story in India is perhaps as difficult as it is premature to write its epithets. India is presently in the midst of only its first PE investment cycle and a lot of lessons are being learnt as the economy's partnership with PE evolves. But optimism about this partnership remains strong and market

sentiment even in such times suggests PE will continue to be a driving force in the economy's growth.

There are market participants who believe that the high value PE transactions in the preceding quarters signposted the recent reiteration by the Indian prime minister that "the mood in the market is worse than the mood on the ground". PE can lead the way in translating the mood on the ground to the mood in the market. Even sceptics acknowledge that moderated sentiment driven by perceived government inaction can have the unintended effect of managing promoter valuation expectations, thus accentuating deal activity. ■

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## Planning for the recovery

BY JULIAN ELMS

With the difficult global stock market environment, many companies with the ambition to float will be anxiously awaiting an improvement in economic conditions. Recent well-publicised, and arguably over-hyped IPOs, have shown how easy it is for there to be disappointment post flotation. The IPO pipeline reportedly has hundreds of companies queuing for the right conditions for their listing to go ahead.

This pause is an opportunity to reflect on the planning needed when the public offering finally proceeds, and in particular the robustness of a company's risk management and corporate governance. It cannot be over-emphasised that a major element of these rules concerns the nature and extent of accountability in any business.

As part of the flotation process, companies produce information such as both preliminary and final prospectuses, circulars and offering statements that are filed with appropriate regulatory and stock exchange authorities. Also, companies will formally present on their road show, outlining their case to potential investors.

From the publication of this information comes the risk of being exposed to civil and criminal liabilities. Any resulting liabilities may threaten the directors who signed the prospectus as well as the offering company itself. Also involved are the underwriters of the issuance and any adviser. The selling or controlling shareholder will also be exposed to possible

## The failure to disclose information in a prospectus or via any representation allows for the possibility of misstatement or misleading statements and heightens the potential for litigation.

liability when it looks to exit the investment. The prospectus for the IPO will provide investing shareholders with considerable information on historical financial performance as well as future prospects – ultimately the decision to invest will be made upon these details.

Only with adequate procedures to independently verify and safeguard the integrity of the company's reporting can this information be accurate and comply with the securities law of the territory of the applicable stock exchange. With the required transparency being higher than ever before, the failure to disclose information in a prospectus or via any representation allows for the possibility of misstatement or misleading statements and heightens the potential for litigation.

So, what can be done to plan for potential litigation?

A culture of risk management is key to any

successful company. The board of directors is a vital mechanism through which risks should be identified and managed. Without the appropriate systems and controls, major losses and damage to reputation will occur. But with the right approach most risks can be managed and mitigated. Insurance is designed as part of this planning and many companies embrace this approach when directors of a company purchase a directors and officers liability policy for their day-to-day liabilities that might attach through management negligence. However, most D&O policies are a 12-month annually renewable contract and, irrespective of it being renewed, there is no doubt that such a potential break in cover introduces an element of unpredictability. It is in fact an undesirable feature and perhaps not a preferred way of doing business, however company risk profiles will change over time and so insurers will always insist on the 12- ▶▶

month rule.

Outside of a D&O contract there is an insurance solution that is arguably superior for IPOs. A Public Offering of Securities Insurance (POSI) policy can be purchased for a continuous period of up to six years (or perhaps longer if necessary). It can specifically be tailored for the IPO and can even be included in any follow-on offering should that be viewed as prudent to do so. Debt offerings could be an added option.

A single aggregate limit of liability will be ring-fenced from any other corporate insurance policies. This will mean protection for the IPO exposure from any other liabilities that might arise from the ordinary operation of the company and be unconnected with the IPO. Therefore, dilution of the limit is avoided and the insurance aggregate purchased remains exclusive to the IPO transaction.

From an insurer's perspective, the jurisdiction in which the offering is taking place in the world is a major consideration when calculating premium. The US will be viewed as the most hazardous because of the potential for class actions. The business sector in which the company operates and how established the company is in its chosen market are important factors and can be indicative of the likelihood of a claim.

An all-encompassing policy, it will also include liability attaching to the company as well as its directors and officers. Again, cover can be

broadened or reduced depending on the preference of the policyholder. Cover will be for a 'prospectus claim', which means any written demand – be it civil, criminal, regulatory, etc. – that seeks compensation. A retention or excess will be applied for the corporate liability; this again will be dependent upon where the offering is and the size of the transaction. It would be common for the US, with the greater potential for claims, to have a US\$250,000 or more retention applied. It may be that a coinsurance element is applied if the insurer views an offering as particularly high-risk.

Coverage afforded under these policies has become wider as capacity and competition in this area increases, although it has not developed as fast as the D&O arena, with some brokers adding the exposure into a D&O policy.

One area of cover that has recently evolved is that of investigation costs. This means there does not have to be a formal prospectus claim for the policy to be triggered – simply the need for there to be an investigation by the authorities concerned. Cover can be available for legal representation when authorities are examining the affairs of the company or the conduct of the directors in relation to the IPO.

Exclusions are broadly in line with a standard D&O policy. Understandably, these are mostly concerned with excluding dishonest and criminal acts that will apply once a final adjudication has been made by a court on the matter.

A single premium for the IPO makes this a one-off expense. Similarly to a D&O premium calculation, there are a number of important factors that will be taken into account. Aside from the jurisdiction of the offering, the business activities and historic success of the business there are additional angles to consider. A major factor will be the size of the offering.

Another important matter to appreciate when purchasing this type of insurance would be to assess what sort of relationship the prospective insured company already has with its existing D&O insurers. If no such contact exists, it may prove to be more difficult to get the type of deal the insured is looking for. Many companies now meet with their D&O insurers to update them on the progress of their business on a regular basis.

Of course, the broker involved needs to be familiar with this class of insurance and advice from a broker with expertise in this area will be essential.

With the apparent increased risk from often-hyped offerings, it appears to be increasingly hazardous to go through an IPO. Purchasing IPO insurance against the threat of litigation is set to become a vital part of the planning process. ■

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