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Private Equity in the United Kingdom

Dechert LLP

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Dechert partnered with *Getting the Deal Through* and *Law Business Research* on their annual Market Intelligence Private Equity Guide. The Guide invites leading practitioners to reflect on evolving legal and regulatory landscapes and global trends. Private equity experts from Dechert's Corporate, Tax and Financial Services practices in London provided the UK content which is in Q&A format and is reproduced below.

Please click here to access the full Market Intelligence Private Equity Guide.

Dechert Authors

Jonathan Angell
Partner, Corporate
London
E: jonathan.angell@dechert.com
T: +44 20 7184 7586

John Markland
Partner, Corporate
London
E: john.markland@dechert.com
T: +44 20 7184 7887

Christopher Gardner
Partner, Financial Services
London
E: christopher.gardner@dechert.com
T: +44 20 7184 7460

Daniel Hawthorne
Associate, Tax
London
E: daniel.hawthorne@dechert.com
T: +44 20 7184 7327

1. What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

Jonathan Angell (JA): The private equity market in the UK and, indeed, much of Europe and elsewhere, is multi-layered. UK private equity sponsors operate very successfully across a range of sectors at all levels, from seed and venture capital funding, to large (multibillion pound sterling) buyouts. It is therefore difficult to generalise, without being caught out by the inevitable exceptions.

In at least one respect, activity levels in the UK have remained broadly stable: the UK private equity market consistently represents more than 25 per cent of private equity activity across Europe (by both deal size and deal volume). That, however, is where the 'stability' ends. In the past 12–18 months there have been discernible peaks and troughs in deal activity, influenced (to a greater or lesser degree) by wider events (the most (in)famous being, of course, the Brexit vote in June 2016 but also the UK general election earlier this year). Low deal values in the fourth quarter of 2016 were matched by low deal values and volumes in second quarter of 2017 (according to reports, deal volume in the second quarter of 2017 was the lowest since 2009). At the same time, the first half of 2017 saw the UK remain the standout European jurisdiction in terms of value. As always, statistics can be misleading and large transactions (or the absence of them), in particular, can have a disproportionate effect; there have been a number of large and very large UK deals this year. That would suggest that the UK mid-market and below has been hit hard. However, in our experience, even when activity levels have undoubtedly been affected, there are still opportunities.

Not surprisingly, in the immediate aftermath of the Brexit vote we saw a tail-off in M&A (and private equity) activity. The lengthy negotiations, and seemingly limited progress, on the actual terms of Brexit have done little to encourage private equity and M&A activity. Although it is difficult to be certain, in many instances this seems to be a case of 'wait and see' rather than a permanent abandonment. Private equity clients, and other market participants, seem to be adopting a watching brief. At least for the short term, our view remains that the only certainty is uncertainty.

2. Looking at types of investments and transactions, are private equity firms continuing to pursue straight buyouts or are other opportunities, such as minority- stake investments, partnerships or add-on acquisitions, also being considered?

JA: Sourcing and origination remains challenging in the UK M&A market, not merely for private equity sponsors. High-quality opportunities are in relatively short supply and, when they do arise, are often subject to intensely competitive demand. For private equity sponsors, this demand is currently heightened because many trade or strategic buyers have large amounts of cash to deploy and are also often able to increase their offer to reflect anticipated synergy benefits. Counter to that, private equity sponsors have huge amounts of dry powder remaining, and multiple sources of debt (for the right asset or opportunity). Understandably, many private equity sponsors continue to look for opportunities outside or beyond competitive auction processes (which is easier said than done).

Against this landscape, it is not surprising that valuation (pricing at entry point) remains the key concern of general partners and limited partners in the first half of 2017 as in 2016; a perceived risk that private equity managers may overpay for assets, given reduced and competitive deal flow.

In terms of private equity buy-side activity trends, we are seeing fewer 'traditional' buyout transactions (in absolute and relative terms), and an increase in other approaches: portfolio acquisitions; buy-and-build

strategies; and alternative investment structures and transactions, including minority stakes, corporate control transactions, club and consortium deals (including private equity and trade combinations), and growth investments. Some sectors remain comparatively strong, such as life sciences, fintech and, perhaps more surprisingly, consumer, and oil and gas.

3. What were the recent keynote deals? And what made them stand out?

JA: Two recent deals stand out. The first is Chrysaor's acquisition of a portfolio of oil and gas assets in the UK North Sea from Shell (for a consideration of up to US$3.8 billion). Chrysaor is backed by US private equity group EIG (through its investment vehicle Harbour Energy). The transaction attracted much media attention, not least because of the boost to the UK's oil industry.

The second example is Mid Europa Partners' acquisition of Profi Rom Food from Enterprise Investors. Not only is this Romania's largest ever leveraged buyout, but it was a fiercely competitive auction process (with many other private equity houses involved), with a large appetite from debt providers to fund the debt portion of the deal. It also illustrates a trend both for UK (and other) private equity firms to look for investments that provide better opportunities (than the more mature domestic UK and western Europe markets), and the 'export' of Anglo-Saxon deal methodologies.

4. Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? Are those challenges evolving?

JA: On the first issue, the answer depends, in large part, on the size of deal. Venture capital investments and mid-market private equity transactions tend to have a stronger UK nexus and are often either domestic UK or with limited cross-border involvement. Although some what a generalisation, a larger target company or business is more likely to have international operations (or plans) and therefore require cross-border expertise. In addition, many private equity funds are targeted at a specific jurisdiction or region. One trend in this respect, undoubtedly driven by investor appetite, but also by the ongoing challenge of deal origination and sourcing mentioned earlier, is the proliferation of funds focused on different geographies (emerging markets being a prime example) and non-traditional private equity areas (such as credit funds).

With regard to the second question, at its most basic, a cross-border element adds a layer of complexity. Multiple jurisdictions will almost certainly affect the tax structuring and add a layer of complexity to the debt and acquisition financing (both in terms of any debt push-down and security). The challenge is ensuring that this does not become a problem to the overall deal – either substantively or logistically. There is, simultaneously, a positive and a negative aspect to being a UK-based legal adviser. On the plus side, English law is (and, notwithstanding Brexit, should continue to be) a significant 'export' of the UK, generating many cross-border transactions and opportunities. At the same time, the 'Anglo-Saxon deal methodology' that English legal advisers typically adopt may not be familiar (or universally welcome). Whether the transaction involves working with our non-UK offices across the globe or, in jurisdictions where we do not have an office, with independent law firms (where we maintain good relationships), the objective is to identify any local law requirements quickly, and in a collaborative manner. These requirements can often be procedural or items of detail and easily solved, but, if left to linger, can become more problematic.

5. What are some of the current themes and practices in financing for transactions? Have there been any notable developments in the availability of debt financing or the terms of financing for buyers over the past year or so?

John Markland (JM): The past year saw borrowers continuing to take advantage of the highly liquid lending market conditions, with many borrowers turning to the European market for institutional loans in preference to high-yield bonds and 'Yankee Loans' (also known as US TLBs). The market demand (outweighed by the volume of funds flowing into the market) was such that a significant number of borrowers used such debt to refinance (or reprice) existing debt, take out existing high-yield bonds with term loans or to upsize existing facilities and return value to the sponsors through dividend recapitalisations.

The pricing advantage of these term loans over high-yield bonds was not the sole driver behind this trend. The market is increasingly tolerating very limited to no call protection on these loans in contrast to the non-call restrictions on high-yield bonds.

With bond-style financial covenants (including covenant-lite and covenant-loose structures) increasingly accepted in the European market, borrowers have sought to negotiate more flexible (or, depending on one's view, looser) covenants. Borrowers have negotiated the ability to incur an increasing amount of incremental or additional debt using fixed basket amounts and ratio- based tests. Restrictions on borrowers making distributions to investors have increasingly been relaxed through lowering applicable leverage ratio thresholds and using consolidated net income (or excess cash flow combined with other sources) (often accompanied by a 'starter basket' providing immediate capacity), as a basis for calculating such permitted payments.

As long as market conditions remain so favourable to them, borrowers can be expected to continue to negotiate for greater flexibility and the loosening of covenants in their financing documentation.

6. How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

Daniel Hawthorne (DH): From a tax perspective, in recent years there has been an increased policy focus on ensuring that businesses pay the right amount of tax in the right jurisdictions. This follows the UK's commitment to be a global leader in the implementation of various measures derived from the OECD's Base Erosion and Profit Shifting project. Recently introduced measures that will potentially have a significant effect on private equity structures and their financing arrangements include extremely broad new anti-hybrid legislation, which seeks to counteract 'hybrid mismatches' arising from entities or instruments that are treated differently for tax purposes in different jurisdictions, and new interest barrier rules that further limit the deductibility of corporate interest. In addition, the UK has also seen an increased policy focus on the taxation of individual private equity managers with significant changes to the UK carried interest rules making it more difficult to achieve capital gains treatment on carried interest and 'disguised investment management fee' rules taxing non-carried interest performance-related investment management returns as income.

7. What are the current attitudes towards private equity among policymakers and the public? Has there been any noteworthy resistance to private equity buyouts by target boards or shareholders? Does shareholder activism play a significant role in your jurisdiction, and if so, how has it impacted private equity M&A?

JA: The typical public view is still that private equity generates significant returns for the wealthy at the expense of other stakeholders in the businesses in which they invest: they see private equity as willing to sacrifice long-term sustainability in return for short-term gains. Given that general public sentiment, some politicians and policymakers inevitably seek to garner support by pledging to clamp down on excess private equity profits.

The UK private equity industry, supported by the British Private Equity & Venture Capital Association and Invest Europe, has, over a period of time, presented a more complete picture. The Walker Guidelines/Guidelines Monitoring Group is an example of these efforts. It has two aims: first, to increase transparency and disclosure; and, second, to provide data that demonstrates private equity's contribution to the UK economy. Although much progress has been made, there is still work to be done to improve understanding of the sector.

Traditionally, shareholder activism has not played a significant role in the UK and Europe (at least in comparison to the US). There have been a couple of notable exceptions recently in the UK (such as Electra Private Equity where, following activist pressure, Electra terminated its 40-year relationship with its investment manager) and reports suggest that investor activism has been rising in the UK (and Europe) over the past few years.

8. What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?

JA: Exits have remained a focus for many UK private equity funds. We have seen a mix of exit routes, predominantly trade, or secondary private equity, sales, but also initial public offerings (IPOs). Buyers' strong appetite for assets means that an attractive environment remains for private equity firms to exit. IPO activity (private equity- related or otherwise) remains down and, given the uncertainty inherent in an IPO, we expect most exits to continue to be by way of trade sale (including secondary buyout).

A recent notable example was the sale of Ziarco Group (which develops products to treat inflammatory diseases such as eczema) to Novartis.

9. Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?

Christopher Gardner (CG): There is still a focus on sponsors with verifiable excellent outperformance, and those that have strong performance in niche sectors. We've seen some scaling back of investors, but have heard criticism of those sponsors that close at over their stated hard cap. Investors are certainly looking at fund terms more closely and continuing to negotiate these before deciding to commit.

We've also seen a marked increase over the past few years of sponsors targeting more focused investment strategies, in an attempt to achieve greater differentiation and to target investors whose investment strategies have become more granular. One example is private equity sponsors moving into

the credit fund space, whether that's in order to be complementary to their private equity activities or not. That market will continue to grow.

There is some pressure on fees, with instances of managers agreeing to management fees on invested capital throughout the fund's life, although there is a residual concern from some investors that this could push managers into making more rushed investment decisions. Equally, of course, investors are interested in ensuring that they have robust governance controls, such as through investor advisory committee representation or protection from investment scope creep. The other issue that is getting increased investor and regulatory focus is the use of fund-level credit lines, particularly where these are used other than for bridging purposes. Investors remain focused on ensuring that capital is deployed in a disciplined way.

Larger asset allocators are reviewing performance in existing funds much more carefully before re-upping than was the case previously. That is to ensure that terms are robust, and is also part of a process to focus down the number of general partner relationships. The very largest investors continue to explore single account mandates and access to co-investment rights. The co-invest pieces will attract markedly lower fees than a fund investment, and we see much greater flexibility on fees for single accounts than fund investments, even taking into account side-letter rebates. These also permit investors to dictate investment restrictions and structure more closely, and can reduce regulatory costs.

Finally, I would note that fundraising continues to be robust, notwithstanding the Brexit vote. Any impact there is offset by greater creativity and focus on terms, investment thesis and strategy. There continues to be a broad preference by continental European investors, in particular, for onshore European fund structures.

10. Talk us through a typical fundraising. What are the timelines, structures and the key contractual points? What are the most significant legal issues specific to your jurisdiction?

CG: There's really no such thing as a typical fundraising process – it is iterative, with the circle of investors gradually increasing before focusing back on key target investors. There are a few questions that any sponsor has to pose at the outset, and those questions have not really changed, notwithstanding increased regulation.

The first questions centre on when the right time is to fundraise: are there restrictions in existing fund documents that prevent you from raising a new fund? Where are you in deploying the committed capital you still have? What will your investors think about capacity issues if you focus on a fundraising, leaving aside successor fund restrictions?

Once the client has decided that the time is right, we typically work with them on a teaser with key outline terms and a fund structure. The structure will have been tested and discussed from a commercial, legal, regulatory and tax perspective, to make sure that it appeals to the largest possible potential investor base, but does not involve an unnecessary level of regulation, complexity and cost. The nuances inherent in that analysis have changed in the past few years, but, as before, the aim is to have a structure that fits both sponsors and investors.

Testing the market with the term sheet may take two weeks, or may take two months. Once there is some traction, we then move to full form documentation. If there is a regulatory approval process, then that will

drive the timetable; if not, then we will work with the sponsor and service providers to get draft documentation into a data room as quickly as is sensibly possible.

The next key step is investor negotiations. Principal-to-principal discussions would precede our re-engagement in the process, but we would then focus on agreeing amendments to constitutional documents – typically a limited partnership agreement – to the extent required, or on side-letter terms. Investors increasingly have a list of points that they intend to raise (the Institutional Limited Partners Association has done a good job of framing some of those discussions). The points tend to break down into commercial points (eg, key man or fee provisions, or restrictions around post-investment period drawdowns or recycling), regulatory points (such as restrictions on certain types of investment, or leverage) and tax points (such as ensuring that there is adequate tax reporting). We are frequently seeing relatively detailed negotiations with one or two cornerstone investors before other first- close investors engage, particularly where those cornerstone investors are known in the market to be prepared to test terms.

I don't think that there are UK-specific points here – the elephant in the room, of course, is what happens with UK-authorised sponsors once Brexit has played out. If, as we hope, we achieve equivalence from a financial services perspective, then there should be no real change.

11. How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?

CG: There is, unsurprisingly, an increase in supervision of private equity and other fund sponsors. That is entirely consistent with how other jurisdictions have moved.

Private equity sponsors located in the UK are typically regulated by the UK Financial Conduct Authority as either investment managers (and there are a couple of types of this depending on size of funds and the investment strategy) or advisers.

From a pan-European regulatory perspective, we have gone from having no supranational regime in the closed-ended space to having a number of regimes, including lighter-touch regimes for venture capital sponsors, for example, to enable them to navigate around some of the more stringent requirements of the AIFMD. How commonplace and successful those regimes become remains to be seen.

The more traditional adviser-only model that was prevalent in the market a decade or so ago is less common than it was. When I last did some analysis, only around one-third of private equity sponsors were authorised on an advisory-only basis, effectively providing recommendations to a non-UK manager. I would expect that number to reduce further.

The rules of the Financial Conduct Authority (FCA), which frame the conduct of private equity (and other) sponsors, are based on EU legislation. The FCA has taken a pragmatic approach to implementation of those provisions, such as making it easy to register funds for marketing in the UK, or permitting application of proportionality principles to remuneration rules.

The big issue that sponsors are currently tackling is the Markets in Financial Instruments Directive (MiFID II), which comes into force at the beginning of 2018. Allied with the impact of Brexit, which of course remains uncertain in its details, the next year will again pose some significant regulatory challenges.

12. What effect has the AIFMD had on fundraising in your jurisdiction?

CG: First, there has been an indirect impact on the types of structure that private equity sponsors now look at, because many investor jurisdictions, particularly in continental Europe, have pushed onshore European structures. Second, the FCA has been much clearer than other regulators in providing guidance around marketing issues under the AIFMD and facilitating registration of non-European fund structures in the UK to enable them to be marketed. Smaller private equity sponsors that have sought to become fully authorised under the AIFMD have probably faced greater operational challenges in how they structure their own business because of the need to separate business functions more strictly than they previously needed to. The AIFMD is just one of the recent challenges – the impact of tax changes, on an international and national level, will have had just as much impact on day-to-day business.

13. What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?

DH: Given the series of complex private equity- related tax changes introduced in recent years, it is hoped that the near future will bring a period of relative stability and increased clarity. Current challenges for private equity managers to consider include the potential application of the UK's new anti-hybrid rules to both pre-existing and new cross-border structures. The rules are extremely broad in scope and may potentially result in the counteraction of any perceived tax benefits arising from any hybridity, such as by denying UK deductions for interest payments, or requiring the inclusion of additional taxable income in the UK. Existing arrangements may need to be restructured if the rules apply. A further consideration is the recent change to the UK rules regarding the deductibility of corporate interest, which may limit interest deductions in respect of periods of account beginning on or after 1 April 2017.

Favourable capital gains tax treatment for carried interest remains available in the UK in certain circumstances, although a new higher special rate of 28 per cent has recently been introduced for carried interest (as compared to the standard 20 per cent rate for capital gains). In addition, 2016 saw the introduction of the 'income-based carried interest' regime that, broadly, looks to the weighted average investment holding period of fund investments in determining whether capital gains treatment should be available. An average investment holding period of at least 40 months is generally required for full capital gains tax treatment, with an average holding period of less than 36 months leading to full income tax treatment. These rules have introduced additional complexity and uncertainty for managers, and have obviously restricted the range of funds in respect of which tax-efficient carried interest is available.

14. Looking ahead, what can we expect? What might be the main themes in the next 12 months for both private equity M&A and fundraising?

JA: The Brexit vote and its aftermath has created uncertainty. This looks set to continue for the short term (at least until there is a clear view as to the 'shape' of, and path to, Brexit). Confidence remains fragile, and other global events may give further pause for thought.

Given the decline in the sterling exchange rate, sterling-denominated private equity funds may be impacted more immediately. However, in the medium to longer term, and as an overall trend, we expect private equity activity to increase. It is not simply a 'glass half full' mindset: it is easy to anticipate

opportunities, perhaps at very attractive pricing (for US-dollar-denominated and, perhaps to a lesser extent, euro-denominated private equity funds).

15. What factors make private equity practice in your jurisdiction unique?

JA: The UK private equity market is perhaps second only to the US, not just in terms of size and scale, but also for its well-earned reputation for quality and innovation. It is, and seems set to remain, the largest hub for private equity in Europe. This results in high levels of expertise, knowledge and efficiency throughout UK private equity industry law (from sponsors to lawyers and other advisers). When coupled with English law's predominance owing to its international reputation as a stable, established legal and judicial system, there is a demand for UK private equity transaction methodologies, and for English law far beyond the geographic boundaries of the UK.

16. What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?

Focus on the individuals in the team:

1. Who will work on your deal? ***JA:*** At Dechert, we typically work in small, partner-led teams. The people you meet at the outset are the people who will do your work, and the partners remain hands-on throughout.

2. ***JA:*** There is no substitute for experience. Our private equity experts across the globe provide sensible, commercial (as much as legal) advice, know what matters (and what doesn't) and can anticipate issues (resolving them before they become problems).

3. ***JA:*** You need to get on with your counsel; we work hard to become part of your 'team'.

17. What interesting or unusual issues have you come across in matters that you have recently worked on?

JA: Each of our current matters immediately becomes the most interesting, it is impossible to single out any one! Every deal poses its own challenges – and hopefully rewards as those challenges are overcome. Equally, every client is unusual, and even unique. There is a thrill to advising a client with whom you have worked for many years where you actually feel a part of their business, just as there a real excitement to getting to know a new client and helping them over the finish line for the first time.

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Dechert's Private Equity Practice

Overview

Dechert is among the most active law firms in the private equity industry. The practice began more than 30 years ago when it advised venture capital firms on fund formation and transactions. Our global team of more than 250 lawyers represents all types of private equity sponsors and other private investment firms, including sovereign wealth funds and family offices, and their portfolio companies, as well as institutional and corporate investors looking to invest in private equity funds. In every phase of the private equity investment life cycle, we help clients accomplish their investment objectives.

Recent Transactions

Examples of recent transactions on which Dechert advised include:

- **Astorg Partners** on the acquisition of Compeed for its portfolio company HRA Pharma.
- **Chrysaor** on its acquisition of a package of assets in the UK North Sea from Shell UK Limited and its affiliates for more than US$3.8 billion.
- **Columna Capital** on the CHF300+ million sale of the Datamars Group to Caisse de dépôt et placement du Québec, a Canadian pensions and insurance company.
- **Endless/Brabant Alucast** on the carve-out and sale of its Brabant Alucast Dutch and Italian businesses to Shiloh, Inc.
- **Mid Europa Partners** on the acquisition (and multi-tiered financing) of the entire issued share capital of Profi Rom Food S.R.L., Romania's largest supermarket chain from Enterprise Investors.
- **Sun European Partners** (as Shareholders) on the US$1.5 billion sale of Albéa S.A. to PAI Partners.

Awards and Recognition

realdeals PAN-EUROPEAN LEGAL ADVISER OF THE YEAR THE PRIVATE EQUITY AWARDS 2018 FINALIST 2018	Dechert was shortlisted and a finalist for the Private Equity Awards by *RealDeals* (2018)
PRIVATE DEBT INVESTOR	Law Firm of the Year in Asia, Europe and the U.S. by *Private Debt Investor* (2018)
The LEGAL 500	Ranked among the top law firms for Private Equity: Transactions United Kingdom by *The Legal 500* (2017)
Bloomberg	Ranked among the top law firms for total number of announced M&A deals. Also ranked among the top law firms for total volume of global announced deals. (2017)
THOMSON REUTERS	Ranked among the leading law firms for the total value of announced M&A deals worldwide. Also ranked among the leading law firms for the total value and total number of announced deals. (2017)

About Dechert

Dechert is a global law firm.

Focused on sectors with the greatest complexities, legal intricacies and the highest regulatory demands, we excel at delivering practical commercial judgment and deep legal expertise for high-stakes matters.

In an increasingly challenging environment, clients look to us to serve them in ways that are faster, sharper and leaner without compromising excellence.

We are relentless in serving our clients – delivering the best of the firm to them with entrepreneurial energy and seamless collaboration.

Dechert Around the World

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* Dechert has in Jeddah and Riyadh an association with the Law Firm of Hassan Mahassni.

900+	40+	28	13
Lawyers	Languages spoken	Offices	Countries

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Dechert practices as a limited liability partnership or limited liability company other than in Dublin and Hong Kong.

Dechert lawyers acted on the matters listed in this presentation either at Dechert or prior to joining the firm.

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