Your World First

Private Equity Watch

Autumn 2016

A bird’s eye view

European Private Equity has been on a bull run for several years and that run has now seemingly slowed. With valuations remaining high, but with businesses now facing a period of heightened uncertainty, not least due to the impact of Brexit which we discuss later, most segments of the market have witnessed a fall in activity volumes. However, as recent history has shown, dealmaking is rarely down for long.

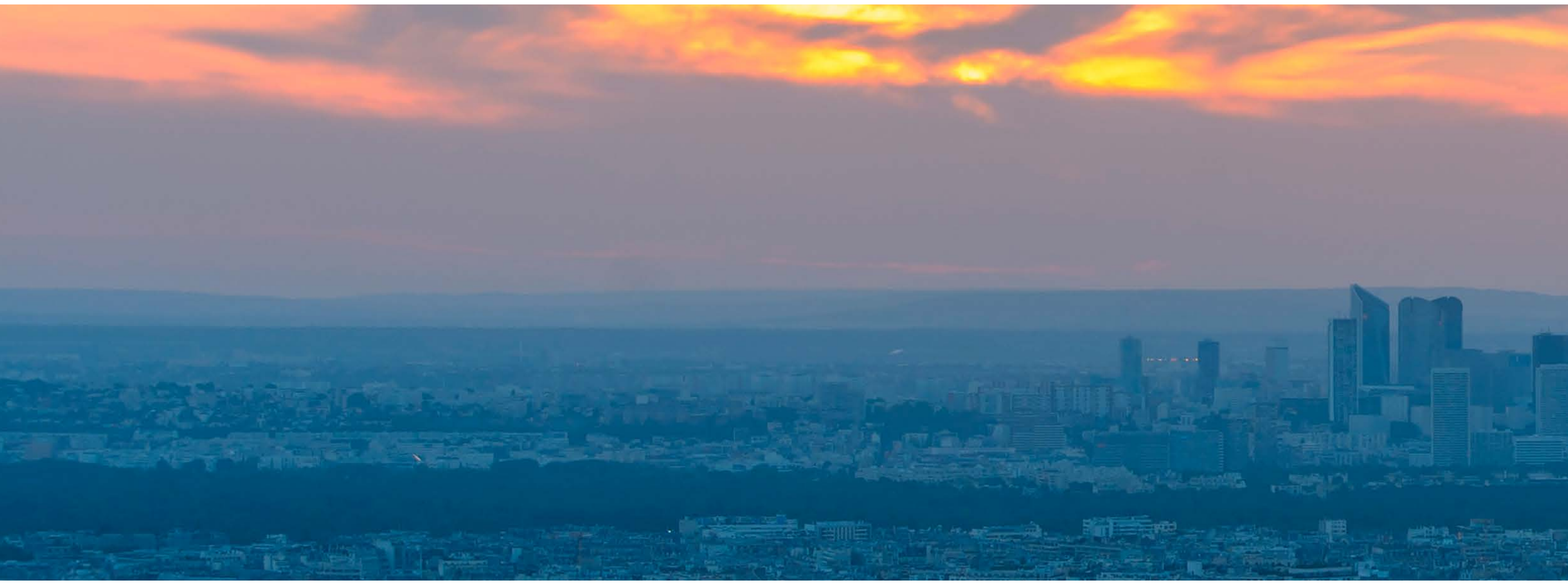
Data from Thomson Reuters showed that the total value of global private equity buyouts plummeted from USD 605bn in 2007 to USD 169bn in 2008, and then dropped further still to USD 80bn in 2009.

Many expected and forecast Armageddon. However, given the severity of the crisis, the recovery was impressively rapid and complete. In the depths of the recession, complex debt situations in private equity-backed deals unravelled but, barring a few high-profile collapses and restructurings, most private equity groups not only nursed their assets through the recession but managed to successfully exit many of them, often making impressive returns for their investors in the process. Indeed since early 2014, many private equity groups have been on a red hot “exit” streak selling companies, carrying out IPOs as well as completing large-scale refinancings.

Thomson Reuters’ figures show that the worldwide value of M&A exits for 2015 was just over USD 245bn, a new record high and topping levels last hit in the pre-boom peak. The number of private equity backed IPOs worldwide also increased sharply in the past two years with proceeds of close to USD 108bn generated from 242 flotations.

M&A volumes overall also returned, during the course of 2014 and 2015, to levels not seen since the pre-crisis boom years, with worldwide corporate activity hitting a new record high of USD 4.3tn last year. Almost no sector was untouched by corporate activity, with some industries, such as pharmaceuticals, oil and gas and telecoms, hogging the limelight with a host of super-sized transactions.

While a lot of this activity has been driven by global corporates aggressively seeking strategic, industrial transformations through mergers, the private equity industry has also played its part. Thomson Reuters’ figures show that private equity contributed about USD 320bn to buyouts worldwide last year (compared to USD 270bn in 2014), with nearly half invested in high technology enterprises and real estate but with other sectors, such as healthcare and consumer products featuring heavily too.



The UK continued to be the largest and most active private equity market in Europe, with 292 buyout deals – amounting to USD 32bn in value – taking place last year. This was up about 28 per cent on 2014. Certainly that has been reflected in our UK team's activity levels, with buy-side deals but also a large number of exits, in particular for the likes of Advent, Electra, LDC and Oakley Capital.

Germany was the second largest market in Europe last year, and again the CMS PE team there were involved in many of the most significant transactions, such as BC Partner's disposal of Synlab Group to Cinven.

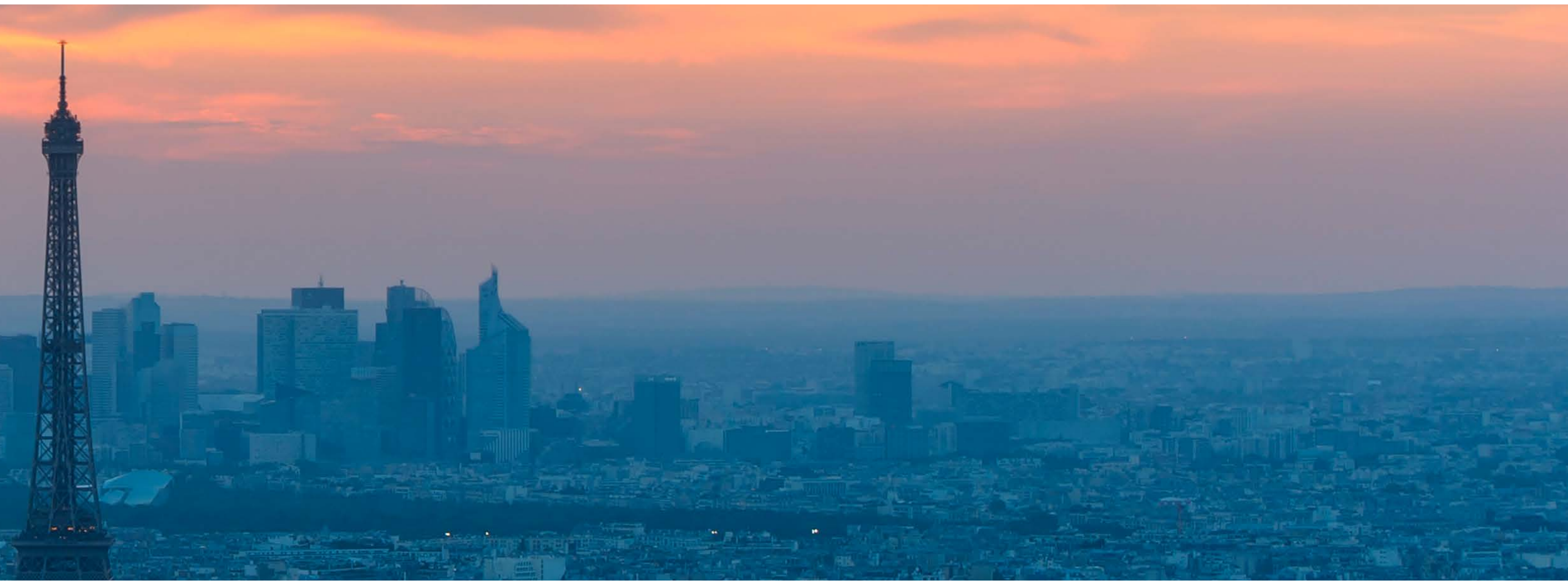
In emerging Europe, which has been less active in recent years, although overall deal volume and value last year were down slightly on 2014, there was a 16% increase in the number of private equity deals year-on-year in 2015. The impressive growth story in CEE (3.6% on average year-on-year in the last quarter of 2015, compared to 1.8% in the UK or 1.9% in the US) and, in some cases, a fresh round of privatisations, continues to attract some of the private equity heavy weights to the region. This is demonstrated by some of the transactions we have worked on over the past few years, such as KKR's acquisition of Serbia's largest cable company SBB/Telemach, Cinven's pursuit of Telekom Slovenije and CVC's buyout of PKP Energetyka, the Polish state-owned energy company. We have also witnessed a gradual rise of sizable cross-CEE assets and portfolios such as the real estate/logistics portfolios acquired by TPG and Blackstone last year, Advent's sale of Partner in Pet Food (a pet food business spanning five jurisdictions) to Pamplona last year and the upcoming sale of brewer SAB Miller's CEE assets, as part of its USD 100 billion takeover by rival AB Inbev.

> Prequin, which provides data on the private equity sector, estimates that the industry is sitting on more than USD 1.2tn of cash.

Although M&A activity in CEE the first half of 2016 has remained largely flat year-on-year, deal flow is expected to pick up momentum towards the end of this year, fuelled by several mega-deals already announced or under way (such as the sale of convenience store chain Zabka, mobile operator P4 (Play), diagnostics chain Diagnostyka and e-commerce platform Allegro in Poland and the SAB Miller divestment), improved valuations and strong interest by strategics and PE buyers alike in Europe, the US and Asia.

This gradual return to health and renewed confidence in private equity as an asset class, has resulted in fresh and sizeable cash inflows surging into funds across the globe for the past few years. Prequin, which provides data on the private equity sector, estimates that the industry is sitting on more than USD 1.2tn of cash. While typically there is a five to six year investment time frame to deploy funds, many private equity groups have been poised for a sustained period of activity going forward.

Overall, confidence within the industry was high at the start of the year. Howard Marks, the co-chairman of Oaktree Capital which currently has more than USD 20bn to deploy, told investors in a memo that now was the time "to move forward … with a little less caution". Bill Conway, co-chief executive of Carlyle, was similarly bullish in the wake of a tumultuous



start to the year for global equity capital markets telling investors that recent market volatility had created a challenging but opportune investment environment for many of its fund teams: "Our current pipeline is strong and we believe that good deals can be financed in the current market."

However, a range of factors, not least of course Brexit and the European political uncertainty generally, has checked somewhat the optimistic mood and depressed recent dealmaking. Indeed the start of 2016 suffered the ignominy of getting off to the worst start for financial markets since the onset of the Great Depression, with stock prices slumping around the world amid mounting concern over the Chinese slowdown and the continued oil price rout and intense currency volatility.

Even before the UK Referendum, some had already been dubbing it the "age of frustration" for private equity firms, which although cash-rich, had been sitting on the sidelines waiting to find the right companies and management teams to invest in at the right price. This was partly because there had been an air of caution for some time among private equity groups, particularly those with legacy pre-recession funds that have had to work extremely hard to return cash to LPs, deterred by what they saw as alarmingly high valuation multiples.

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Many private equity funds wanting to do deals had also simply been outbid by large trade buyers seeking industrial consolidation in the large auction processes which had been a feature of the M&A world in recent years. For example, CRH, the Irish cement company, convincingly outbid a consortium led by Blackstone for a near EUR 6bn portfolio of assets last year, sold as part of the merger between France's Lafarge group and Switzerland's Holcim.

Private equity is also not only competing against peers and trade buyers for assets, but also facing up to greater challenges from sovereign wealth funds, pension funds and other institutional investors which have much greater appetite to carry out direct investments themselves than in previous years, and whose much longer investment hold periods can prove, in some situations, to be a real competitive edge over PE. This "shadow capital" is fast becoming a dominant feature of the market and is putting pressure on the traditional private equity fund manager business model.

The events of June 23rd and the Brexit vote then, almost inevitably, had an immediate dampening effect on deal activity as the market generally assessed the implications for business. Exactly how much of an impact the vote has had on private equity activity still remains relatively uncertain at this stage: certainly Europe generally does appear to have suffered a reasonably significant fall, with aggregate deal values in H1 2016 down nearly 20% compared to H1 2015.

However, the picture does appear to be quite mixed to date, and certainly in some segments of the market, notably parts of the mid-market, the deal volumes appear to have been largely maintained. Indeed, we have seen a number of instances where transactions were put on hold in the immediate aftermath of the vote, but shortly afterwards reactivated such as the IPO of Electra-owned Hollywood Bowl.

> In any event, in an increasingly competitive environment, private equity will have to think laterally to find value and win deals.

The general view appears to be that a slight cooling down and taking stock, with a pricing readjustment, whether triggered by Brexit or otherwise, would be no bad thing for the market at large. Although on recent data so far, there does not appear to have been any particular downward pressure on valuation multiples for those deals that are transacting, with the average EBITDA multiple holding firm at 8.5 x or thereabouts in Q2 of this year (and in fact there have been some high profile deals closer to 20 times earnings recently, such as General Atlantic's acquisition of Argus Media group).

In any event, in an increasingly competitive environment, private equity will have to think laterally to find value and win deals. This could mean thinking bigger and smarter, whether that means hunting for opportunities in new geographies, taking minority investments, partnering with strategics, kickstarting buy and build strategies, or upping their game on the origination side, whatever it may take to generate the returns.

For private equity, under pressure to generate returns, maintaining price and bid discipline and avoiding over-leveraging the funding structure of any deal, will be paramount in the years ahead.

As always, the road ahead will bear some bumps and obstacles. Private equity is operating in an environment challenged by global macro-economic concerns, and as its remarkable comeback from the tumultuous days of 2009 demonstrated, it is almost uniquely capable of adapting to those challenges. The current European political position will in reality take many years to resolve itself with any degree of clarity, and with the sheer levels of funds currently allocated to the industry, sitting still for that period of time is simply not an option.

The UK perspective

Until the events of this year, mergers and acquisitions in the UK had been soaring high at levels unseen since the financial crisis in seemingly a new golden era of dealmaking.

The worldwide M&A market was riding high and Europe's private equity industry accounted for a significant proportion of this activity with data from Thomson Reuters showing that just over USD 170bn worth of buyouts have taken place in the past two years.

The UK represented the largest and most active private equity market in Europe, where 292 buyout deals, amounting to USD 32bn in value, took place in 2016, up about 28% on 2014. The UK's share of European M&A in the first half of last year was a huge 44%.

Financial services, energy and power and the telecoms sectors dominated buying activity among private equity last year, although the retail and media and entertainment industries also proved popular with dealmakers. Leisure and dining assets also continued their strong resurgence as an investment sector, with the likes of Mayfair Equity Partners acquiring Yo! Sushi and Electra Partners snapping up TGI Fridays.

Auctions of high quality assets have drawn significant interest and commanded sometimes heady valuations (at times close to 20 times multiple), while the resurgence in London's IPO market continues, albeit at a less frenetic pace and with more modest valuations than in 2014.

Many houses have been taking advantage of the UK's recovering economy, rising employment levels, and improving consumer sentiment to exit some portfolio companies, some of which were pre-recession legacy deals. Data shows that UK private equity M&A exits soared by 120 per cent to USD 31.8bn last year, up from USD 14.4bn in 2014.

LDC for instance, successfully carried out ten exits last year, grabbing the headlines with sales such as that of Two Four, the maker of Jump and Educating Yorkshire, to ITV. The deal valued TwoFour at an initial 15 times earnings and generated a healthy return for LDC. Similarly, after less than two years under their ownership, LDC also sold uSwitch to Zoopla for more than GBP 160m, representing an IRR of nearly 70%.

As to the IPO route, after a bumper 2014 for private equity backed floats – when more than USD 12bn of proceeds were raised through 21 deals – activity was somewhat more subdued in the UK last year but still healthy with USD 8.4bn across ten deals.

Much of the pick-up has been driven by the fact that the UK, even during the recession, has always benefitted from a relatively stable economy and its plethora of top-flight companies with rated management teams.

However, while the trajectory has certainly been upwards, even before the impact of the Referendum vote, private equity activity in the UK never quite hit the levels reached in the last boom, when in 2007 nearly USD 80bn worth of buyout transactions occurred.

This has been for a number of reasons, but certainly increased competition from large cash-rich corporates has certainly been a key factor. Pension funds have been expanding their direct investment teams, representing a relatively new form of competitor for PE, capable of far longer hold periods. Similarly we have started to see infrastructure funds encroach upon asset territories that would previously have been solely the preserve of private equity.

The industry is also facing the additional challenge of adapting to the rise of “shadow capital” competing for deals. Institutional investors have in recent years been seeking to retain more control over their funds. This is taking the form of either co-investment alongside private equity partners or separate direct investments. Such “shadow capital” is, according to Bain & Company, “reshaping” the private equity industry as it “injects even more money into the already saturated deal market, increasing competitive intensity”.

> The industry is also facing the additional challenge of adapting to the rise of “shadow capital” competing for deals.

It is widely recognised that deals are harder to come by. The much remarked-upon rise in global public equities markets has left a barren field for private equity houses trying to dig out lucrative public-to-private transactions, and whether public or private, it is now harder than ever to generate the multiples on investments that were once commonplace during the boom years.

In a market where global surges of liquidity and zero, or near zero, interest rates have inflated asset valuations, but with the leverage ratios still nowhere near the eye watering levels of the pre-recession era, private equity has had to evolve and find new ways to generate the expected returns. Certainly firms are also putting their asset-management skills to better use and are intensively grooming their portfolio companies into shape so they can prosper in any economic environment and business climate. Investment strategies have also evolved with, for instance, minority investing and buy and builds now increasingly commonplace.

Global buyout houses are also becoming more resourceful, casting a wider net when assessing sectors and situations that could benefit from private equity ownership. For instance, in the UK we have witnessed private equity muscling into the lucrative home loan market for some time, notably Cerberus Capital Management which secured a portfolio of GBP 13bn of former Northern Rock loans from the UK government last year.

The corporate carve out is an origination path being furrowed heavily by PE at the moment, as corporates, tempted by some high valuations achieved in the last 12 months, are looking to dispose of non-core assets. Often not necessarily the most straightforward of acquisitions for private equity, those deal challenges can nonetheless pay off with, typically, a lower entry price than on more vanilla auction processes.

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Market experts have been commenting for many years that Europe lurches from one crisis to another and it is an assessment that was proved ominously accurate by the UK's vote of 23rd June. The uncertainty, both before and after the vote, has already had an impact on UK PE: the first half of this year saw the UK's share of European private equity drop to 17%, more than half its share from the previous year. However, as the previous article mentions, there are some positive signs already, albeit somewhat mixed, that the industry is already returning to form, with a number of previously stalled processes coming back to market. In some instances, the sterling depreciation may also grease the deal machinery by offering, on the face of it, a discount to foreign buyers who are willing to back the UK economy going forward.

The overriding sense appears to be that private equity investors in the UK are charting these uncertain waters with admirable pragmatism and confidence, and provided that general market sentiment is maintained, the UK should have no difficulty maintaining its place at the top table of global private equity.

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W&I not?

Warranty and indemnity insurance ("W&I insurance") is becoming such an increasingly regular feature of the M&A landscape, particularly in the private equity sector, that its use should be considered as a matter of ordinary course.

The form of insurance is frequently used in competitive auction processes, where bidders can use it to enhance the value of their bid. It also provides an attractive alternative to claiming against an ongoing management team and potentially damaging future working relationships. From a seller's perspective, in order to ensure a "clean exit", a seller can arrange the W&I insurance policy, which then "flips" to the successful bidder as part of the transaction process.

Why, then, would anyone in the private equity sector not take advantage of this product and the benefits it has to offer?

What is W&I insurance?

W&I insurance fundamentally bridges the gap between the protection (i.e. the "market-standard" warranties and indemnities) the buyer requires in connection with an acquisition and the protection that the seller is willing to provide. W&I insurance is therefore an irreplaceable tool used to assist parties in reaching a position they are both happy with, a position that would not otherwise be attainable through a more traditional negotiation process. The policy can enhance the protection on offer under an SPA. This can be in terms of scope of the warranties and indemnities on offer or in terms of quantum/time where the insurance "tops-up" the financial cap or longstop date offered by the seller, or indeed increasing the scope by removing knowledge qualifiers applying to the warranties.

> It is […] possible to gain cover for identified risks, though, unsurprisingly this will usually be more expensive and time-consuming than the basic cover. Such risks tend to be in areas of high exposure but low risk […]

W&I insurance policies are normally structured as "buy-side" policies (in that the buyer has the benefit of the policy), rather than "sell-side" policies (under which the sellers have a primary liability to the buyer, but which it can recover from the insurer). The key commercial difference between the two is in relation to which party takes the liability for exposure in the gap between the warranties being written and the policy biting or the insurer paying out (i.e. the liabilities which are not covered by the policy, or not accepted as covered by the insurer). On a buy-side policy, it will normally be the buyer and, on a sell-side policy, the seller. The rationale for taking out a policy will vary depending on whether it is driven by sell-side or buy-side motivations.

In its basic form, W&I insurance provides cover for unexpected and unknown issues arising in connection with a corporate transaction, which would otherwise give rise to a claim under the standard warranties and indemnities contained in the SPA. Generally, basic W&I policies exclude any liability arising from known risks, those identified as part of the due diligence process or disclosure exercise. It is, however, possible to gain cover for identified risks, though, unsurprisingly this will usually be more expensive and time-consuming than the basic cover. Such risks tend to be in areas of high exposure but low risk, where insurance provides an alternative to the unattractive position of having funds tied up in an escrow account for a potentially long period.

Where a number of warranties are given on a seller awareness basis, underwriters may be willing (for an increased premium) to offer a knowledge "scrape". The "scrape" has the effect of excluding the knowledge qualifiers in determining whether there has been a breach of warranty for the purposes of the policy. This is a valuable feature for buyers in transactions where the seller is unwilling to give any warranties on an absolute basis.

The W&I insurance policy typically contains a "retention" or "attachment point", which is a financial threshold at which the insurer will become liable under the policy and below which the insurer is generally not liable. This operates in a very similar way to an "excess" on your car insurance. Typically this "excess" equates to the maximum cap on liability of the warrantor(s) under the SPA. However, it may be possible for this to be structured as a "tipping retention", whereby once the threshold has been breached, the insured can recover the full amount and not just the excess (in a similar way to the typical financial basket in an SPA). "Retentions" on UK transactions are currently in the region of 0.5% to 1% of the transaction value, though can be lower on pure real estate transactions.

The price of a W&I policy will depend on the nature of the transaction being insured. Insurers will consider factors such as the policy limit and attachment point sought, the nature of the target business (including the jurisdictions it operates in) and the breadth of the warranties before setting a premium. The typical premium for unknown risks will be 0.9% to 1.6% of the policy limit.

When can W&I be used?

W&I insurance can be used in any transaction and thanks to the growing understanding of those using and providing it, the product can fit unobtrusively into the transaction mechanics and fit seamlessly into the transaction timetable.

On a buy-side policy being used as a tool in an auction process, insurers are typically willing to complete their underwriting processes (to a large extent) prior to a bid being submitted. This allows a seller to consider the W&I insurance as part of a bid and ensures the transaction timetable is not impacted whilst W&I insurance is put into place.

Similarly, insurers are typically willing to engage with a seller as part of an auction process in order to complete their underwriting processes as far as possible. Once a successful bidder has been selected, the policy will then "flip" to the bidder and the insurers will complete their underwriting processes with the bidder.

W&I insurance continues to be used in ever new and innovative ways. Recent developments have seen insurers provide protection on a "nil-recourse" basis, when no contractual protection is available from the seller, for instance in sales out of insolvency.

CMS – Our Expertise

In addition to advising our private equity clients on W&I insurance policies they may be securing on a transaction, CMS is also widely regarded as one of the leading advisers in the W&I insurance market.

We have extensive experience advising potential insureds in arranging W&I insurance as well as advising the vast majority of insurers in connection with the underwriting of transactions. We are therefore well-placed to assist you in arranging W&I insurance as we understand how the insurers in the market operate and are familiar with their underwriting processes. Our global footprint enables us to advise on multi-jurisdictional transactions and provide local law advice where it is needed in connection with W&I insurance.

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Co-investments between private equity and strategic investors in the German market

The current German market for transactions with private equity backing is highly competitive, with challenging valuations and debt ratios at a record high. This fits into the general observation that the number and volume of deals has reached record levels not only in Germany, but also in the EU and worldwide.

The German private equity market has drawn specific interest because of the famous hidden champions in the German Mittelstand (German midsized manufacturers), and also because of the strong German economy which has seen a very healthy recovery following the last financial crisis. Private equity investors are therefore looking for alternative deal structures and intelligent investment strategies. One interesting development is the joint investment or co-investment of private equity investors together with strategic investors. Such co-investments face a number of specific challenges and conflicts of objectives for which mutual satisfactory solutions need to be found. There are intelligent and established ways of achieving an effective set of rules for the joint shareholding of a private and a strategic investor in the target.

> The most obvious conflict of agendas between a private equity and a strategic investor is the exit.

There are a variety of reasons for such co-investments, key among which being that first, the private equity investor usually has a lot of dry powder which needs to be invested and the availability of suitable targets is limited; second, the strategic investor often has available for investment relevant assets to contribute into the joint target company which may otherwise not be available, at least not to the private equity investor; and third, the various and different resources of the private equity investor and the strategic investor to be made available to the target are capable of raising the business of the target to a new level.

However, there are also a number of pitfalls. The most obvious conflict of agendas between a private equity and a strategic investor is the exit. While every private equity investor, even a long term investor with lower return expectations, requires an exit sooner or later, the strategic investor usually wants to avoid an exit, at least with an obligation of the strategic investor to sell its shares along with the private equity investor. There are other usually highly debated deal points, such as the right and the valuation of additional investments into the target, board composition and veto rights, and general corporate governance issues.

Despite some fundamentally different objectives, co-investments between private equity and strategic investors are becoming more and more popular in the German market. Some typical features which are often subject to discussions in the negotiations about the future corporate governance are described in more detail below.

> In the German market, often the investors agree that the target management may make capital calls vis-à-vis the private equity investor up to a certain maximum overall and a minimum individual amount and within a certain period of time after closing.

Another obvious issue is the valuation of the respective investment contributions. Often both the private equity investor and the strategic investor contribute money, but the strategic investor also contributes assets. Such assets are of particular interest for the target because they may not otherwise be on the market due to their proprietary nature. While the cash component is not subject to discussions, the valuation of the assets can lead to complex discussions. The different investors need to agree on the valuation of the target and on the valuation of the assets to be contributed or otherwise made available by the strategic investor to the target.

The next question is under which conditions the strategic investor is prepared to make available the assets to the target. The target and the private equity investor will want to make sure that the assets are, during the co-investment period, permanently and irrevocably made available to the target while the strategic investor may wish to secure some more restrictions with regard to access to the assets. Furthermore, a solution needs to be found as to whether or not the strategic investor may use the assets during the co-investment for its own purposes or whether the assets must be made available to the target on an exclusive basis. A related question is whether the involved parties are subject to a non-compete during the co-investment period.

One of the main drivers for co-investments between private equity and strategic investors is the strong financial and strategic background of the two different types of investors, typically for the benefit of the target. What solutions are available if the target claims to have additional cash needs, for example for add-on acquisitions? Do both investors have an obligation to contribute or do they just need to make available such additional funds, pro rata to their respective shareholding in the target? If only one investor agrees to make available such additional funds, are there consequences with regard to the number of shares held in the target? In the German market, often the investors agree that the target management may make capital calls vis-à-vis the private equity investor up to a certain maximum overall and a minimum individual amount and within a certain period of time after closing. As long as such additional investments are made at fair market value, whereby "fair market value" needs to be defined in the underlying documentation, the number of shares of the investor deploying additional capital to the target is increased, while the other investor's shareholding is diluted.

The private equity investor commits itself vis-à-vis its investors to a certain minimum return on the investors' investment in the fund. What happens if this minimum return is not achieved in an exit situation? The strategic investor as well as the target management (if it also holds shares in the target) sometimes agree to shift value to the private equity investor resulting in the private equity investor achieving its minimum return, thereby enabling the exit, but, such provisions can be very difficult to negotiate.

The usual corporate governance questions must also be answered in the transaction documentation, such as board representation, veto rights for specific (usually material) decisions, put and call options for the benefit of the various shareholders during the investment period and in an exit situation, etc. These questions do however always need to be answered where more than one shareholder invests into a target company, and these are not specific questions for co-investment situations with a private equity investor and a strategic investor.

As indicated above, one of the most difficult and usually highly negotiated questions is the route to, and the right to pursue an exit. While the private equity investor typically has no room to manoeuvre when it comes to the exit right, the only question is whether the strategic investor succeeds in negotiating a right to purchase the private equity investor's shares after the decision to make an exit has been made. Then the devil is in the detail: what is the value of the shares which are subject to the purchase right of the strategic investor? Does the private equity investor have a put right towards the strategic investor? What happens with the shares held by the management team, and so on. If the strategic investor does not succeed in negotiating a purchase right, are its shares subject to drag and tag rights and what happens with the assets made available to the target by the strategic investor? All these questions need to be addressed at the outset of the co-investment.

In summary, co-investments between private equity and strategic investors provide for an interesting approach to successfully invest in target companies which would normally not fit into the investment strategy of a private equity or strategic investor alone. However, each structure does give rise to some more complex questions that need to be answered in the transaction documentation which would not arise in case of a pure private equity investment, but with a pragmatic and innovative approach to negotiations, appropriate solutions can be found to these questions.

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The availability of financing for private equity transactions in CEE

Recognisable as an investment trend from the previous years' rounds of fund raising, it is now clear that the economies of Central and Eastern Europe (CEE) no longer represent a homogenous emerging market, with earlier EU entrants now being developed economies.

However, one of the continuous unifying trends is the dominance of local banks and large regionally focused Western banks (most of which have subsidiaries in each CEE jurisdiction) as main providers of finance and little penetration (so far) of alternative lenders (by comparison to Western markets).

Poland and Czech Republic lead the pack as matured liquid loan markets with local banks delivering on sophisticated transactions with terms reflecting Western market structures and pricing. Despite political upheavals in some of these jurisdictions (Poland, Hungary), borrowers have been able to go to market locally for repricing or refinancing pushing aggressive terms and tight pricing. Further South and East in the Balkans, local banks continue to lend, albeit on more conservative terms.

> "[…] one of the continuous unifying trends is the dominance of local banks and large regionally focused Western banks […]"

Whilst a few years back, issuers based in the region had to overcome investor discomfort with the relevant jurisdictions, this is no longer an issue with successful high yield bonds linked to private equity acquisitions having been made across the region, from Serbia to Czech Republic.

The scarcity of large-cap strong credit transactions and increased appetite of capital markets investors have further driven the competitive environment among local banks.

> Even though pricing levels remain competitive across the market, overall local banks remain more conservative and financing terms and leverage levels are generally tighter ([…] especially […] on lower end of mid-market transactions […]).

Even though pricing levels remain competitive across the market, overall local banks remain more conservative and financing terms and leverage levels are generally tighter (and especially so on lower end of mid-market transactions and on lower cap transactions). Whilst recent transactions have seen covenant erosion, covenant lite structures have not gained ground. However, "Term B Loan" financing structures without an amortizing piece have been successfully closed. The presence of infrastructure funds in the region has also seen successful completion of hybrid infrastructure finance transactions backed by local funders.

Western based alternative lenders have generally had limited appetite for the region as the availability of local finance and pricing levels result in insufficient yield levels. However, with bank debt being less readily available in some jurisdictions (such as the Baltics) or more conservative on mid-market transactions, the activity levels of direct lenders in the region should be set to increase. Debt funds solutions have already been used as viable alternatives in more complicated structures or asset light sectors (such as financing acquisitions of software and online solutions companies). Also, existing regional debt funds (originally providers of mezzanine finance), are bridging a gap in the market providing direct lending solutions to lower-cap transactions.

International financial institutions such as EBRD and IFC continue to have an important strategic role and are active providers of finance especially in Southern and Eastern Europe, often participating in financing structures alongside commercial banks (for example providing post-acquisition capex or expansion facilities). Their involvement in a transaction usually assists commercial lenders getting comfortable with the jurisdiction or the credit.

> […] existing regional debt funds (originally providers of mezzanine finance), are bridging a gap in the market providing direct lending solutions to lower-cap transactions.

The legal systems across Central and Eastern European jurisdictions have developed and improved considerably with new legislation being implemented in relation to taking security and insolvency regimes which further enables execution of buyout transactions and helps extend the universe of commercial lenders beyond local borders as confidence in the jurisdictions has increased.

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Navigating the privatisation landscape

Among the most prominent features of post-communist CEE were the large-scale and largely successful privatisations that took place across the region in the late 90s and early 2000s. Ten years on, privatisation is still on the agenda for many countries in CEE, but momentum seems to be lacking this time around as does political and public support for privatisations.

Many stop and go and aborted processes as well as high price tags have led potential buyers to question the resolve of governments to see these processes through. Some countries suffer from fractured political environments that are not fully supportive of privatisations, while public perception around privatisations remains generally negative and weighs heavily on the process. Other countries are lagging some way behind in implementing appropriate legal and economic reforms to create a more investor-friendly business environment.

The issue, this time around, may well be that these privatisations are by and large the result of agreed bailout plans (as is the case in Greece or Romania) or massive budget deficits (in Russia, Slovenia, Serbia or Croatia) rather than governments genuinely seeing the benefit of foreign investment in the state sector.

But the good news is that there are a number of good assets in CEE still to be privatised, particularly in the infrastructure, telecoms, energy and banking space, which keep investors coming back despite, in some cases, several failed attempts (as was the case with the two incumbent telecoms operators in Serbia and Slovenia). And – since some of these assets are valued above the EUR 1bn mark and often have great potential for restructuring and consolidation, one can see the appeal for cash-rich private equity and strategic investors alike.

So will privatisations eventually deliver on investors' expectations or continue to disappoint? With the CEE region being more fragmented than ever, one would have to consider this on a country by country basis.

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Croatia

The new Croatian Government commissioned the due diligence of over 53 state companies, including those managing Croatian railways, airports, motorways, and marinas in preparation for a potential privatisation (much needed to lower Croatian foreign debt which is now at the level of cca 85% of the GDP). Tourism remains one of the strongest sectors in Croatia, alongside infrastructure and energy, and the government openly recognises the need for private investment in the sector (particularly when it comes to state-owned hotels and former coastal military resorts). It has already invited binding bids for the concession on the Kupari tourism site near Dubrovnik, while

stating recently that the Maestral hotels near Dubrovnik should also be in private hands. It also plans to put Croatia Airlines up for sale again despite previous failed attempts, while Petrokemija and Hrvatska Poštanska Banka will most likely undergo restructuring before being offered to investors again.

Poland

In Poland, privatisation through IPOs of state-owned companies (such as insurer PZU or coal mining business JSW) had, by 2013, propelled the Warsaw Stock Exchange into the top ten of Europe's capital markets by value of listed companies. The country has, in the sale of PKP Energetyka (the fifth largest energy provider in Poland) to CVC Capital Partners in late 2015, also seen one of the few successful privatisations in CEE in recent years involving a sale to a private equity buyer.

However, Poland remains the country with one of the highest rates of state control in the economy in Central and Eastern Europe. And the new statist government elected in November last year has already announced that it will wind down privatisations and only privatise those companies that are "redundant" (it remains to be seen which ones those are). So it would seem like large-scale privatisations are no longer on the table in Poland, at least for the time being.

Romania

Even in Romania, a country that has seen resounding privatisations in the past, things are proceeding slowly this time around. The privatisations of 11 state-owned enterprises (out of the 20 earmarked for privatisation) are still pending, despite pressure from the IMF and the EU and the fact that these companies continue to weigh heavily on public finances. A poor track record of successful privatisations in recent years has not helped Romania's case either. The privatisation of CFR Marfa, the state-owned cargo railway company, failed in 2013, while Sanevit (the disposable syringe producer) was launched for privatization in 2015, but no offers were received.

While 2016 was the year heralded as the one to see large-scale privatisations finally take off, particularly in the energy and infrastructure sectors, the government announced the contrary early this year. A few companies such as the National Salt Company, Hidroelectrica, Aeroporturi Bucuresti, Portul Constanta and Posta Romana are seen as "viable candidates" for listing on the Bucharest stock exchange over the coming years, but no resounding sales are expected in the near future. If not floated on the stock exchange, the other more sizable businesses (such as national air carrier Tarom and chemical plant Oltchim) are more likely to end up in strategic (possibly Chinese) hands than with private equity investors.

Russia

Economists predict another year of recession for Russia, and while the government is revising its budget and cutting public spending, privatisation may be instrumental to improving the sovereign balance sheet. Major state companies, including Aeroflot, diamond miner Alrosa, shipping firm Sovkomflot, oil companies Rosneft and Bashneft and VTB bank are the most likely candidates. Of these, Alrosa is expected to see the largest interest as demand for diamonds is on the rise globally, while Sovkomflot generates a large share of its revenues outside Russia so is less exposed to country-risks.

Foreign investors are clearly being "welcomed to the table". However, the unrest in Ukraine and the resulting sanctions, a history of disputed property rights, as well as certain restrictions on investment proposed by the Russian President, have foreign investors wary and watching from the side-lines. Equally, a privatisation programme announced by the Russian Government and prompted largely by falling oil prices and economic recession risks to meet the fate of the one in 2009, which was quickly dropped when oil prices rebounded.

So, it remains to be seen to what extent investors, private equity or strategic, will have the appetite to step up to the plate.

Serbia

In the second part of 2014, the Serbian government pushed through new privatisation, investment, bankruptcy and labour laws in an effort to improve the business environment. On 1 February 2016, the Serbian Privatization Agency ceased to exist, with privatization prerogatives being taken over by the Ministry of Economy. With this, privatisation is expected to gain momentum again, despite its modest success last year (according to the EBRD transition report for Serbia, privatisation proceeds in the first half of 2015 were 40 per cent lower compared with the same period in 2014).

Following the announced strategic development of Belgrade Nikola Tesla Airport (expected to take place by the end of the year which would make it the largest transaction in Serbia in 2016), other assets may spark interest from private equity investors, such as the Bor copper mine, agricultural business PKB Corporation, pharmaceutical company Galenika and commercial bank Komercijalna Banka.

As regards the privatisation of Telekom Srbija which was abandoned in December last year, when binding bids failed to meet pricing expectations, despite strong interest from large PE funds such as Apollo, Advent, CVC and BC Partners, the government announced its plan to carry out a complete reorganisation and modernisation of the business ahead of a new attempt, which may well draw private equity investors back to the table. It remains to be seen whether a well-positioned investor will make a play to acquire both Telekom Srbija and Telekom Slovenije, as part of an ambitious consolidation strategy.

Slovenia

Privatisation is still high on the agenda for Slovenia and the country has seen a healthy amount of interest from private equity investors, albeit mostly around the incumbent telecoms operator Telekom Slovenije and state-owned bank NKBM. And, while US investment fund Apollo was successful in signing a deal for NKBM last year (sparking hope for the other upcoming bank privatisations in Slovenia), Abris Capital won the bid for Paloma (the tissue manufacturer) and German investment fund 4K KNDNS agreed to buy Adria Airways earlier this year, the privatisation of Telekom Slovenije was abandoned last year, making it the second failed privatisation of the asset.

Despite the slow pace of privatisation, EU membership, a strategic location and easy access to regional markets keeps Slovenia on the map for foreign investors. The Slovenian state holding company SDH, which is coordinating the privatization process, plans to sell stakes of various sizes in a number of state-owned companies in the coming years, including NLB (the largest bank in Slovenia) and Unior (one of the largest exporters of spare parts, tools and machinery). Telekom Slovenije is also expected to go through a restructuring process to increase valuations in view of another attempt at privatisation in the coming years.

Turkey

Privatisations, which drove M&A activity in Turkey in recent years, dropped to one of the lowest levels in 2015. Recent years have seen a number of stop and go, cancelled or postponed processes and, while there is an expectation that the privatisation agenda may be mobilised once again this year, there have not been any clear signs of this yet.

However, according to the EBRD, who remain one of the most important sources of foreign investment in Turkey, there are plenty of opportunities for international investors, particularly in the infrastructure space. If it goes ahead, the privatisation of national air carrier Turkish Airlines will likely generate healthy interest. The same can be said for the energy sector. 2015 saw Turkey's state-run oil company TPAO's oil distribution unit and 26 hydroelectric and gas-turbine powered power plants of the Turkish Electricity Generation Corporation (EÜAŞ) transferred to the Privatisation Authority in anticipation of their privatisation, to be completed by 2020.

Ukraine

In May last year the Ukrainian Government announced that over 300 state-owned companies were to be put up for sale as a part of the 2015 privatisation campaign (the largest held in Ukraine for the last 20 years, driven in particular by the IMF's four year plan for Ukraine).

There are a number of good assets in the line-up, particularly prime energy, infrastructure, chemicals and mining assets and a healthy amount of interest, albeit less so from private equity outside of Ukraine and Russia, for the time being. However, the need for legal reform, greater transparency and better investor protection is still holding up the process.

On a positive note, recent changes to the privatisation legislation (which allows, amongst other things, the appointment of investment consultants and the choice of international arbitration for resolution of privatisation-related disputes) are generally seen as a promising start.

Lessons learned

While the CEE privatisations landscape is varied, our experience with privatisations in the region and elsewhere in Europe highlighted some common features (both on the legal and the practical side) which, alongside the political and social environment in each country, could play an important role in the success of the process.

One such feature is the post-sale undertakings which the government typically seeks to impose on buyers, such as to maintain a certain number of employees or to invest in the business (and local economy) post sale. In EU countries, one would have to rule out state aid when considering these, which would typically involve demonstrating that the government is acting as an independent commercial company (the 'private investor vendor test') and that the privatisation process was open and non-discriminatory, with the company being sold to the highest bidder. Often this results in any such undertaking being relatively 'soft' rather than definitive hard commitments.

Other concerns are focused around the risk of post-sale regulatory change, particularly in heavily regulated industries, such as manufacturing or telecommunications. Governments are, unsurprisingly, reluctant to commit to maintaining the *status quo,* among others, on the basis that they cannot affect the market artificially by restricting or accelerating regulatory change or, indeed, compromise the independence of the country's regulators. Albeit usually heavily negotiated, there are ways to obtain certain assurances from the sell-side in this respect, while EU countries also have the benefit of the relative uniformity of the *acquis communautaire* and the scrutiny of EU regulatory bodies.

The other typical concern around privatisations relates to the historic reluctance of the state to assume any liability in respect of the asset or business sold (beyond the 'bare minimum' title warranties). However, in a market where the focus is increasingly on securing a high-price deal, state sellers are now conceding more and more often to a reasonable set of commercial warranties and, on recent transactions we have acted on, even indemnities akin to that which a buyer might expect from a private seller.

From a more practical perspective, the need to win over management as well as labour unions and to keep the press in tow are also useful considerations to be had early on in the process. State-owned companies often have a powerful and influential management team having enjoyed close working relationships with the government for many years and a change in ownership may

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feel unsettling or, in some cases, even come as a cultural shock. Unions (particularly in certain countries, like Poland) are also very influential and viscerally opposed to privatisation for fear of massive job cuts. A combination of the above mentioned post-sale obligations around maintaining the work force and incentivising and reassuring management early on in the process (by, for example, agreeing to introduce performance related bonuses or management stock option plans similar to those seen in the private sector) should smooth the way with both sets of stakeholders.

Privatisation is generally closely scrutinised both internally and abroad and public opinion – often fuelled by media speculation – can weigh heavily on the process. Keeping the media properly informed and managing external communications, through dedicated media or comms teams on both sides can help limit the amount of "bad press" that the process might receive.

A variety of other issues can come up in a privatisation process, making it a lengthy and complicated one by most standards. However, most committed investors – armed with a good advisory team – tend to see past this to the ultimate and often considerable reward of acquiring a sizable business that often holds a dominant market share in an underpenetrated market.

Click here for our CEE privatisations track record.

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Private equity in the Middle East – how the crash in oil prices is generating surprising new opportunities for PE and VC investors

At the outset, it is important to distinguish the Middle East region from other global markets. Investment in the Middle East has traditionally been dominated by family businesses, HNWIs/UHNWIs, sovereign-linked funds and PE funds. However, recent years have seen a marked increase in alternative investment models and opportunities in the PE space, and more recently (and notably) through the development of a genuine VC market. Wealth in the region, whilst high, is comparatively "new money" and the region still lacks the financial sophistication and reliability of more established markets.

The overall macro-economic picture in the MENA region for the past few years has been characterised by geopolitical threats and instability of oil prices, the latter of which in particular has resulted in reduced government spending. In a region as reliant on government funding as the Middle East is, this has a proportionately higher knock-on effect on the private sector. Following the crash in global oil prices, a deceleration of growth in 2015 was inevitable, with the region's economy expanding approximately 2.6% in 2015 as opposed to 2.9% in 2014. The steepest deceleration naturally hit oil export driven economies hardest, most obviously demonstrated in KSA, with the country citing a GBP 98bn budget deficit in 2015. It is little surprise therefore to hear of the Saudi Government's recent plans to combat this through the proposed float of a minority stake in Saudi Aramco as the centrepiece of a newly transformed Saudi economy, ultimately aimed at diversifying the Saudi economy away from hydrocarbons. It is reported that the IPO would seek to raise USD 100bn through the sale of a 5% stake in the company, valuing the overall group at USD 2tn. Should the IPO

succeed, it would be four times the size of the next biggest global IPO (Alibaba's 2014 IPO which raised approx. USD 25bn) – a real game changer for the region.

The Saudi Aramco float aside, the overall regional deceleration, coupled with lower government spending and a consequent squeeze on bank funding, has meant a generally slower deal flow overall, but there remain good opportunities for those funds that are prepared to be bold in finding and committing to investments. The adjustment to the "new normal" of USD 40 – USD 50 barrels of oil has helped instigate diversification in the markets and increase opportunities for VC investors, and consequently, PE funds too through Series C rounds. PE funds have also become more open to the idea of a secondary buyout market for regional targets, something which as recently as 2015 remained largely off limits for local PE houses.

Since Q3 2015, there has been increasing optimism in respect of the VC space, with talk of the "floodgates opening" and an estimated growth boom in the next four years. High profile Series C investment from Abraaj Capital in Careem, a web-based chauffeur driver service operating across 20 cities, was followed by a portfolio of VC funds (including funds based in UAE, Saudi and Kuwait) that invested through Series A and B. The Careem deal is viewed as a validation of this increased optimism for VC players, and sits alongside investments into JadoPado and Souq.com as examples of how VC can work well in the region. Particular markets to watch in the VC space include the UAE, Saudi Arabia, Jordan, Egypt and Lebanon.

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Whilst the global IPO market has generally died down from last year's highs, a bounce back is predicted, which will have a knock on effect in the MENA region, perhaps to be triggered/buoyed by the Aramco IPO, should that get away successfully. Governments have sought to promote their domestic markets through easing of foreign investment restrictions and the lowering of minimum float percentages, however it is to be seen whether these measures will make much of an appreciable difference. Increasingly, given uncertainties around exits, investors have run dual-track strategies (trade exit & IPO run in parallel), such as the recent exit from Network International, although managing the stakeholders' interests successfully during that process can prove difficult.

Globally, there are an increasing number of funds open to investing in the secondaries market, with European markets being particularly active in this area. However, secondary transactions in the Middle East have historically not featured at all. With PE funds under increasing pressure to deploy capital raised, and with primary investment options being thin on the ground (and trade exits and IPOs proving challenging) there

are signs that the secondary market is seeing some traction. Funds are required to lend greater thought and ingenuity to how they might unlock value from targets in a secondary buyout context, with strategic synergies and access to new markets being seen as the key drivers for both core and direct secondary buy-outs. (A distinction should be made between secondaries and distressed sales, which are seen as a separate asset class requiring distinct experience and skills, as well as with turnaround investments, which remain rare).

Outside of traditional PE markets for the Middle East, Iran is the key market to watch. Iran boasts a wholly compelling proposition. It has a young, talented, ambitious and tech-savvy population, a solid and growing stock exchange, a strong higher educational system and a strong manufacturing base. First mover advantage opportunities are naturally exciting many investors globally, with many PE and VC funds considering how best to structure their operations so as to enable them to invest into Iran but without jeopardising any US investors' positions or otherwise fall the wrong side of remaining sanctions. Many years of neglect in investment in infrastructure (oil fields, infrastructure, financial services, hospitality and communications) mean significant opportunities for outside investment both in the VC and PE spheres. However the need to enable domestic and international banks to properly transact with one another, the need for new and innovative financing, legal issues and a lack of managerial talent and low-level corruption may all present primary obstacles to the market which are likely to delay, to some extent, the rush that was otherwise anticipated following easing of sanctions in January 2016.

The African market has experienced a degree of pessimism in recent years, perhaps unjustifiably so. The common theory was that there is a lot of capital chasing too few deals. However there remain opportunities in the consumer products, healthcare and energy space, and particularly in solar energy. The large pool of young people and its potential as the future centre for manufacturing is a positive sign and could pave the way for investments in other sectors too as a result.

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Inbound investment into the Middle East remains cautious, with the lack of "big-ticket" deals cited as a key reason for the lack of investments. Whilst not so at risk of shadow capital, co-investment structures remain popular in the region with the recent co-investment example of Blackstone and Fajr Capital. Co-investments, particularly for PE investors situated outside the region, provide the benefits of an increased sense of security (particularly with shareholders in mind) and assistance with understanding the local markets. There has also been an appetite for co-investment between MENA based parties, as demonstrated by Dubai Capital Group and Abraaj Capital.

The advantage for PE houses in partnering with family businesses remain as compelling as ever – creating access to a trusted family brand and reputation, access to local capital and high quality human resources with good connections in the region. However issues remain in negotiating a workable corporate structure and the often-differing expectations in terms of timeline for exit and valuation.

Generally, it is predicted that the short-term markets will continue to feel the pressure of poor deal flow and regional uncertainty, but the longer-term outlook looks much more positive. On the other hand, those looking at VC markets and frontier investments (notably in Iran) see huge opportunities in the short, medium and long term for those capable of researching, structuring and executing the right transactions. Particular sectors to watch include healthcare, food and beverage, education and other consumer led markets.

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However from a wider perspective, this has also highlighted the need for proper legal and fiscal reform. The region currently does not have the degree of legal and fiscal sophistication most international investors would prefer to see. The lack of robust accounting standards and lack of transparency generally gives rise to difficulties on pricing, which continues to cause difficulties for international PE houses investing into Middle Eastern businesses. Furthermore, the lack of suitable domestic corporate structures for PE investments continue to encourage investments to be routed through offshore structures (Channel Islands, Cayman and BVI continuing to be primary routes). As international money markets increasingly scrutinise investments routed through these jurisdictions in light of the Panama Papers scandal, the pressure to find alternative structures which have the benefit of corporate flexibility, predictability and sophistication, with tax efficiencies, may increase, although we do not expect any major changes to those options in the short term. There are indications that these issues may change in future, such as the proposed introduction of VAT in the UAE which, if properly implemented, is likely to force businesses to focus more on proper accounting standards and record keeping. However, as with any such developments in the Middle East, this is likely to take some time to implement effectively.

In the meantime, for those prepared to look at smaller ticket prices and brave new markets, there are opportunities for a range of investments and strong returns.

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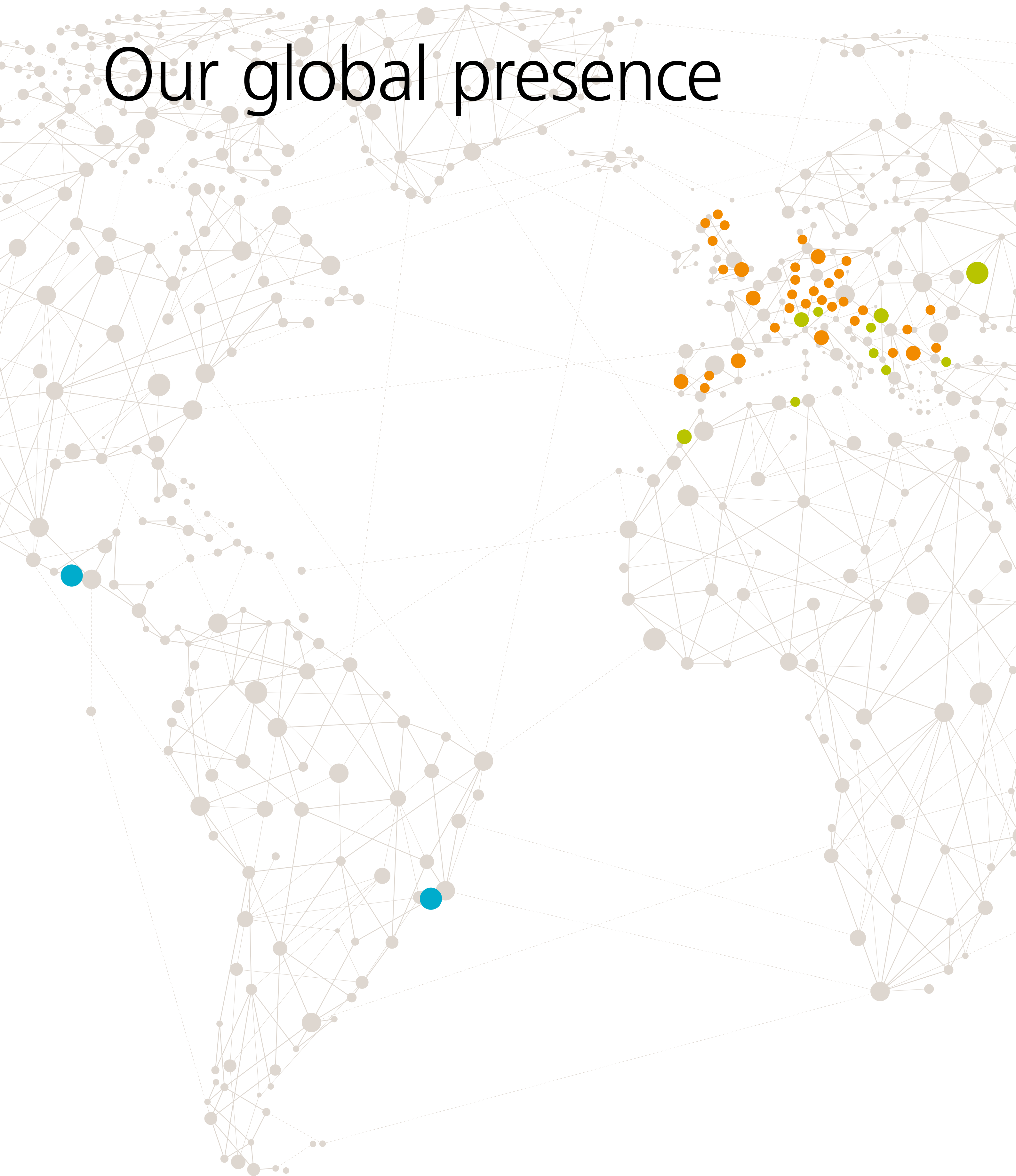

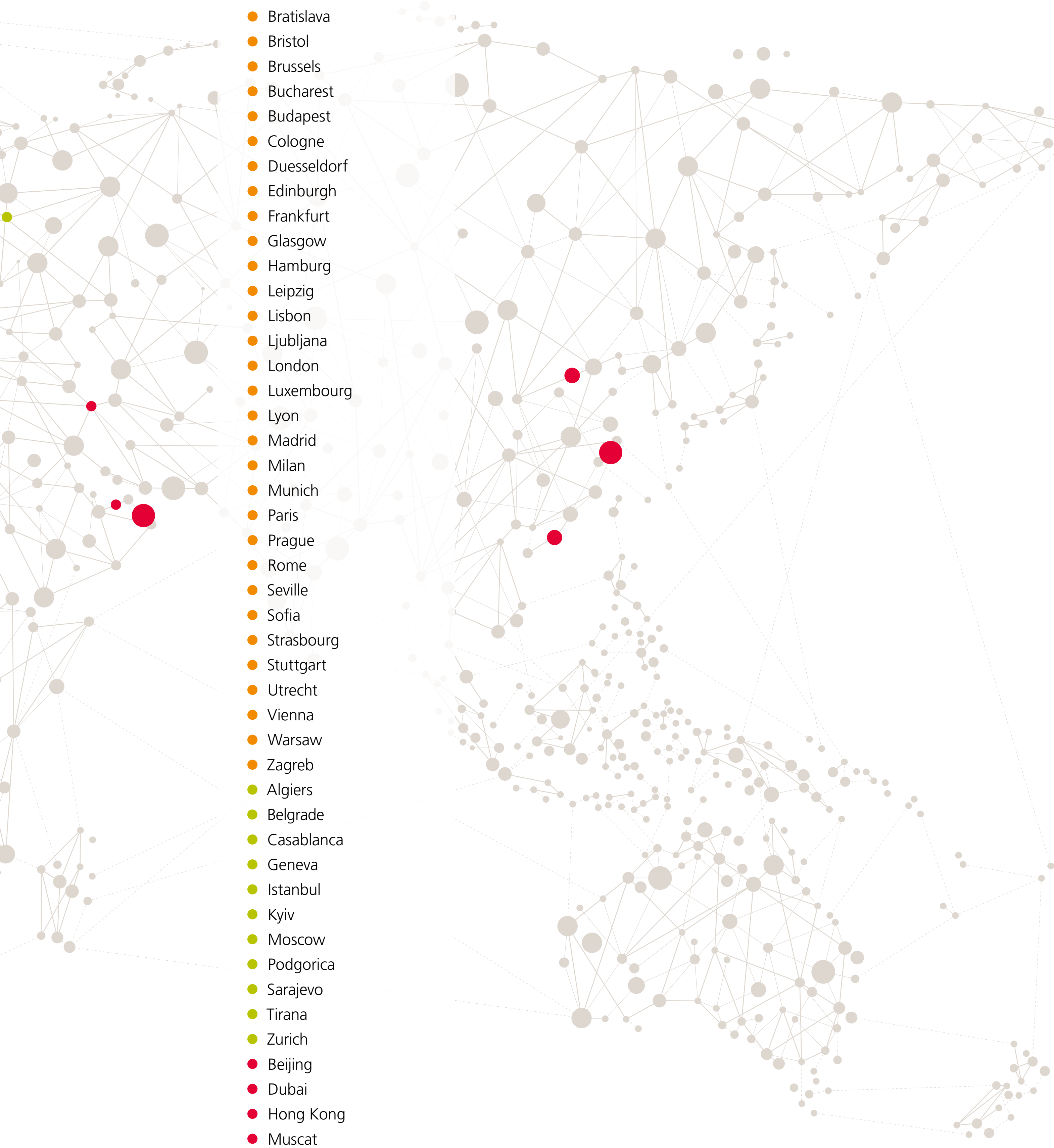

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