

WORLDWATCH



PRIVATE EQUITY



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CONTENTS

Fortune favours the bold (and well structured)
GILBERT + TOBIN

BVI legal and regulatory framework –
insight for offshore private equity investors
O'NEAL WEBSTER

The recovery of private equity – a series of false dawns?
PRICEWATERHOUSECOOPERS

Regulation of private equity in Germany
MAYER BROWN

54	Current status of Portuguese private equity RUI PENA, ARNAUT & ASSOCIADOS	62
56	Carried interest taxation: on the edge of a sea change? VEDDER PRICE	64
58	US private equity industry assesses impact of financial industry reform legislation HUNTON & WILLIAMS LLP	66
60		

PORTUGAL

Current status of Portuguese private equity

BY FRANCISCO XAVIER DE ALMEIDA AND VASCO RODRIGUES

Although private equity transactions may date back to the beginning of the 20th century, private equity would not gain its true form until after World War II, when venture capital and private equity firms American Research and Development Corporation and J.H. Whitney & Company were incorporated in 1946 in the United States. These firms were known for their investments in the buyouts of Digital Equipment Corporation and Florida Foods Company (which developed the Minute Maid orange juice), respectively, which created massive returns for their investors.

In Portugal the first private equity legal framework was enacted in the mid-1980s to facilitate alternate forms of financing of small and medium companies (SMEs) as opposed to traditional bank loans – this piece of legislation created the private equity companies (*sociedades de capital de risco* – SCRs) as a vehicle for private equity investment.

In its early stages (and, to a certain extent, today), banks and State wholly-owned entities dominated the industry, whereas their investments were primarily focused on distressed assets and turnarounds and not in private companies with high growth potential (as originally intended).

In the 1990s, private equity in Portugal took

a step back with a surge of IPOs and privatisations flooding the markets and proving to be the primary target of investor demand. It was not until the end of the decade and beginning of the 21st century that private equity made its foothold in the markets, mostly because, on the one hand, there was an increase of investor demand and, on the other hand, legal developments came forward which: (i) facilitated the incorporation and operation of private equity companies and funds; and (ii) created tax benefits applicable to these investment instruments.

Moreover, the creation of private equity funds run by private and independent managers, such as Explorer Investments, Magnum Industrial Partners, and ECS Capital, greatly contributed to the development of the industry in the last decade.

Legal background

As the industry expanded, the legal regime applicable to SCRs and private equity funds (*fundos de capital de risco* – FCRs) was significantly amended in 2007 with the enactment of Decree-Law 375/2007, of 8 November, providing more flexibility and simplicity to the private equity activity. SCRs and FCRs maintained their position as the primary vehicles for private equity activity, whilst a new vehicle for private equity investment was created, the private equity investors (*investidores em capital de risco* – ICRs).

Main features of SCRs and ICRs

SCRs are companies incorporated under the companies limited by shares (*sociedades anónimas*) legal rules. SCRs may invest directly in other companies by purchasing minority or majority shareholdings in such companies or manage FCRs, acting on behalf of the FCRs' investors. If the SCR's sole activity is to manage FCRs, the share capital requirements for its incorporation are lower (€250,000) than if it intends to carry out private equity investments directly (€750,000).

ICRs are deemed, under the current legal framework, as private equity companies (SCRs) which must take the form of wholly-owned limited liability companies (*sociedade unipessoal por quotas*), the share capital shall be held by a single private individual. The creation of this instrument is based on the rec-

ognition by the Portuguese legislator of the relevance of business angels in the industry. Capital requirements of ICRs follow general corporate rules for these types of companies, i.e., €5000.

Main features of FCRs

FCRs incorporated in accordance with Portuguese laws are tax exempt, which makes them the preferred vehicle for private equity activities.

Under Portuguese law, FCRs are deemed as autonomous assets which are owned directly by the investors (LPs). The liability of investors is limited to their participation in the fund and although FCRs do not qualify as legal persons, legal action may be brought against them in a court of law.

The invested capital in a FCR is represented by participation units held by each investor, the minimum value of which must exceed €50,000 and, in aggregate, shall amount to at least €1m.

The operation of FCRs is carried out by a management company (general partner) – usually an SCR – who acts on behalf of participants of the fund (the LPs). The management company is legally bound to protect the interests of the LPs and to act in accordance with high standards of diligence and professional skills in all facets of the operation.

FCRs are subject to a management bylaws (*regulamento de gestão*), drafted by the management company, which provide for a set of rules that the FCR and management company must follow in its operation, e.g., FCR's term and investment policy, indebtedness ratios, identification of the different categories of participation units and their respective rights and conditions, distribution of earnings to LPs and management company's fees.

New challenges

The global financial crisis may be deemed as both a blessing and curse for the private equity industry.

A blessing because the financial crisis presented private equity firms with investment opportunities in companies which have a good business model and maintain a high growth potential, but may be facing liquidity or financial issues which undermine their present value and, therefore, may be bought out for a ►►

The creation of private equity funds run by private and independent managers, greatly contributed to the development of the industry in the last decade.

lower consideration. Firms with liquidity may find excellent investment opportunities at low cost and, therefore, possibly maximising their returns in the future.

This is however the silver lining, as the financial crisis also created at least two major obstacles for the private equity industry.

The first is related with the fundraising activity, as the investor base has demonstrated that it is less prone to invest in FCRs.

The second is the credit crunch that has affected the markets in general and private equity firms in particular, especially those which focus their activities on leveraged buyouts. The credit freeze has also had an impact on the day-to-day operation of the companies held by

private equity firms, jeopardising the growth and exit strategy that had been put in place at the time the investment was made.

For legal practitioners, the current environment has also given rise to new challenges, as lawyers are expected to be more creative in their participation in deals in order to overcome any issues that arise during a transaction. It is clear that transactions are taking a longer period of time to be finalised. In some cases, because of the uncertainty that has affected the markets in others because target's shareholders may feel unwilling to sell at the prices the market is giving them and may wish to hold out on selling their businesses at a later stage in a boom market. Legal advisers must play a cru-

cial part as they may act as mediators and come up with solutions that fit the parties' needs and facilitate the conclusion of transactions.

Portuguese M&A activity has suffered deeply from the present market conditions and we have witnessed a sharp decline in deals since its peak in 2007. Private equity has not, however, followed this trend, as the amounts invested by private equity rose by 13.7 percent in 2009, according to the Portuguese Private Equity Association (*Associação Portuguesa de Capital de Risco*).

In conclusion, all players, from private equity managers, to investors and lawyers, must adjust to these new market conditions if they intend to prosper in the current climate. ■



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Rui Pena, Arnaut & Associados (RPA) is currently one of the leading firms in the Portuguese legal market and its practice covers all areas of law, while focusing on providing the legal services required by market players from all sectors of the economy. Our Private Equity practice has

experience in creating funds, fundraising procedures, acquisitions, sales, business restructuring, financing acquisitions, strategic partnerships and assistance in daily management of investment portfolios. We help clients to manage their investments so they can increase the returns they

get from them. We try to make sure that we help our customers with their individual investment problems. RPA's client portfolio includes a large number of international clients and some of the biggest Portuguese corporate groups. For more information visit www.rpa.pt.