



Crisitunity?

We have often heard over the years that the Chinese have the same word for both Crisis and Opportunity. Hearing this, Homer Simpson amusingly created the portmanteau of “Crisitunity”.

While scholars generally agree that the actual words “wei ji” have been twisted by non-native speakers, most do agree that the word can be most literally translated as “precarious moment”.

And that is precisely what we face at the present time with tightened debt markets, fund raising, and the upcoming exit overhang.

Times of uncertainty create fear and so what to do next? Simply, the industry is to go back to basics of creating alpha by moderating risks, reducing costs, and guiding regulators to be sensible and avoid stunting a job-creating industry.

In this edition of PE Update, we focus on opportunity.

Guy Hands of Terra Firma shares insights into where the opportunities lie, with a focus on the hard graft, operational changes, long-term perspective that are all needed to create value in a volatile and uncertain market.

Christian Schatz of SJ Berwin’s Munich office reflects on German KGs that were often setup in years past due to uncertainty in the German tax code which created fear of double taxation. As the tax law was clarified, investors benefited from less complex and lower cost structures – the challenge now is to clear up the legacy of the past efficiently.

Andrew Whittaker, MD of our London operation, comments on the perils of the emerging regulatory “reefs”.

Speaking of opportunity, I would like to take this moment to thank all of our clients and friends for their ongoing business and to wish you all a happy and productive remainder of 2011.

Justin Partington,
Commercial Director, Ipes

Why creating alpha is going to be more relevant to private equity than ever before

by Guy Hands

Back in 2006 I remember referring to the years from 2002 to 2006 as ‘the Woodstock years’ for the private equity industry. Since then the industry has been toughened by very harsh markets. The tide of rising multiples and opportunities for creative financing have disappeared for the foreseeable future and our industry is having to focus once more on the challenge of creating alpha.

Right now I have two predictions about the markets. First, until a convincing solution to the Euro is hammered out amongst politicians, we are in for a long period of volatility. Second, I do not believe that the stock market at the beginning of 2020 will be any higher than it was at the end of 2010. It will mean a second lost decade in the public markets.

By contrast, a private equity industry rediscovering the importance of generating alpha offers an attractive proposition. Private equity will not provide a “safe harbour”, but it can provide a reasonable environment in which to build businesses.

Those who are able to transform and grow companies successfully will succeed. The bad news is that generating alpha through this kind of interventionist approach requires insight and commitment:

- Insight because the best investment opportunities are likely to be those that benefit from long-term trends that will prevail even in the current turbulent environment. Avoiding some of that turbulence is one of the reasons that Terra Firma looks for businesses in ‘essential’ industries.
- Commitment because creating alpha through business transformation takes time and energy. A long-term approach is critical, particularly at present, but can be rewarding. We have found that businesses that require fundamental change invariably deliver the most alpha.

I believe that it is vital to know, right from the start, where value can be created. When looking at a potential investment, I don’t put too much faith in what the incumbent management team says is possible. I am far more interested in what my team thinks is possible. I also want to know that the business is rich in assets. Our due diligence not only assesses the shape of the existing business, but also triggers a process of planning the strategic and operational changes that we will make to create alpha. Over the years we have refined that process and it works as well for renewable energy businesses as it does for cinemas or aircraft leasing businesses.



terra firma

Once we have control (and control is one of the keys to transformation) our first move is to strengthen the management team. We will typically make several new appointments. However, in the case of AWAS, the aircraft leasing business that we acquired in 2006, we ended up replacing almost the entire senior management team as it was so scattered around the Globe that it hampered effective decision-making. As is often the case, our strategy was also rather different to their existing plans – we wanted to reduce the risks of operating in a notoriously cyclical industry by improving the mix of AWAS's fleet and reducing its dependence on some key customers. It would help us to lower the business's cost of capital.

Next comes investment and operational improvement. We generate alpha by creating best-in-class businesses and that cannot be done just by making cuts. We build through acquisitions and sustained capital programmes. Odeon and UCI is a great example of both; since acquiring and combining these two cinema chains, we have secured a leading position in Europe through bolt-on acquisitions. We have also invested in a vastly improved retailer offer, better seating and digital projection across our sites. It has improved customer experience and spend per visit. At Tank and Rast, our German Autobahn service station business, we have had similar success growing the number of customer visits and their spend through steady investment. (Last year our total capital expenditure across our portfolio was over €1 billion.)

I expect that, within 18 to 24 months, there are going to be a substantial number of investment opportunities such as these for European GPs, provided they can raise investment capital and debt finance. Opportunities will emerge as small and mid-sized companies find that they lack the capital to grow. Meanwhile, divisions of large European companies will also be divested as their parents invest in Asia. Governments too will also be sellers of assets. There will be plenty of potential alpha within this market for investors with insight and commitment.

In a volatile world where people are rightly concerned about paper assets, I believe that private equity firms with a proven track record of generating alpha will provide attractive investment opportunities.



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Guy Hands is Terra Firma's Chairman, Chief Investment Officer and Founder. Guy sits on the General Partners' boards.

Guy started his career with Goldman Sachs International where he went on to become Head of Eurobond Trading and then Head of Goldman Sachs' Global Asset Structuring Group. Guy left Goldman's in 1994 to establish the Principal Finance Group (PFG) at Nomura International plc which acquired 15 businesses with an aggregate enterprise value of €20 billion. Guy led the spin out of PFG to form Terra Firma in 2002.

Guy has an MA in Politics, Philosophy and Economics from Mansfield College, Oxford University. Guy was elected a Global Leader of Tomorrow of the World Economic Forum in 2000 in recognition of his achievements. Guy is also the President of "Access for Excellence", a campaign based at Mansfield College, Oxford, which promotes the broadest possible access to higher education in the U.K. He is a Bancroft Fellow of Mansfield College, Oxford and a member of the University of Oxford Chancellor's Court of Benefactors. Additionally, Guy is a Fellow of the Duke of Edinburgh's Award Scheme.

Ipes News

New mandate wins

Crescent Capital's Clean Energy Transition Fund LP ("CETF") announced a first close in September. It is Turkey's first private equity fund with a focus on the clean energy sector. Ipes was appointed as the administrator for the Guernsey fund following a competitive pitch process. Aygen Yayıkoglu, the founder and managing partner of Crescent Capital said "Ipes' credentials in both the Turkish market and the clean energy sector stood out. The experience of the team we met and their willingness to support us through the set up process was also an important factor in our decision.

Steadfast Capital, a leading buyout advisor, achieved a first close on its third fund at €104m earlier this year in just four months. The fund, which was supported by existing investors has a final target of €250m. Ipes already works with Steadfast Capital on its second fund. Nick Money-Kyrle, Steadfast Capital's founding partner, said "Working with service providers like Ipes with whom our team already have a good relationship, and who really understand our business was certainly a benefit both to Steadfast and to our investors".

Ipes sponsors 2nd Alternative Assets Regulation Conference

Ipes is pleased to be supporting and speaking at this one day Private Equity Forum event in London on 29 November 2011.

The AIFM Directive is now in force, and Member States have less than two years remaining to transpose the Directive into national law. In November, the new European Securities and Markets Authority (ESMA) will publish its technical guidance to the European Commission on the Level 2 implementation provisions of the legislation. Through company case studies, in-depth presentations and panel discussions, the event will provide you with clarification on the next series of changes to ensure you are aware of the necessary key actions and deadlines.

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**PRIVATE EQUITY
FORUM**

How to get rid of a KG?

by Christian Schatz

Many international private equity fund structures set up prior to 2005 include a German Kommanditgesellschaft – limited partnership ("KG"). The purpose of these KGs was to invest in parallel to the fund vehicles established outside of Germany and they were most commonly used with respect to investors who were tax resident in Germany.

The reason for implementing such KGs was uncertainty as to whether the German Foreign Investment Fund Act ("FIFA") was applicable to non-German private equity funds. German investors feared a negative tax effect were FIFA to be applied. However, through investing via the KG, investors were in a position to argue that FIFA was not applicable.

No need for parallel KGs anymore

With effect from 2004, FIFA was replaced by the German Investment Act and the German Investment Tax Act and subsequent to this, the German administrative practice confirmed that such legislation is not applicable to private equity funds. Accordingly, nowadays KGs are no longer set up and most investors invest directly into non-German private equity funds.

What to do with such a parallel KG when the term ends?

Funds which use such KGs and are coming to the end of their term are faced with the question of what to do with them. Should they be liquidated, or are there more clever ways to get rid of these now obsolete KGs?

Standard way: Liquidation

KG limited partnership agreements normally also provide for a specified term. If the term of a KG ends, the KG enters into liquidation pursuant to German partnership law. The KG is then not allowed to pursue its business any longer. The liquidators of the KG, which are either already provided for in the partnership agreement, or which need to be appointed in due course, are responsible for arranging the settlement of all liabilities and the distribution of all assets of the KG. In particular, this requires them to investigate any liabilities and to dispose of all assets not available in cash.

During the liquidation, the liquidators also need to take care of all compliance affairs. Beside the relevant reports for the liquidation process, this requires them to prepare annual accounts until the liquidation is complete. In addition, the liquidators need to arrange all tax and other filings for the KG.

Deregistration

A KG ceases to exist with its deletion from the commercial register in which it is registered. The court responsible for the KG will only "deregister" it when all its affairs are settled. Unfortunately, this also requires that the German tax authorities have confirmed that all tax affairs, including all tax audits in respect of the KG have been finalised.

As you may have experienced, this can last for some time given the German system of tax assessments and tax audits. We have already seen KGs needing to be administered for several additional years where it was not possible to settle the tax affairs. In addition, such a liquidation process can trigger substantial costs for which the partners of a KG are generally still responsible.

How to speed up things?

There is a way to arrange a winding up of a KG more quickly. A KG requires two partners. If all limited partners transfer their interests to the general partner of the KG, the KG automatically ceases to exist. The general partner then assumes all assets held and liabilities owed by the KG as a matter of universal succession without any further actions to be taken. In particular, this includes, all tax affairs of the KG for which the general partner is then responsible.

This fast winding up can be arranged within days. Certainly, the liquidation of the GmbH may then take some additional time, but the investors are no longer troubled by also being a partner in the parallel KG.



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Christian Schatz is a partner and certified tax adviser (Steuerberater) in the Munich office.

He specializes in tax with a particular focus on fund formation and M&A transactions (buy-out, venture capital, reorganizations) and advises fund houses on structuring issues as well as investors in funds with a particular focus on private equity, infrastructure and real estate funds.

In addition, he represents several clients in front of German tax authorities in tax ruling and tax audit procedures. Christian joined SJ Berwin in 2001.



The perils of reefs

by Andrew Whittaker

With the changing regulatory landscape fund managers must now chart their way through a number of regulatory reefs which endanger their good ships in delivering value to clients and attracting investors. As austerity measures begin to bite and the authorities close in on investors and structures, the portent of these reefs is becoming apparent.

One such reef for funds with American investors is the need to plan for FATCA compliance. Whilst the initial reaction for many managers will be one of trying to stay out of this regime, operationally it may well be worthwhile working with your advisors to make sure this is the most pragmatic approach.

While many are still in the planning stage, registration in the right format to avoid funds being labelled as Foreign Financial Institutions can greatly reduce the operational burden of the regime. Planning in this regard is particularly prudent given that comparable European regulation (particularly in the north) is likely to follow suit.

A similar story is taking shape with the AIFMD and third countries. For the sophisticated investor the feared exclusion of some offshore jurisdictions has actually proved to be a fillip as high quality jurisdictions such as the Channel Islands will meet or exceed the third country rules allowing use of the private placement regimes to gain access to EU investors. Indeed, these offshore locations are often able to interpret and apply the rules more thoughtfully to the investors they are looking to service than some of the more prescriptive onshore watchdogs.

Increasingly we are seeing our clients establishing parallel structures. These are either an offshore GP to run in parallel with the onshore GP, or a Luxembourg parallel fund to run alongside a Channel Islands structure. Further, some think that managers and investors can create subsidiaries in third countries which mirror the EU structure, creating a whole parallel substructure outside the AIFMD.

We are all aware that some influencers are keen to keep fund structures onshore by creating and facilitating tax-efficient vehicles for investors into alternative asset classes. This seems to be undermined by idiosyncrasies of onshore law makers maintaining barriers, such as the UK's unique Stamp Duty Reserve Tax "SDRT" regime (which adds roughly five basis points to a captured structure's cost base). Despite consistent appeals for its revision, and studies attempting to quantify its inefficiencies to funds, it remains an ongoing presence requiring consideration by onshore funds with respect to the holding, turnover and exit strategies of certain captured assets and vehicles.

Similarly, the Investment Trust regime has had a recent legislative and tax revisit. For those in the UK, Listed Funds often favour an offshore domicile to make use of the wider tax advantages available to certain investor and asset types.

Meanwhile Solvency II continues to simmer in the background for institutional investors. It is possible that some of the restrictions being placed on insurance companies may, due to a possible higher risk rating, diminish both their ability and appetite to invest in alternative asset classes, such as private equity. More concerning still is that similar restrictions are being mooted for pension funds.

The uncharted reefs of regulation never did seem so colourful in offering so many opportunities to founder in peril! Let's hope for a steadier hand on the legislative tiller in the coming year.



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Andrew is the Managing Director for Ipes UK and has overall responsibility for the management and development of the London office.

He joined Ipes in January 2011 from Capita Financial Group's Specialist Fund Services (formally Sinclair

Henderson) where, as Managing Director he led teams specialising in Real Estate, Private Equity, Investment Companies, Offshore Hedge Funds, Taxation and DTP; whilst also providing scalable back office support to the Group's Channel Island and Gibraltar offices.

Prior to this, Andrew held senior management roles at Moscow Narodny (now VTB Capital), where he was part of the team responsible for returning the Bank to investment grade status and at DML and led a restructure to meet SEC requirements.

Andrew graduated from Cardiff University and is a Chartered Management Accountant. He is a member of the Association of Investment Companies' (AIC) Technical Committee and the Association of Real Estate Funds' (AREF) Regulatory Committee.

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Ipes is regulated in each of the jurisdictions in which it operates.
For more information, please see our website.

