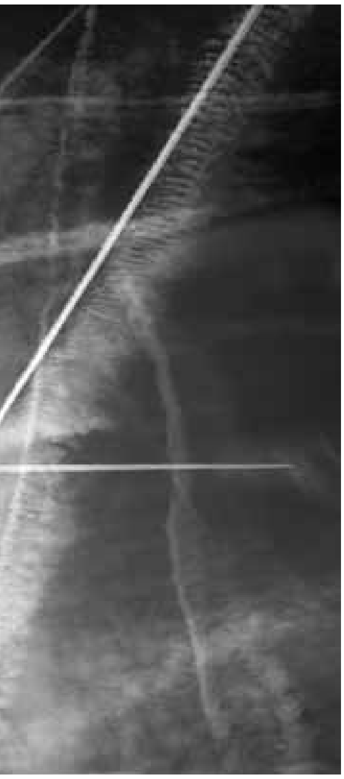

2011

The Netherlands private equity and leveraged finance market - an outlook

NautaDutilh

Introduction

There was talk of the death of private equity as the credit crunch in 2008 cut off access to debt as the industry's 'lifeblood' and the ensuing global recession threatened to topple many of private equity's debt-laden portfolio companies.

Then again, the demise of private equity had been predicted before. In 1990 for example, when the collapse of the high-yield bond market and the US savings-and-loan crisis triggered a recession. Or in 2000, when the burst of the technology bubble set off another recession and a period of economic uncertainty. Each time, however, private equity rebounded and proved adaptable and able to find new areas of activity and new ways to grow.

Today, it seems that we are seeing a rebound once again, as private equity deal activity has shown a remarkable growth after a dismal 2009. This growth, however, is taking place against a background of continuing global economic uncertainty; a banking system that is still recovering from its own near-death experience; and politicians and regulators who continue to look for ways to contain the risk and instability that has built up in the financial system.

Against this backdrop, NautaDutilh set out to investigate the outlook for private equity and leveraged finance in the Netherlands. We conducted an online survey among private equity managers, M&A and leveraged finance bankers as well as corporate finance advisers, and followed up their responses in a series of interviews with industry participants.

In NautaDutilh's first outlook on the Netherlands private equity and leveraged finance market, we present the results of this investigation. In addition, we have included our own analysis of recent regulatory and tax developments and how these are expected to influence the sector. We sincerely hope this outlook helps you to form, validate or challenge your own views on the future of private equity in the Netherlands. We welcome your comments.

Gaike Dalenoord, partner Private Equity
David Viëtor, partner Leveraged Finance

Law Firm of the Year: The Netherlands | IFLR Europe Awards 2011
Law Firm of the Year: The Netherlands | Chambers Europe Awards 2010

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1. The climate for private equity in the Netherlands

“Is private equity dead?”, asked Henry Kravis, one of the industry’s titans, in his address at the SuperReturn conference in Berlin in early 2009. At this get-together for the private equity industry, Kravis went on to deny the approaching demise of the industry he had helped grow to unprecedented heights. But just by posing his question, he verbalised the sense of gloom present among the private equity chiefs and the difficult times they were facing. In any case, an end had come to the days of ever-larger multi-billion dollar deals and near-automatic returns fuelled by an abundance of cheap credit. As Kravis declared, the mantra for private equity for the years to come would be “portfolio, portfolio, portfolio”. Restructuring portfolio companies, deleveraging them and weathering them through a severe recession would be the key to survival for many private equity firms.[1]

But that was all two years ago. Participants at this year’s SuperReturn conference heard a remarkably more optimistic view expressed by David Bonderman, founding partner of TPG Capital. He confidently stated that it is “absolutely possible to do a 10-to-15-billion-dollar deal now. It might not be one you want to do. It might not be one you should do. But the capital is available.” Bonderman should know. In 2007, together with Kravis’s KKR, TPG Capital bought TXU Energy for US $44 billion in the largest buy-out to date.[2]

“It is absolutely possible to do a 10-to-15-billion-dollar deal now.”

[1] As quoted in: http://in.reuters.com/article/2009/02/03/us-buyout-idINTRE5125A020090203

[2] As quoted in: http://dealbook.nytimes.com/2011/03/03/bonderman-sees-a-return-of-big-private-equity-deals/

Cautious optimism

Although not a market in which those 10-to-15-billion-dollar deals occur often, this new optimistic sentiment, albeit coupled with caution, is also present in the Netherlands market. In our survey and follow-up interviews, respondents were for the most part optimistic about the deal climate in the Netherlands this year, in comparison to both last year and other European countries (see Figures 1A and 1B).

Figure 1A: Private equity deal volume 2011 compared to 2010

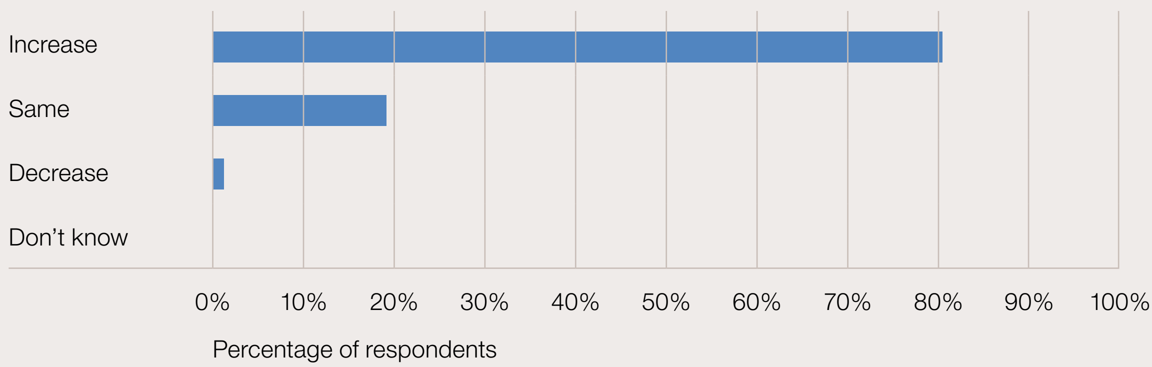
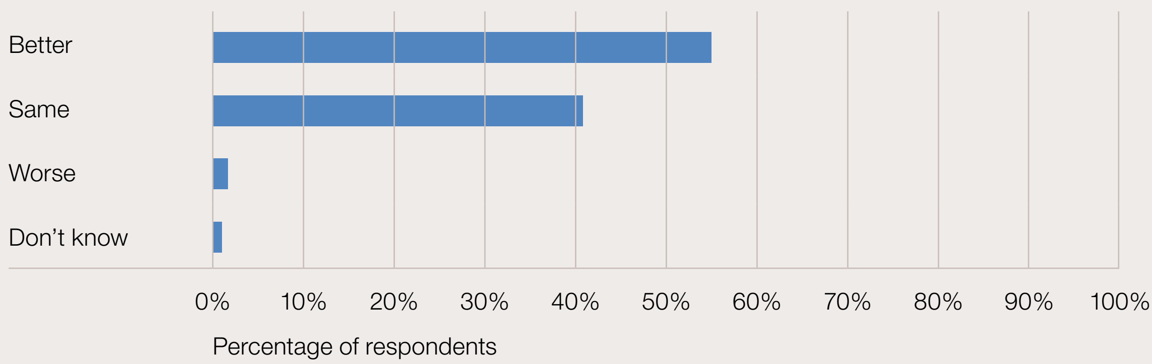


Figure 1B: Private equity market Netherlands compared to Europe



The picture that emerges for 2011 is that the year is off to a good start, as the upturn that began in the second half of 2010 is continuing. This is generally attributed to a backlog of deals that had been put on hold during the previous two years and which were resumed once economic and financing conditions started to improve.

As the M&A market opened up again, private equity firms were among the most active buyers. “There was a real eagerness on their side to do deals”, observed a banker who saw private equity firms participating in “nearly every auction process that was started.” In a few cases, this eagerness has, in the opinion of several interviewees, led to deals of “not very good quality”, for example where buyers are said to have overpaid.

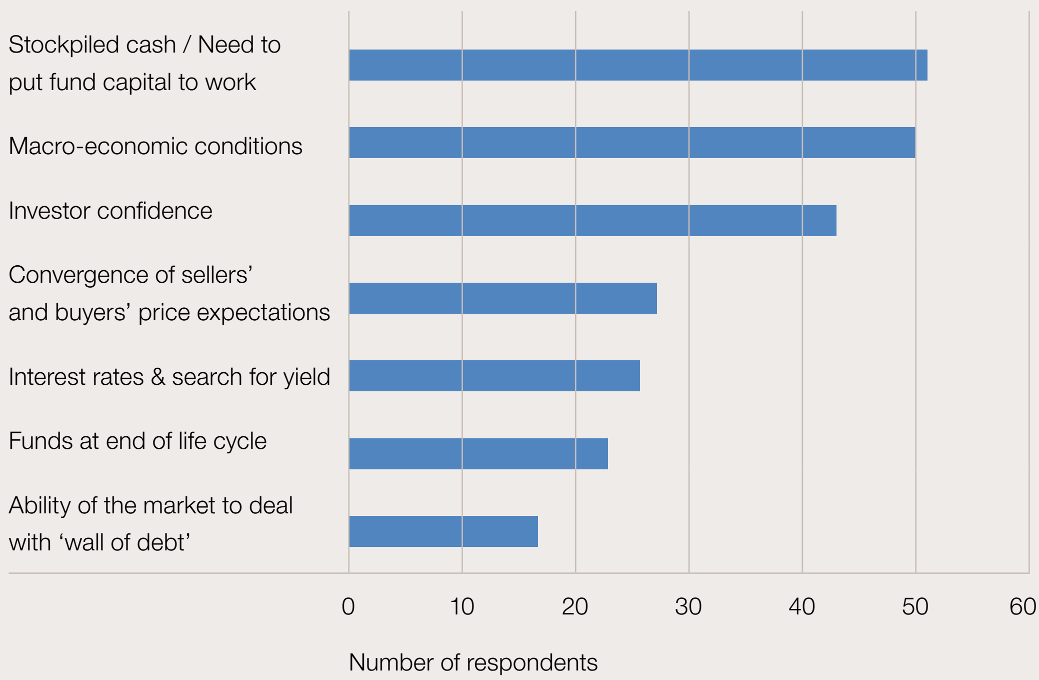
As far as private equity activity on the ‘sell-side’ is concerned, our interviewees generally think that only the best performing and best positioned companies, the pearls in their portfolios, have been put on the market in this upturn. Portfolio companies that require more time and effort to fully recover from the recession and focus on growth again have not yet been put up for sale. Sponsors are holding on to those companies as they hope to receive a more attractive price down the road once earnings have gone up. Potential buyers are still hesitant to pay a premium on growth potential amidst the general economic uncertainty, in particular the uncertainty caused by the sovereign debt crises in Europe. In fact, several respondents have recently noticed a slight drop in deal activity that might be explained by these factors. However, most respondents remain optimistic about deal activity for the remainder of 2011, as they point for example to deals they are currently preparing to launch after the holiday period.

As the M&A market opened up again, private equity firms were among the most active buyers.

What drives private equity deals in the current market?

When asked about the main factors that determine private equity deal volume in the current Netherlands market, respondents to our survey gave the answers shown in Figure 2 (seven highest scoring options only).

Figure 2: Main drivers for private equity deal volume



The pressure that many private equity firms face to put their ‘dry powder’ to work is clearly recognised by our respondents and interviewees. “They can’t just sit around and read investment memoranda for three years”, says a banker. Moreover, many funds that were established during the heyday of private equity in 2006 and 2007 are now nearing the end of their life cycle and may feel pressured to divest their portfolio companies. Without one or more successful ‘exits’ to show to investors, launching a new fund will be much more difficult. These combined pressures can be expected to result in many secondary or tertiary deals. However, based on our interviews, it seems that thus far there have been only a few signs of private equity firms responding to these pressures by doing deals against their better judgement.

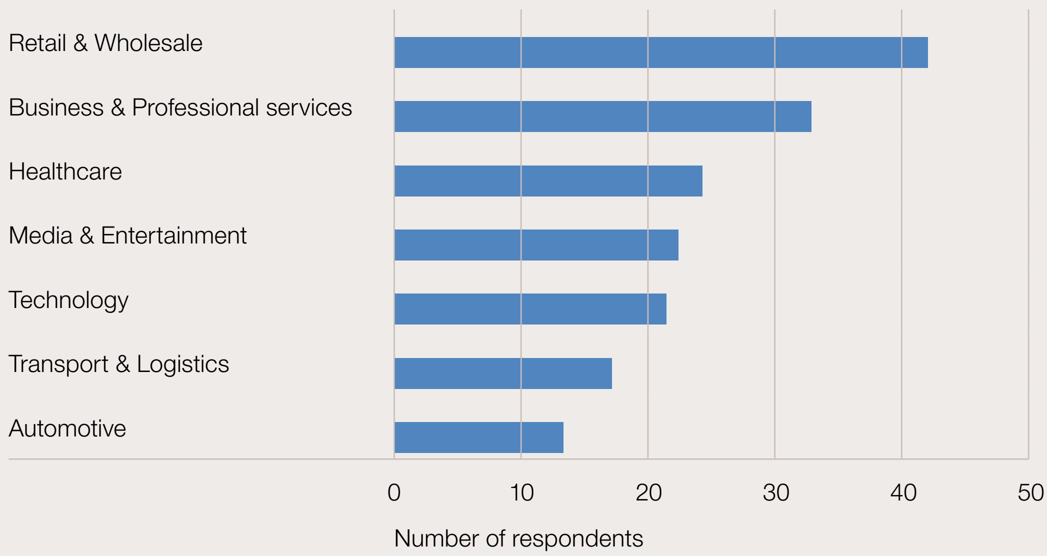
Apart from these drivers related to ‘fund mechanics’, the general economic and financial climate is regarded as the main determinant for private equity deal volume. The general picture that emerges is, again, one of cautious optimism in which the macro-economic climate is gradually becoming more conducive to doing deals. “When is the last time you read about a double dip?”, asked one banker. Specific economic developments mentioned as possible dampers on deal activity are the highly volatile commodity prices, the slow growth in several major economies and uncertainty about how the sovereign debt crises in Europe will play out.

But as economic conditions have stabilised and gradually improved, so too have companies’ results. This in turn is leading to greater confidence among investors about their companies’ valuations and a closing of the valuation gap between sellers and buyers. Low interest rates continue to make private equity attractive as an asset class, both for investors looking for higher yields and as a financing opportunity for banks in search of yield (see also Chapter 2).

Where is all this activity going to take place?

According to our respondents, most private equity deal activity is expected in the following industry sectors:

Figure 3: Industry sectors with most expected private equity activity



In the interviews it became clear that this overall view is the result of many individual views that sometimes differ wildly. Whereas some market participants, for example, consider ‘Business & Professional services’ an attractive sector for private equity because of its growth potential in a mature, service-oriented economy like the Netherlands, others point to the high risks inherent in ‘people businesses’ or their low leveragability that make them less attractive for private equity investors. Views differ particularly on the healthcare sector. Factors cited as creating a favourable environment for private equity investors are the sector’s potential for operational improvements, the growing part of healthcare that is open to market parties and the structural increase in demand for healthcare due to demographic and technological developments. However, as one interviewee observes, “many firms are looking to invest in healthcare, but few have actually taken the plunge yet”. This reluctance to invest is mainly attributed to the fact that the sector requires a long investment horizon, is heavily regulated and is subject to large and sometimes unpredictable government influences. To know the ins and outs of the sector and stay on top of future developments, private equity firms must therefore specialise. While such a barrier to entry makes life comfortable for the few investors on the inside, it currently seems to be keeping out many more potential investors.

Who's selling and who's buying?

According to our respondents, private equity firms are expected to be the most active players in the Netherlands M&A market, both as sellers and as buyers (Figures 4A and 4B). On the sellers' side, family-owned companies come next, whereas on the buyers' side corporates are expected to be the second most active players. Apart from 'forced sellers', for instance those in the financial sector, relatively few corporates are expected to come to the market as sellers. In our interviews, this is generally explained by the assumption that corporates have already used the past few years to divest most of their non-core or underperforming businesses.

Figure 4A: Most active sellers

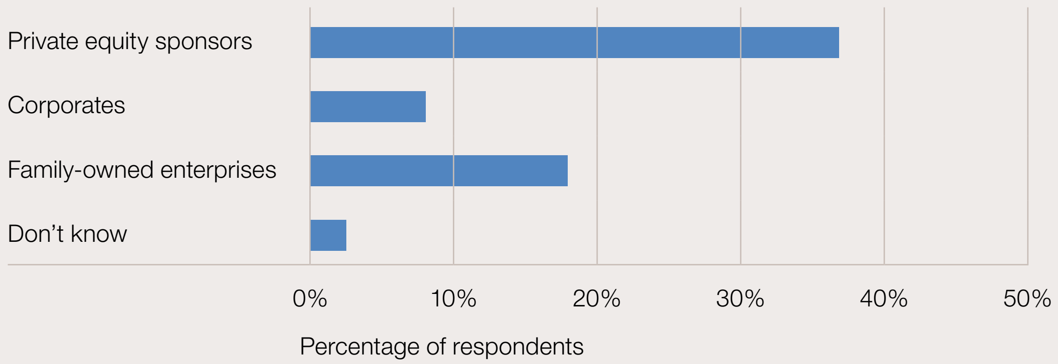
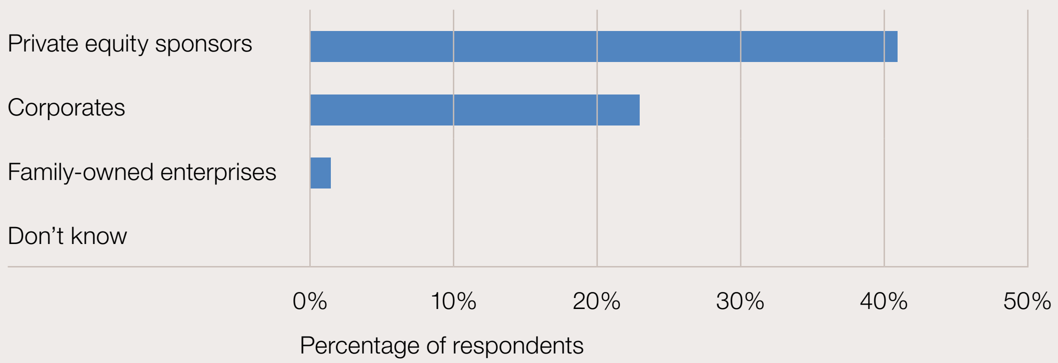
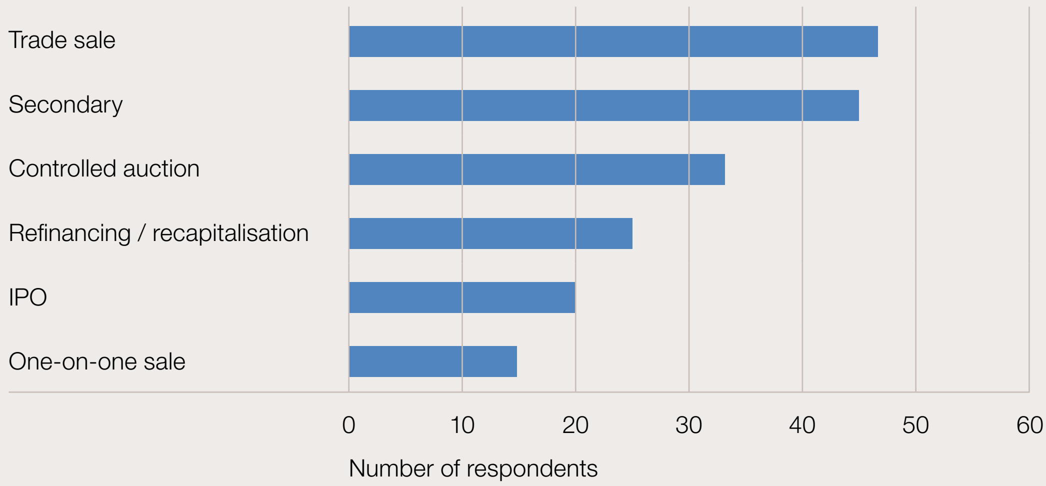


Figure 4B: Most active buyers



Private equity sponsors that want to divest their portfolio companies are looking to strategic buyers as much as to other private equity funds.

Figure 5: Preferred exit routes for private equity sponsors



The relatively high score for ‘refinancing / recapitalisation’ is linked to the fact that many portfolio companies are currently not ready for exit scenarios that fulfil sponsors’ expectations with respect to prices. Therefore, instead of a full exit, sponsors choose to hold on to such companies longer and recapitalise them in order to, for instance, take out a dividend.

In our interviews, IPOs were largely dismissed as a valuable exit scenario for portfolio companies in 2011. Of course, there is the traditional view that private equity owners usually prefer a full exit over a partial float combined with a lock-up in an IPO. In addition, in the absence of an active stock exchange for small to midmarket companies in the Netherlands - like AIM in the UK - few portfolio companies are considered to have the size or growth potential to seek a listing on NYSE Euronext Amsterdam. Some interviewees, however, foresee an increase in IPOs in a few years, as they become a more fitting exit route for companies that have grown (for example through a series of buy-and-build transactions) to a sufficient size under the ownership of successive private equity firms.

The expected activity of corporates as buyers is based mainly on the large amounts of cash accumulated on their balance sheets. However, despite this financial firepower, several interviewees report a lack of M&A activity from corporates. “The window in which corporates can responsibly outbid private equity is closing rapidly. Yet we see corporations being very careful and hesitant when it comes to acquisitions. They pass on deals and some prefer to buy back shares instead. I guess there is some fear to face their shareholders with plans for new acquisitions”, an M&A adviser. Such plans would require quite a turnaround, especially for listed corporates, which for the past few years have been held accountable by their shareholders mostly on such issues as the strength of their balance sheets, their ability to stay their course while avoiding pitfalls and their success in securing sufficient financing.

Trend: Moving down the food chain

Private equity firms are expanding their focus to smaller companies that were previously deemed too small to be of interest to them, several interviewees report. There seem to be various reasons for this. First is the reported lack of new, primary deals appearing on the market, relative to the amount of untapped liquidity that private equity firms can put to work.

Secondly, this new interest in smaller companies may be driven by the recognition that growth and improvements in operational performance in their portfolio companies will become an increasingly important source of returns for private equity firms. Indeed, 50% of the value created by private equity from 2010 onwards is expected to come from operational improvements, with multiple arbitrage (30%) and leverage (20%) accounting for the other half [1]. In the past decade, these factors contributed 36%, 39% and 25% respectively to all value created by private equity, continuing the trend in which operational improvement has become increasingly important from the 1980s onward. The assumption behind the shift towards smaller company sizes is that, while these are inherently riskier as an investment, they also offer more scope for operational improvements and hence for higher returns.

Thirdly, there is some crowding out taking place on the Netherlands market caused by the increased activity of foreign private equity firms on that market, specifically those from the UK and the US. Of all respondents to our survey, 43% think that Netherlands private equity firms will be the most active players on the Netherlands market, while a combined 53% think that UK (37%) or US (16%) firms will be the most active players. As these foreign private equity houses aim mainly at the larger-sized companies, local firms are responding by turning their attention to smaller targets.

1: Silverlake presentation, SuperReturn Conference, 11 February 2010, as included in 'Rating Operative Performance of PE Portfolio Companies', a study by A.T. Kearney.

Such acquisition plans would also require a convincing investment thesis, as their current trading multiples are generally lower than those that private equity sellers expect to receive on their exits. The premiums these corporates thus need to pay for an acquisition would have to be compensated through synergy gains. If shareholders cannot be convinced of the feasibility of such gains, the stock price may take a hit.

Opinions differ on the wisdom of the lack of M&A activity among corporates. "Yes, they are very careful when it comes to acquisitions, but rightly so", says one banker, referring to the current economic uncertainty. Another disagrees: "If you want to grow, if you want to get somewhere, you need to be prepared to pay for that. That requires vision, leadership and sometimes a willingness to confront your shareholders. Some corporates' inaction with respect to acquisitions to me suggests a lack of these qualities."

2. Leveraged finance climate

Deemed toxic at the onset of the credit crisis, leveraged finance is no longer a no-go area for banks. The general market sentiment is that, by and large, private equity portfolio companies have weathered the crisis much more successfully than feared at its onset. The restructurings of portfolio companies that have occurred have, generally speaking, affected equity holders and junior lenders rather than senior lenders. The risk perception of the latter group is shifting. “Many companies have shown they can carry more debt than we thought they could”, says one banker, “Maybe we have underestimated the disciplinary effect of debt on companies, and how it forces them to make tough decisions fast.” Respondents to our survey tend to expect fewer restructurings, leveraged loan defaults and ‘loan-to-own’ transactions in 2011.

Figure 6A: In 2011 the number of ‘loan-to-own’ transactions with respect to portfolio companies will:

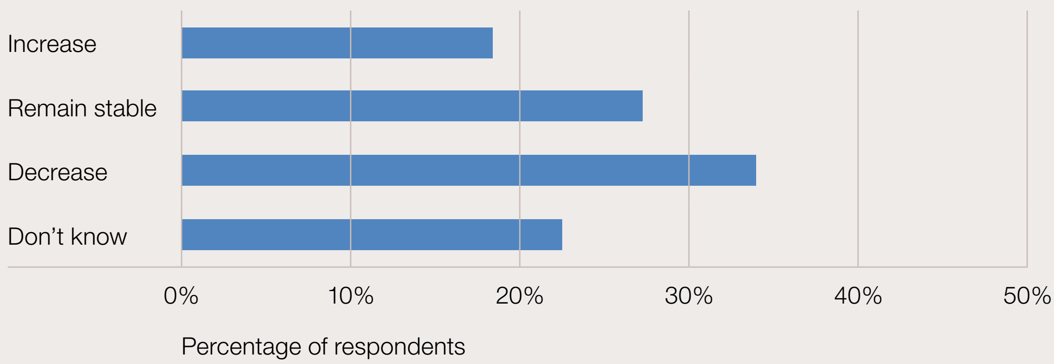
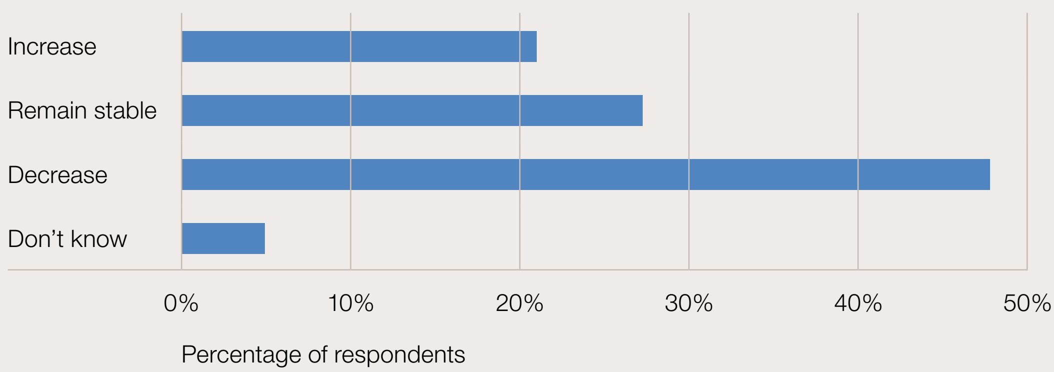


Figure 6B: In 2011 the number of leveraged loan defaults and leveraged buy-out restructurings will:



One private equity manager says he never bought into the predictions of the bloodbaths that the credit crisis would cause among portfolio companies. “Private equity companies were always better placed to make it through the crisis. True, their higher leverage carries a higher risk. But in my view, that extra risk is more than compensated by the superior governance that the private equity model offers over that of listed companies.”

Findings in a recent A.T. Kearney study seem to prove him right[3]. The report reads: “Since 2006, PE portfolio companies have outperformed their public-industry peers on key financial metrics. [...] This superior performance may be due to the ability to react faster to evolving market conditions, to perform a more realistic assessment of the changes required and, consequently, to develop more effective improvement measures.”

So, despite everything, private equity is still alive and well and leveraged finance bankers fully intend to keep it that way.

Ample liquidity to support private equity deal flow

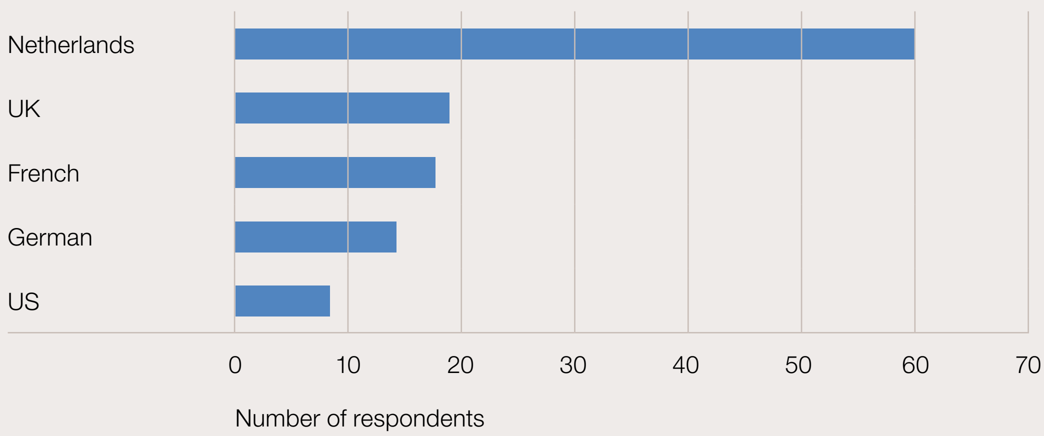
In sharp contrast to much of the past three years, at the moment there is ample liquidity available to finance acquisitions, practically all interviewees confirmed. As monetary authorities have flooded the financial system with cash in their effort to keep it alive during the ‘credit crunch’, investors as well as banks now face the challenge of putting their money to work and making a return on their capital. As one banker put it: “There are not enough deals in relation to the liquidity that is available. More specifically, there are not enough good, new deals in the market.”

“Private equity companies were always better placed to make it through the crisis.”

[3] ‘Rating Operative Performance of PE Portfolio Companies - PE fund companies in Europe stage a post-recession comeback’, A.T. Kearney.

What is more, competition among banks to become involved in transactions is fierce. In the Netherlands nearly all banks focus primarily on the mid-market segment, where the vast majority of Netherlands leveraged finance activity (in terms of value) takes place. Competitive pressure in this segment is added by foreign banks that are brought in by increasingly active foreign private equity firms (see Chapter 1) or that have teams lined up specifically covering the Netherlands (or Benelux) market. "Such teams need to get visibility in the market and have to get involved in transactions at one point. Then you don't look at a deal purely on a rational, stand-alone basis, you may even want to pay to get in", observes a (Dutch) banker on what he calls "a fighters' market". Add this to the fact that providing acquisition finance is often seen as a unique opportunity for banks to become a target company's 'house bank', which may allow them to sell their other, perhaps more lucrative products – such as transaction banking, insurance, working capital and cash management – and it is no wonder that leveraged finance loans are readily available again.

Figure 7: Most active banks on senior lender side in 2011



Although banks generally sustained losses on their leveraged loan portfolios during the crisis, all prominent Netherlands-based banks continue to view leveraged finance as an attractive and lucrative investment activity. This is true despite the current pressure on banks, specifically those with governments as shareholders, to reduce their risk profile and in spite of Basel III (see also Chapter 4), the looming new regulatory regime which will require banks to hold extra capital and secure long-term funding against the long-term loans typically used in leveraged finance.

Pricing of leveraged loans

In the ‘small’ market segment, with enterprise values of up to €50 million, competition among banks in the leveraged finance market is very intense. In this part of the market, one or two banks typically provide the acquisition finance for a particular transaction and local bank branches play a relatively large role. This is the segment where the eagerness of banks to build or maintain relations with customers has the strongest downward effect on pricing for leveraged loans. “We see competitors buying deals at prices that in no way whatsoever fit in our risk-return models”, says one banker about the level of competition in the ‘small’ market segment.

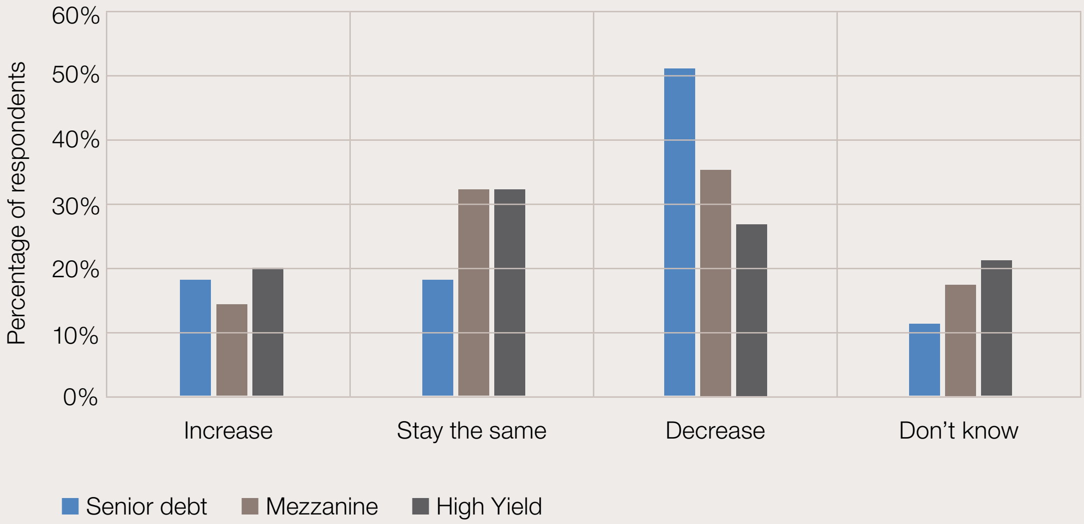
To acquire companies with an enterprise value of up to around €250 million, bank financing is usually provided in the form of consortium deals, whereby several banks each provide a part of the financing. This somewhat reduces the competitive pressure on pricing among banks and helps explain why pricing in this ‘medium’ segment is significantly higher than in the ‘small’ segment (“typically 350 - 400 basis points over EURIBOR for a B-type loan”, according to one banker), even though medium-sized transactions are perceived to be less risky than small-sized transactions.

In the ‘large’ and ‘jumbo’ segments of the market, with enterprise values of up to and over €1 billion respectively, pricing for leveraged loans is governed mainly by international investors as deals in these segments are still ‘structured for distribution’. “Institutional investors have managed quite well to keep pricing at an attractive level”, observes one banker, “typically 100 basis points higher than in the medium segment”. Pricing in these segments has recently come down somewhat because the secondary market for leveraged loans has become more active, mainly due to re-investments from Collateralised Loan Obligations (CLO)-vehicles (see next page).

A set ‘A-B-C-D pricing grid’ for leveraged loans, such as the pricing grid that existed during the private equity boom for medium and large-sized transactions, has not been re-established yet. The A and B-type loans are still there, and while occasional C-type sightings are reported, D-type or ‘second lien’ loans are not.

“We see competitors buying deals at prices that in no way whatsoever fit in our risk-return models.”

Figure 8: How will margins on various types of debt change after 2011?



Most bankers we interviewed foresee an upward pressure on pricing for leveraged loans as a consequence mainly of the new Basel III regulatory regime. As banks are required to hold additional capital on their balance sheets and to secure long-term funding to provide leveraged loans, they will attempt to load off to borrowers the increased costs these measures impose on them. However, the results shown in Figure 8 indicate, particularly for senior debt, that leveraged lenders may not fully succeed in passing the additional costs on to their clients, as most respondents expect margins on senior debt to decrease.

Another cause of upward pressure on pricing is that the current activity of many existing CLOs will cease once they reach the end of their re-investment period, which for many CLOs will occur some time during the next 18 months. As the size of the secondary market is not expected to reach the same volume it had in the years leading up to the credit crisis, this will significantly decrease liquidity in the market and create an additional upward pressure on pricing (see the section on The 'wall of debt' for more on the role of CLOs).

Deal Structures

A common observation among our interviewees is that the market seems to be returning quickly to many practices and standards that were common during the boom years of 2006 and 2007 and that were presumed by many to be gone forever. The leverage ratios or debt/EBITDA multiples are increasing once again, and many respondents expect senior debt/EBITDA ratios in 2011 to be in the 3.0 - 3.5x region and total debt/EBITDA ratios to be in the 3.5 - 5.0x region (see Figure 9). By comparison, for 2010 the European average debt/EBITDA ratio was 4.2x, slightly higher than the 4.1x in 2009, but still far below the record high of 5.9x in 2007.[4] Financing structures are becoming more aggressive as various types of junior debt, such as mezzanine and PIK loans, are increasingly being used and sponsor-friendly features are re-appearing in transaction documentation (see also Chapter 3). Recently the first European 'covenant-lite' loan since 2007 was reported, whereby private equity firm Apax added £150 million of new debt to its Trader Media Group, publisher of new and used car magazine Auto Trader, to finance a dividend payment.

The market seems to be returning quickly to many practices and standards that were common during the boom years of 2006 and 2007.

[4] Leverage Matters, Standard & Poor's, Issue 17.

Figure 9: Expected leveraged ratios 2011

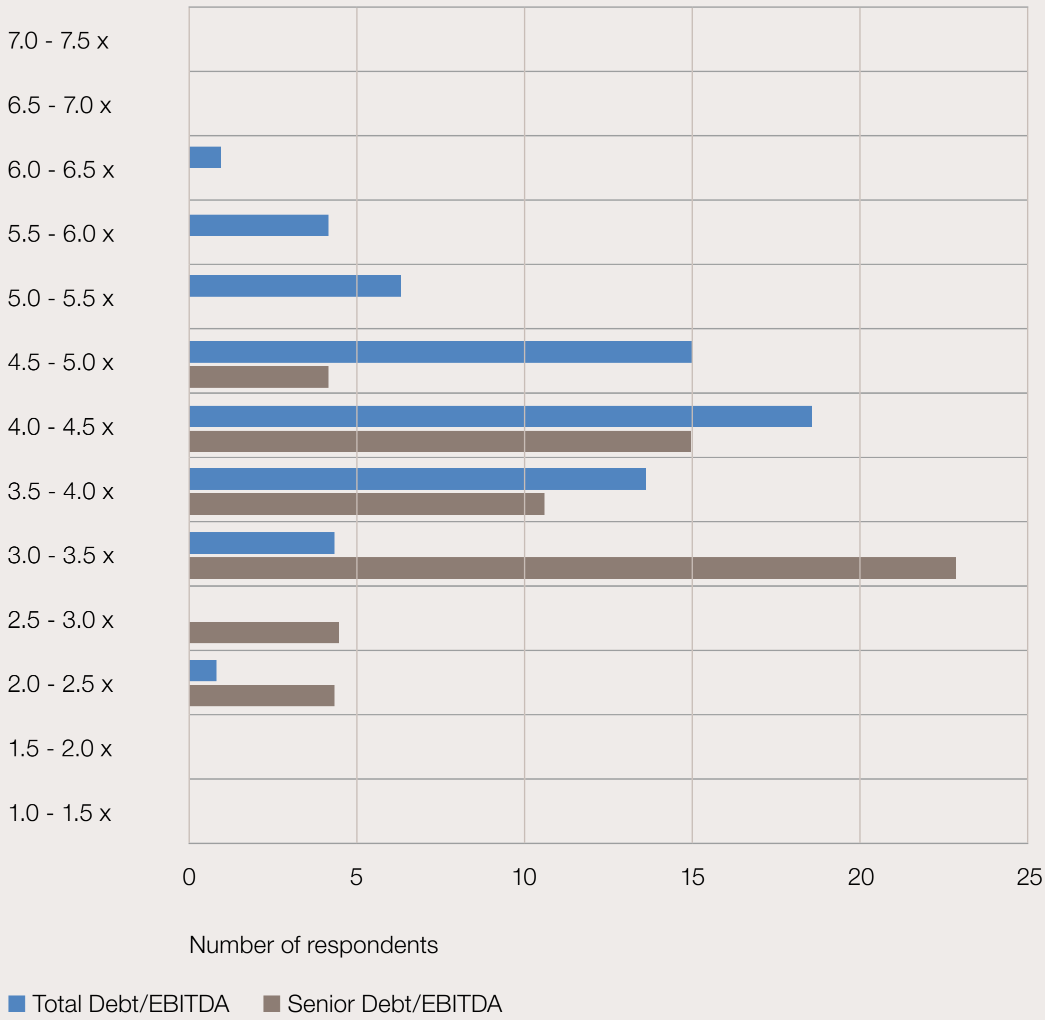
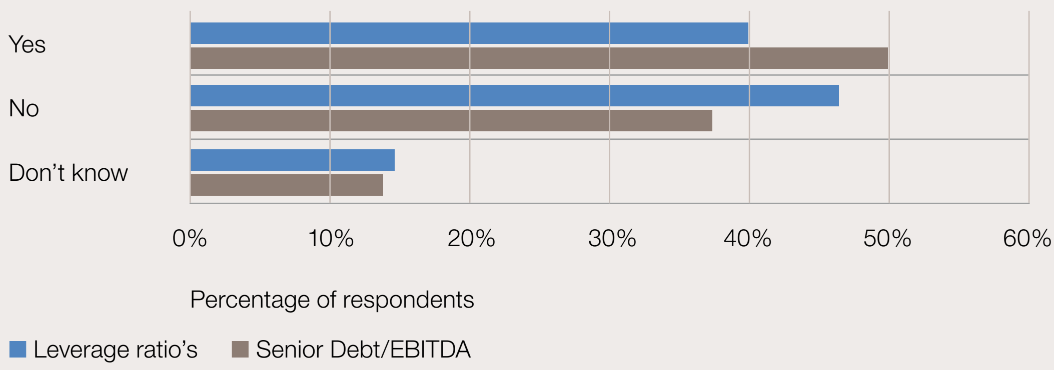


Figure 10: Do you expect an increase in leverage and debt/EBITDA ratios?



Most interviewees indicate that they do feel slightly uncomfortable with this trend: “I really hope it stops here” and “All the things we said we would never do again after 2007 are back. The only difference is that in 2007 we did them across the board. In this cycle we have so far only done them for really solid assets”, are two of their remarks. More specifically, another interviewee commented: “We have already seen a deal at 6 times EBITDA, which was unheard of last year. But in that particular case, I don’t think that’s an irresponsible level, since the underlying business is extremely stable.”

When asked what will prevent this trend from continuing into the ‘irresponsible’ zone, bankers point to a number of factors:

- regulatory and fiscal measures (e.g. Basel III, further discussed in Chapter 4);
- the minimum equity contribution that banks have been requiring in transactions; this puts a cap on the amount of debt that can be used and thereby, in some cases, also on multiples;
- the practice by banks of keeping a larger part of leveraged loans on their own balance sheet instead of placing them entirely in the secondary market. Leveraged finance banking therefore becomes more risk-return driven as opposed to fee-driven, which should lead to more rigorous risk analysis and in turn provide a barrier against ‘irresponsible’ lending.

On the other hand, bankers are confident that a private equity firm seeking aggressive financing will find ways around these measures, for example by bypassing banks and having what could be called ‘private debt’ investors participate directly in deals (see Trend: Diversification of funding).

Trend: Diversification of funding

Corporates and private equity portfolio companies alike have responded to the ‘credit crunch’ by reducing their dependency on bank financing and seeking access to new alternative sources of funding. The latter is a particularly pressing imperative for companies which have their outstanding debt maturing in the next two to four years, when the full impact of the ‘wall of debt’ is likely to be felt.

For private equity, high-yield bonds and mezzanine loans are the most important sources of alternative financing. The European high-yield bond market, while still much less ‘deep’ than the US market, has recently expanded rapidly, with high-yield bond issuance in 2010 at €66 billion, up from €43 billion in 2009. “In terms of covenants, pricing and the willingness of high-yield investors to take on more risk than leveraged finance bankers, high-yield bonds are now more attractive than leveraged loans”, said a banker, who expects this situation to continue for “quite a while.”

Mezzanine loans are another potential source of new funding. While high-yield issues below €250 million are considered “too expensive and almost impossible in Europe”, mezzanine financing in this segment offers more flexibility and requires far less disclosure of financial statements by issuers. Currently, however, the pricing of ‘mezz’ is “extremely inelastic and absolutely not competitive”, particularly so in the view of cash-rich Netherlands sponsors. One interviewee attributes this to the fact that high-yield issues are predominantly fee-driven, whereas mezzanine lenders are much more risk-return driven. Our respondents expect ‘mezz’ to be provided mainly by specialised mezzanine lenders (48%), followed by UK banks (25%) and Netherlands banks (10%).

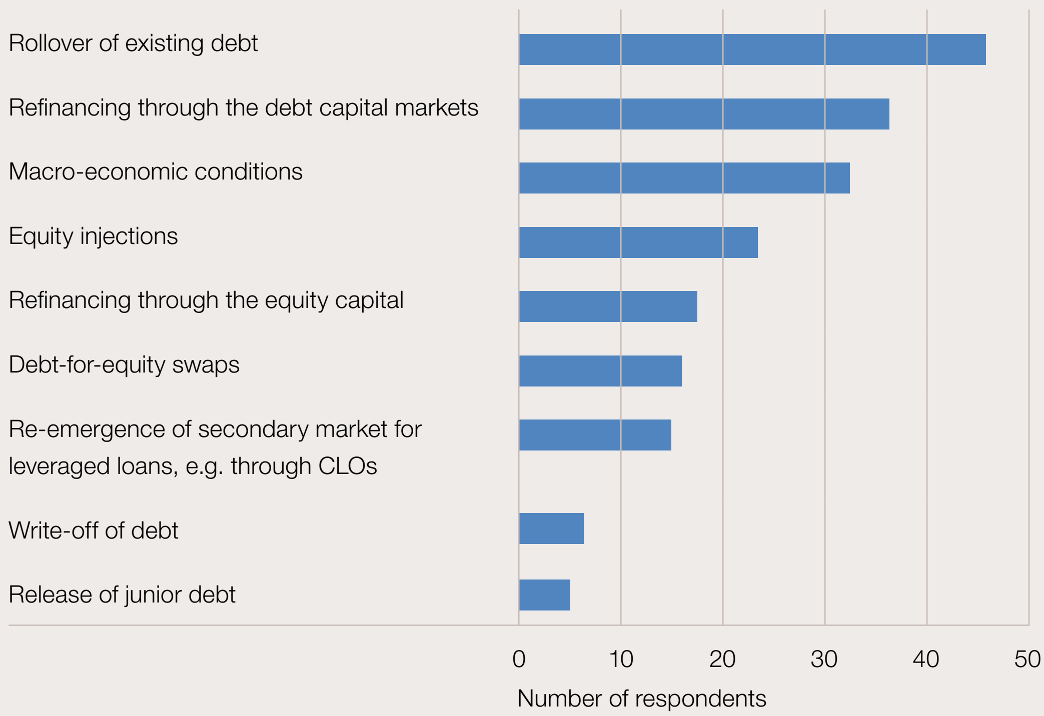
One interviewee hinted that the role of banks in leveraged finance might shift from providing loans towards intermediation. He predicts the development of ‘private placement’ type of structures in leveraged finance transactions, i.e. the provision of financing directly by a limited number of investors, such as insurance companies and pension funds instead of via a syndication process arranged by one or more banks. Banks could play a role in setting up these structures, but, because of the pivotal role debt plays in their governance and business model, it is also likely that sponsors will become more active in this area. Most large sponsors already have credit arms (for instance, GSO (part of Blackstone), Sankaty (part of Bain), KKR Fixed Income and Permira Debt Managers).

The 'wall of debt'

In its Global Financial Stability Report of April 2011, the International Monetary Fund identified the funding of banks and governments as the "most pressing" challenge standing in the way of global recovery. The IMF pointed to the $3.6 trillion "wall of maturing debt" that the world's banks face in the next two years alone. "These bank-funding needs coincide with higher sovereign refinancing requirements [and] heightening competition for scarce funding resources," the IMF warned. Of this total 'wall of debt', a significant portion consists of leveraged loans. According to most estimates, between $650 and $850 billion of leveraged loans will have to be repaid or refinanced before 2017. Reported debt in Netherlands buy-outs accounts for around $30 to $50 billion.

When asked how they think this 'wall of debt' will be refinanced, respondents to our survey gave the following assessment:

Figure 11: How the wall of debt will be refinanced



Many of our interviewees do not think that this ‘wall of debt’ will be a major disruptive issue in the Netherlands market. Numerous companies anticipated potential refinancing issues early and have already, albeit at a price, secured financing well past the looming debt wall, sometimes by way of a ‘forward start’ agreement. Moreover, they point to the tight, long-term relationships that often exist between banks, sponsors and companies which provide a strong incentive to “work it out together”. The main mechanism to do so is expected to be the rolling over of existing debt through ‘amend and extend’ agreements, in which loan maturity is extended in exchange for better terms for the lenders. Remarkably few respondents expect debt holders to be affected by the refinancing of the ‘wall of debt’, given the low scores for ‘write-off of debt’ and ‘release of junior debt’.

But although bankers agree that there is an incentive to reach mutually beneficial solutions, they differ on whether the parties will be able to do so: some are confident there will still be sufficient liquidity, others see this as denying the problem and as “ostrich politics”. The latter group refer scornfully to ‘amend and pretend’ agreements. ‘Amend and extend’ agreements have recently also been dubbed “zombie buyouts” which are set to return for another round of restructuring soon[5].

Several of our interviewees point to the particularly crucial role that CLOs will play in dealing with the ‘wall of debt’. Although a relatively small portion of the debt of Netherlands portfolio companies may be held by these special purpose vehicles, they consider it inevitable that the winding down of CLOs elsewhere in Europe will cause rippling effects to be felt in the Netherlands market. CLOs typically have an investment period of up to 7 years, and as most existing CLOs were established in 2006 and 2007, their collective capacity to reinvest will soon decrease, for some starting as early as this year. An internal company analysis shared with us by one of our interviewees calculates that much of the CLOs’ reinvestment capacity, once several hundreds of millions of dollars annually, will have practically disappeared by 2014. “Much of the liquidity that is now available to finance deals is there only because CLOs feel tremendous pressure to reinvest. We’re fooling ourselves if we think that makes it a great market we’re in; a substantial part of that liquidity will be gone in a few years.”

“Much of the liquidity that is now available to finance deals will be gone in a few years.”

[5] A. Javed, Zombie buyouts set to return for another round of restructuring, Private Equity News, 22 June 2011.

3. Transaction trends

In the years leading up to the financial crisis in 2008, the market for leveraged buy-out transactions came to resemble an ever-faster turning carousel. Increasing debt leverage ratios and an abundance of cheap credit were by themselves enough to inflate companies' valuations. With these higher valuations, the temptation for investors to cash in also grew. Private equity investors therefore sold their portfolio companies like hot potatoes and the average holding period was reduced to just around two years.

In such an overheated market, risk perceptions and transaction standards eroded quickly: private equity sellers were typically not willing to give any sort of business warranties or recourse possibilities to buyers. Banks typically sold multi-billion dollar 'sponsor-friendly' loans (sometimes referred to as 'covenant light' loans) in the secondary market in a matter of hours.

In the current climate, sellers and buyers alike are proceeding with considerably more care. "If you simply run your standard auction process, you are not likely to be successful. That is a clear break with the past", says an M&A banker. "Now the process has to be much more tuned to the asset you are trying to sell." So instead of "calling up 20 potential bidders and sending them an investment memorandum", sell-side advisers now have to actively market the company on offer, investigate which potential buyers truly have an investment angle and spend more time and effort arranging a stapled finance package upfront. In fact, in the current transaction environment it is much more likely that this stapled finance will actually be used, given the more critical attitude of financing banks. In the past the seller-side financing package was often used only to negotiate even better terms with the buyer's own banks.

Trend: The rise of Asia

The entire world seems to be looking towards key emerging markets and in particular Asia as the strongest area of economic growth in coming years. Several interviewees report that Netherlands private equity firms are actively seeking Asian investors for their funds. The region's steady GDP growth and better macro economics also offer a solid basis for private equity firms to seek attractive investment opportunities and a potentially higher internal rate of return. The big question is how long these macro economic trends will continue and whether Asia is actually ready for the western style of private equity. Inevitably, new challenges lie ahead as witnessed by, for example, the very recent action taken by a Taiwanese regulatory body to block the KKR-backed buy-out of electronics company Yageo. At the same time it is clear that Asian investors are looking towards the West: note, for example, the acquisition this year by Asian private equity firm Unitas Capital of Netherlands hydraulic cylinders maker Hyva from 3i. "Asian investors are unmistakably getting more interested to acquire Western companies, particularly high-tech companies. They are not as successful though as macroeconomic conditions would allow, they still need to cross a considerable cultural divide to participate for instance in a European-style competitive auction process", says an M&A adviser. In 2010 China, the main driver behind the growth in Asian M&A activity, completed 264 foreign acquisitions (2007: 181 acquisitions) with a combined worth of over US $33 billion[1]. Time will tell whether private equity, with its drive to find arbitrage opportunities wherever they occur, can become a catalyst in the unstoppable trend towards true globalisation.

1: Source: Robert W. Baird & Co, Global M&A Monthly, March 2011.

Buyers seem to recognise that the future success of their acquisitions will depend more on the quality of their 'equity story', and much less on the use of leverage or simply waiting until multiples have risen again. "Private equity buyers spend considerably more time getting to know a target company and the industry it operates in", observes a banker. "They realise they need to have the plans in place for a buy-and-build strategy or for operational improvements, and that they need to be able to execute those plans."

Due diligence

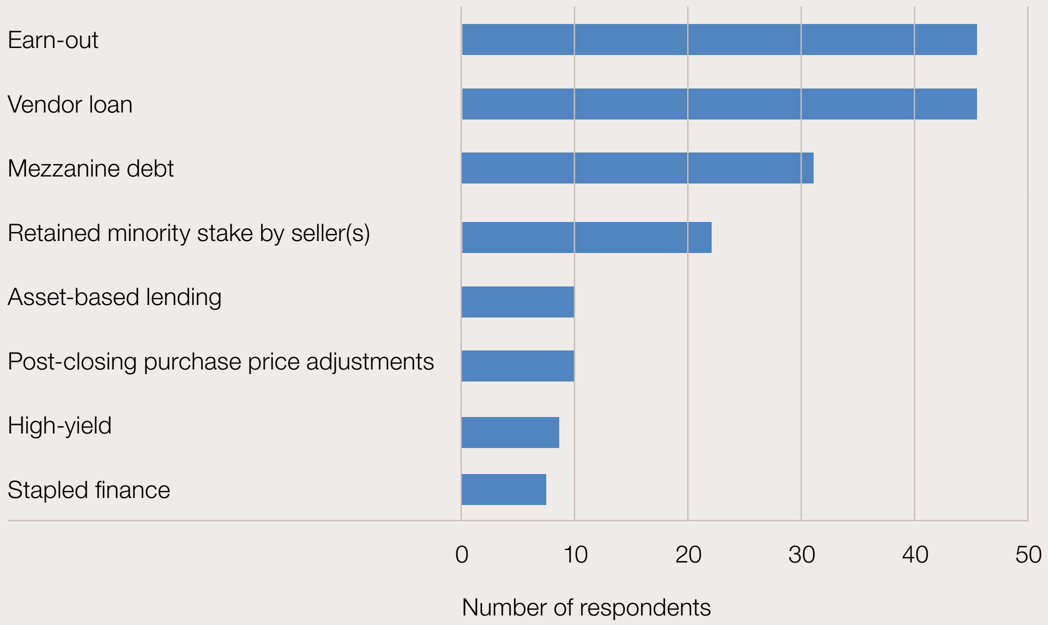
Our respondents are split evenly on the question of whether due diligence will become increasingly important in 2011; 47% answer 'yes' while 52% answer 'no'. To us this is somewhat surprising because in the transactions in which we are involved, we notice a clear trend to put more emphasis on risk evaluation and due diligence in order to satisfy both the purchaser and the financing banks. In sale processes, a majority of the respondents expect vendor due diligence to continue to play an important role, specifically in relation to financial (89%), legal (83%), tax (82%) and commercial (67%) issues. On the lender's side, 49% of financing banks rely solely on sponsor's reports for due diligence, while 39% confirm using a combination of their own due diligence and sponsor's reports.

"Private equity buyers spend considerably more time getting to know a target company and the industry it operates in."

Bridging the valuation gap

A necessary element of any successful transaction is a rough agreement on what the company changing hands is actually worth. If there is an initial 'valuation gap' most of the burden for closing this gap will fall on sellers, most respondents to our survey expect. The high scores for 'earn-outs', 'vendor loans' and 'retained minority stakes' (see Figure 12) all suggest that the market is currently a buyer's market in which sellers are often requested to 'keep their skin in the game' and accept some responsibility for a transaction's future success.

Figure 12: What mechanisms will be used to close the valuation gap?



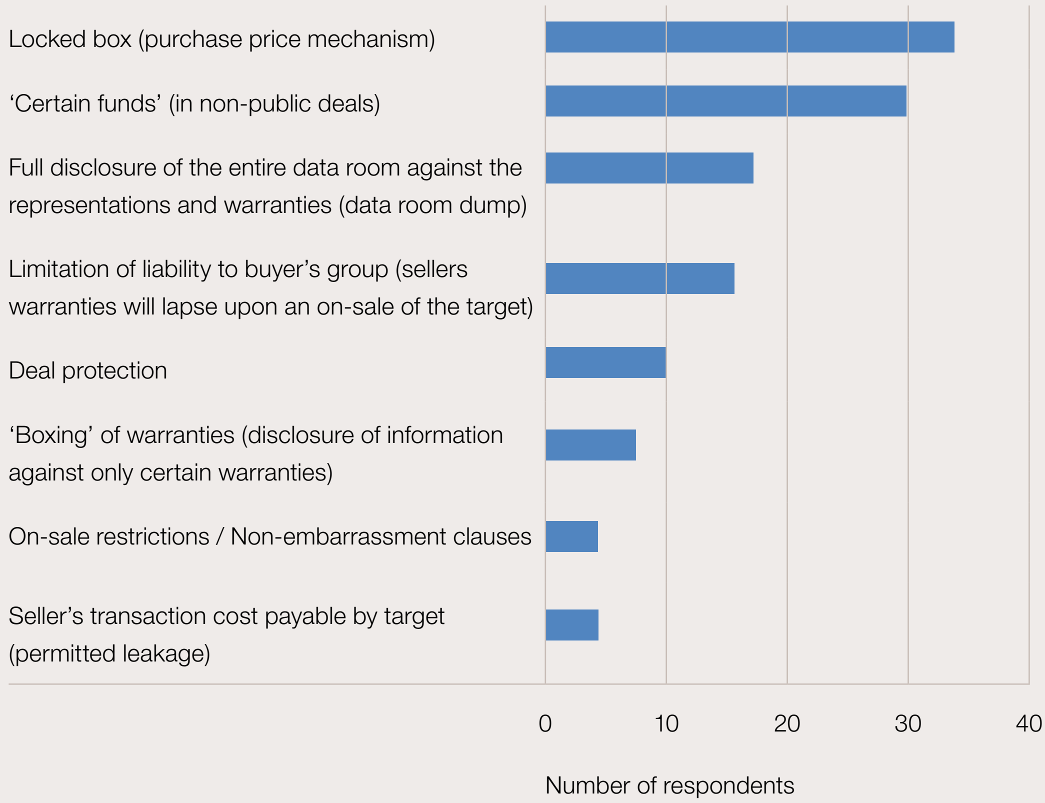
Negotiations and documentation: ‘acquisition’

On the other hand, it is very clear that the most sought-after target companies still tend to be sold by way of a competitive auction process. Not surprisingly, in a competitive auction for a company which is considered a real gem, buyer-friendly concepts such as MAC-clauses, completion accounts, generous provisions on liability for breach of warranty and an extensive set of closing conditions are still not the norm (see Figure 13). In fact it appears that seller-friendly terms like those aimed at deal certainty, locked box purchase price mechanisms (i.e. fixed price at an effective date on a debt-free cash-free basis) and the ‘data room dump’ (in which the entire data room is disclosed against the representations and warranties) have not disappeared at all (see Figure 14). The question is whether this will indeed remain the norm or whether it is just a temporary balance which will change as soon as the less-than-perfect gems in the private equity portfolios come to market.

It is very clear that the most sought-after target companies still tend to be sold by way of a competitive auction process.

Figure 13: Focus areas in negotiating aquisition documents

Figure 14: Seller-friendly features to re-appear in deal structures / acquisition documentation



In order to bridge the 'negotiation gap' between sellers and buyers, there appears to be an increasing preparedness among sellers to give more representations and warranties (including business waranties by private equity sellers). Sellers also tend to anticipate a demand for some type of limited recourse, for instance in the form of an escrow arrangement.

Negotiations and documentation: 'finance'

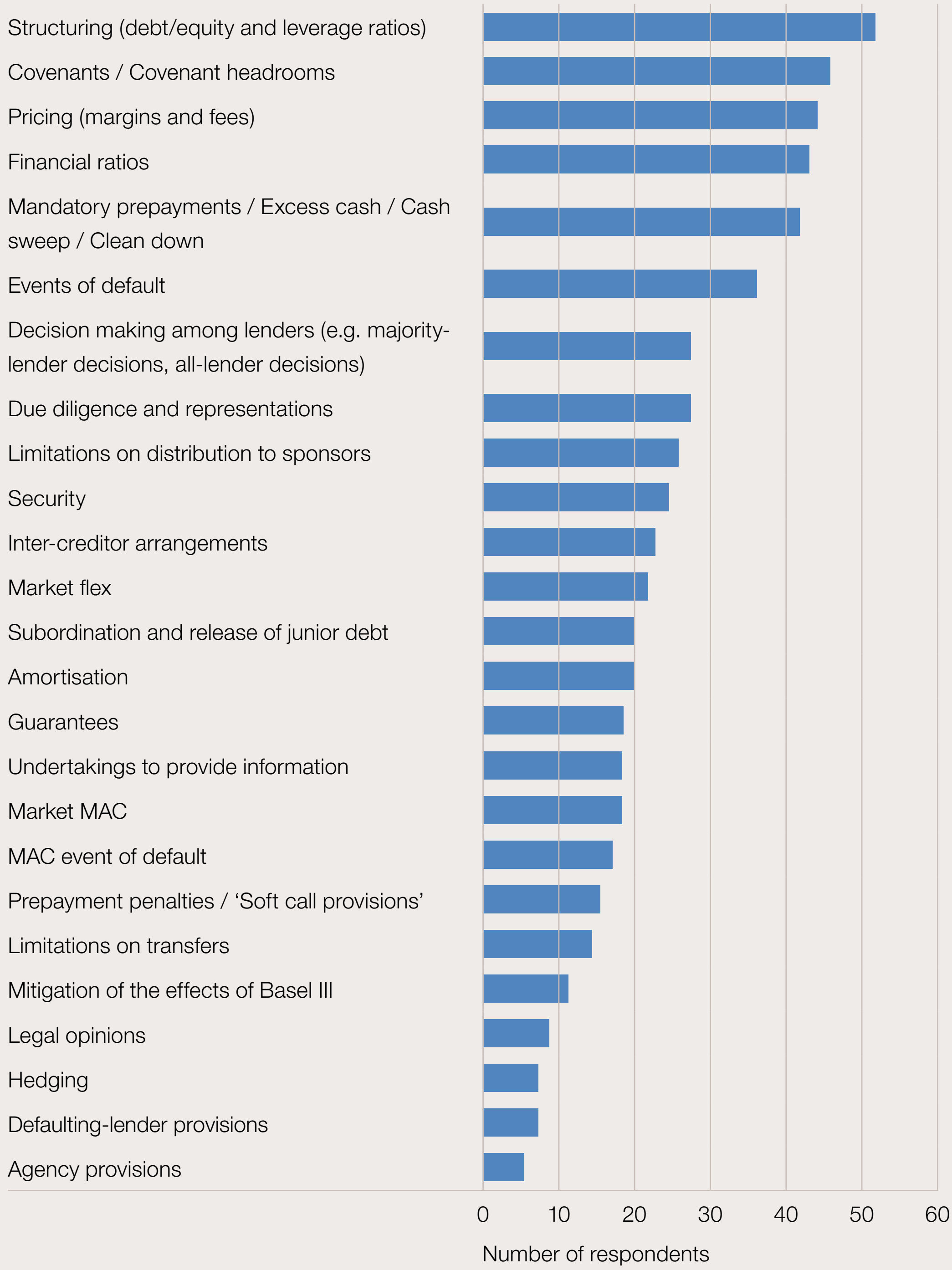
The model facility agreement for leveraged finance transactions published by the Loan Market Association is widely used in all segments of the Netherlands market. Often a 'lite form' is used and it tends to be governed by Netherlands law.

Under the current market conditions, both banks and sponsors attach great importance to negotiating the loan documentation and negotiations can be long and tenacious. Three main focus areas emerge from the responses to our survey, besides the structuring of the financing. The first of these is the covenants (including the financial ratios) and the events of default, to which either party in the negotiations will continue to pay much attention. The sponsor's objective here is to maintain as much flexibility as possible and the bank's objective is to have 'a seat at the table' when important decisions are made or the company requires a restructuring. The second focus area is pricing, with the sponsor resisting upward adjustment or 'hidden fees' where possible. Lastly, both sponsors and banks will want to be able to control excess cash and cash flows, with the bank's point of departure being that such amounts should generally be used to repay the debt.

The MAC event of default (and Material Adverse Effect definition) are still heavily negotiated, although one interviewee commented: "I sometimes find it difficult to justify a MAC. We have just experienced one of the most severe financial crises in history and, apparently, even then the MAC event of default was rarely invoked." And while far from the standard, 'reverse market flex' has already been used again in some deals. However, nobody expects private equity to regain the position it had during the boom years anytime soon. For the time being, most interviewees seem to agree that sponsors are steadily improving their negotiation stance and that banks - due to the fierce competition in certain segments of the market - often have no choice but to, reluctantly, give in on many of private equity's demands for sponsor-friendly features.

"We have just experienced one of the most severe financial crises in history and, apparently, even then the MAC event of default was rarely invoked."

Figure 15: Focus areas in negotiating finance documents



Our interviewees confirm that the four features with the highest scores seem to have already become more or less the market standard again. Equity cure rights are coming back as well, but only insofar as they are used to reduce the level of debt. It seems unlikely that second lien loans, fundable term sheets and Mulligan's will be back any time soon, if at all (see Figure 16).

Figure 16: Sponsor-friendly features to re-appear in deal structures / finance documentation

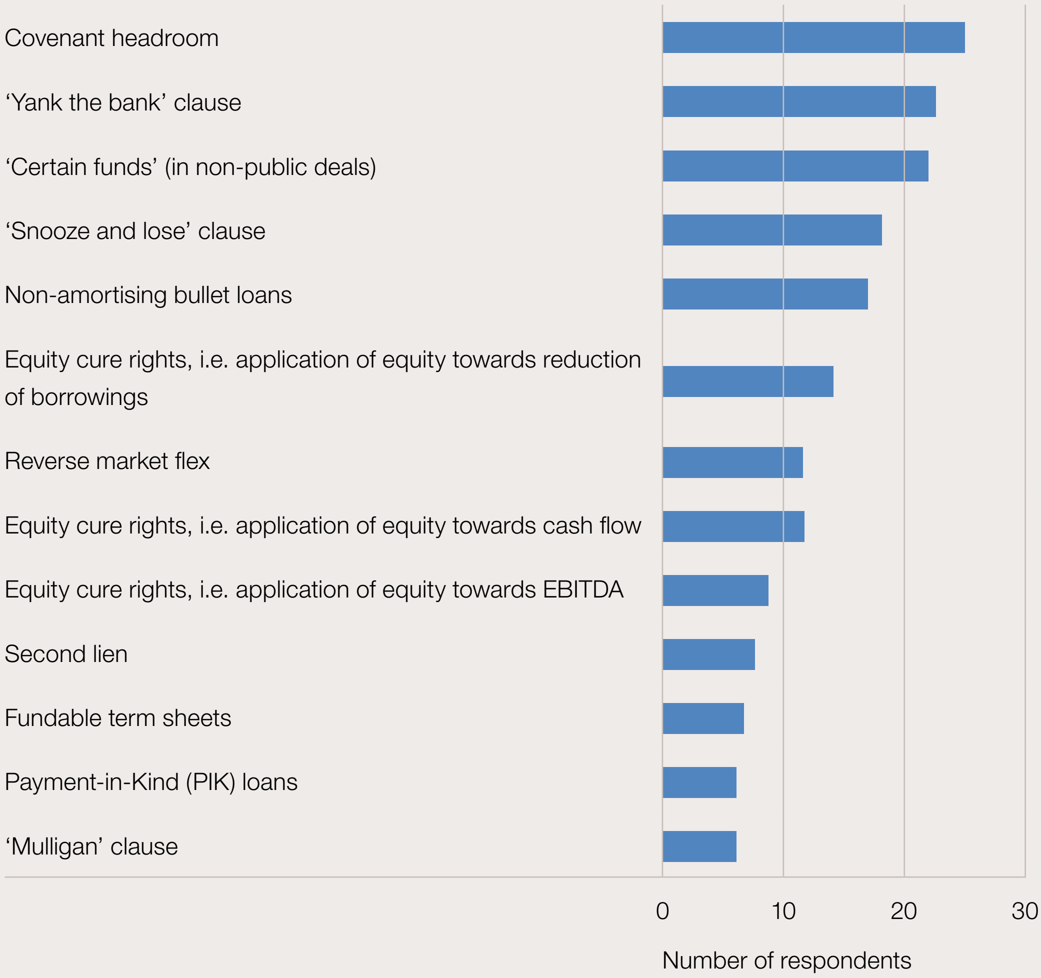
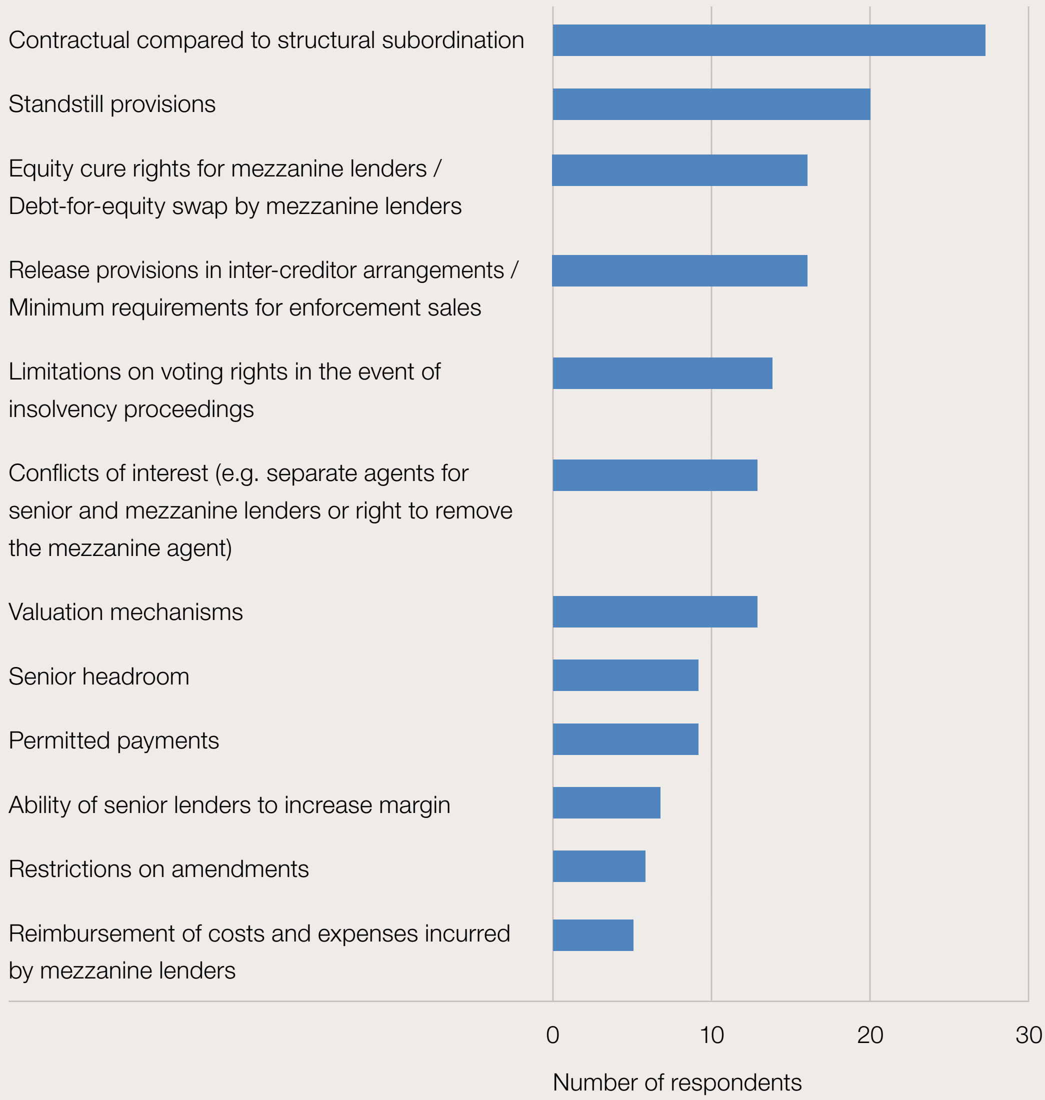


Figure 17: Hotspots in negotiations between senior and mezzanine lenders



As mentioned before in Chapter 2, the outcome of many of the recent restructurings has been disastrous for mezzanine and other junior lenders, as often their interests were completely wiped out. As the market for mezzanine debt seems to be moving again, it can be expected that there will be tough negotiations between senior lenders and mezzanine lenders regarding intercreditor terms. Many mezzanine lenders do not regard the current model intercreditor agreement published by the Loan Market Association as properly addressing their concerns[6] and consequently it is likely that they will resist using these documents as a starting point for their negotiations. A critical provision that undoubtedly will continue to receive a lot of attention from senior and mezzanine lenders is the release provision under which senior lenders may 'release' mezzanine debt, guarantees and security in the case of an enforcement sale.

[6] For an overview: M. Crobsy, Issues the Loan Market Association forgot in new intercreditor agreement, Private Equity new, 13 April 2009.

4. Regulatory and tax climate

Since the end of the 1970s, when KKR turned up the scale of its leveraged buy-out activities significantly, modern style private equity has survived severe economic storms, including the junk bond crisis in the eighties and the bursting of the dot-com bubble earlier this century. In this relatively short period of time, the private equity industry has actually grown and matured fast, and some early movers have become institutionalised companies capable of doing mega-buy outs and facilitating the listing of private equity funds.

So what can private equity expect to face after the recent burst of the financial bubble? Well, as usual after a crisis – in particular one in the financial industry – there is an outcry for more regulation, supervision and transparency. In short, this means that the cautious steps of the private equity industry to self-regulate have proven to be too little and too late. Politicians have already reached that conclusion and are pursuing an agenda that caters to the public outcry.

The planned regulatory and tax changes and developments are simply too numerous to be covered in full in this outlook. In the remainder of this chapter we will highlight three changes that are, in our opinion, of particular relevance to the private equity and leveraged finance sector: 1) the Alternative Investment Fund Managers Directive (AIFMD, or the 'Directive'); 2) the Basel III banking regulation; and 3) the recent Netherlands tax initiative to restrict the deductibility of interest expense.

Trend: 'Gold plating' the new regulatory regime?
As European policy makers are still busy responding to the recent financial crisis, it is too early to tell if their new regulatory measures will contribute to positioning Europe favourably in the new global investment balance. Brussel's 'one-size-fits-all' regulatory regime for very different alternative investment classes - ranging from activist to arbitrage hedge funds and from venture capital to private equity - has been criticised for its potentially negative impact on an industry that plays an important role in allocating capital to entrepreneurship and innovation. European policy makers have apparently taken this criticism to heart. Very recently a European staff working paper was released for discussion and consultation purposes. The paper presents the core elements of a possible European framework to create an internal market in the EU tailored to venture capital.

In addition to new pan-European regulations, private equity players active in the Netherlands market are also confronted with potential tax measures, proposed unilaterally by the Netherlands government. These proposals will influence the concept of optimising the interest tax deduction as practised by private equity. Although it is understandable - especially in a difficult economic period - for a country to try to protect its tax base, it is questionable whether the current plans are well-timed, well-balanced and fair. Some of our interviewees agree that the practice of using expensive shareholder loans to strip a portfolio company's revenues and thereby avoid corporate income tax should no longer receive the favourable fiscal treatment it currently enjoys. Others consider this practice to be part of the general fiduciary duty of any company's board - at least vis-à-vis the shareholders - to optimise the company's tax position. While both these positions could be defended, especially the foreign private equity industry will probably find that the retrospective effect of the proposed measures will render the Netherlands market less reliable, dependent as the industry is on its ability to carefully plan cash flows.

Continue on the next page.

At least as important is the proposal to limit the deductibility of interest paid not only on shareholder loans, but also on ‘real’ (read: third party) debt. The latter is arguably one bridge too far. First of all, in the post-crisis market leverage multiples have already normalised through free market processes and through anticipating banking regulations such as Basel III.

Secondly, to impose a fixed debt/equity ratio for tax purposes will rigidly limit the amount of debt that a private equity firm will use whereas, economically, the optimal debt/equity mix differs from industry to industry and even from company to company. An undesired side effect of such a fixed ratio may therefore be that it prevents companies from using the optimum debt level. Within the private equity model, the ability to use the optimum debt level is considered key to ‘enforcing’ the strict financial discipline and related corporate focus which are essential to the model’s success.

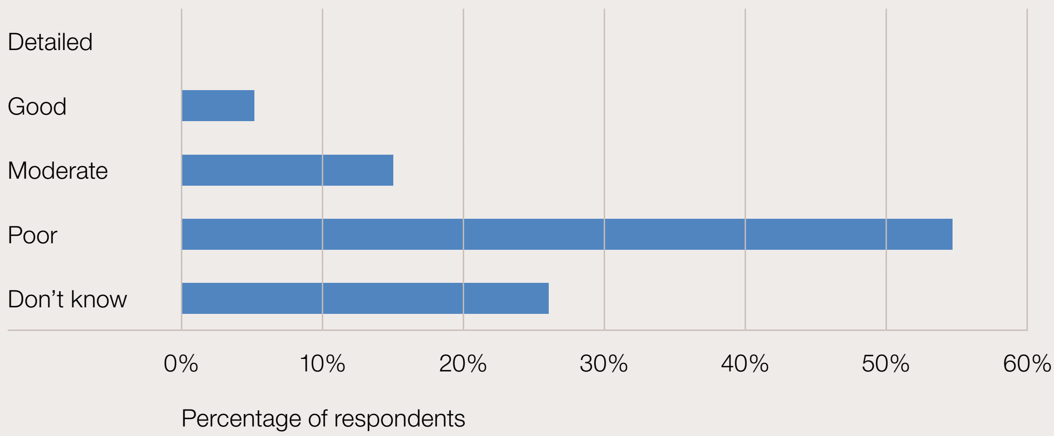
Thirdly, the announced tax plans are also controversial because they may very well have the effect of ‘gold plating’ the blanket of regulation which the AIFMD will thrust upon the European private equity market. In its ambition to turn the fragmented EU alternative investment sector into a single harmonised market, the Directive is already likely to cause a reset of the country attractiveness index for venture capital and private equity[1]. The extent of such a reset will depend on how each member country uses the freedom it has in implementing the AIFMD. In the index published for 2011, the Netherlands holds the 9th position globally and, within the EU, is second only to the UK. A very favourable position for a country with the ambition to be and remain an attractive financial centre. In preparing this index, taxation is the third of six key drivers for measuring a country’s attractiveness. One can just guess at this stage what the bottom line effects will be of extensive unilateral tax changes at the start of a new and regulated era for private equity. Any ‘gold plating’ in addition to the new EU regulation may lead to a decline in the favourable position of the Netherlands. It may also chase away the much needed cross-border activity in an industry which, through providing capital for entrepreneurship and innovation, plays an important role in our economy and its keeping pace with the rest of the world.

1: As published annually by the IESE Business School.

1. The Alternative Investment Fund Managers Directive

Are you aware that future plans for ‘stripping assets’ of a company just acquired may be obstructed by the new Alternative Investment Fund Managers Directive (AIFMD)? That these new European rules could require you to notify the competent authorities of your holdings, also in private companies in Europe? That these rules may oblige you to share strategic plans for portfolio companies with regulators and that they set minimum standards for communication with employees on those strategies? If that is not enough to make you reconsider your acquisition plans, perhaps the new rules for the remuneration of private equity managers, including rules on deferral and clawback, are.

Figure 18: How would you rate your knowledge of the AIFMD?



“The new rules may oblige you to share strategic plans for portfolio companies with regulators.”

Respondents to our survey reported a, frankly, remarkable lack of knowledge about the AIFMD. This is probably due to the fact that the road travelled by the Directive has been quite tortuous and the implementation of its rules through national legislation may still seem somewhat far away.

After an extensive debate which started in 2009, the controversial AIFMD was published in the Official Journal of the European Union on 1 July, 2011, triggering its entry into force 20 days thereafter (see the timeline in Figure 19). Under the new rules the alternative investment industry, including private equity fund managers, will become a regulated industry. This will likely have a significant impact on the way business is conducted and transactions are arranged in practice, as well as on the economic, political and social standing of the alternative investment sector as a whole.

Why does Europe want new regulation?

The European Commission (EC) decided that a new directive was necessary following a storm of post-crisis criticism which concerned the lack of financial regulation in the area of alternative investment. In the EC's opinion, the recent financial crisis underlined how alternative investment funds (AIFs, hereinafter 'Funds') create, and are themselves subject to, a wide range of risks. Whereas macro-prudential risks are more closely associated with hedge funds, the EC also identified risks related to the governance of portfolio companies, a subject of particular relevance for private equity firms. The AIFMD aims to create a single European alternative investment market and at the same time provide the authorities with the tools necessary to regulate the alternative investment industry and monitor its risks throughout the European Union.

Under the new rules the alternative investment industry, including private equity fund managers, will become a regulated industry.

Who will be affected by the AIFMD?
The AIFMD will apply to alternative investment fund managers (AIFMs, hereinafter 'Managers'), including private equity fund managers, whose total assets under management amount to €100 million or more or, where the funds do not employ leverage and the investors do not have redemption rights exercisable within five years of their initial investment, €500 million or more. Such fund managers must apply for authorisation and will face the full impact of the new rules. Fund managers falling below the above thresholds will only have to register with their home regulator and provide it with certain information. However, many market participants expect that sophisticated professional investors will require AIFMD-compliance from the smaller fund managers as well. This will likely lead to many of these smaller fund managers opting-in, meaning that the Directive will apply to them in full.

The primary aim of the AIFMD is to regulate the managers of hedge funds and private equity funds, to the extent they are not already regulated under the UCITS Directive. The implementation of the Directive will result in far-reaching changes in the supervision and day-to-day conduct of such Managers. Only a limited number of categories fall outside the scope of the Directive, such as joint ventures, corporate holding companies and family businesses.

What will change?
Managers covered by the Directive (including private equity fund managers) will have to reconsider their organisation, internal governance and compliance structure and should expect that upon implementation of the AIFMD in national law, the new rules will have an impact on transaction dynamics and on how Funds deal with their portfolio companies. New rules for private equity fund managers to comply with at 'transaction level' include a notification obligation for holdings in listed and non-listed companies and asset stripping.

Holdings in listed or non-listed companies

The AIFMD contains specific rules that apply upon the acquisition of control of a listed or non-listed company. Control means, in short: for non-listed companies, more than 50% of the voting rights and, for listed companies in the Netherlands, 30% or more of the voting rights (the percentage can be different in other EU member states). If a manager acts jointly with other managers on the basis of an agreement aimed at the acquisition of control, the voting rights must be aggregated. Upon the acquisition of control, far-reaching notification obligations as well as restrictions on the sale of assets (asset stripping) apply.

Pursuant to the notification obligations, Managers of the relevant Funds must, depending on the obligation in question, provide information to the home regulator, the company, the other shareholders and/or the employee representatives about (among other things):

- the identity of the Fund manager(s);
- the policy for preventing and managing conflicts of interest, in particular between the Manager, the Fund and the company; and
- the policy for external and internal communication relating to the company.

If control is acquired of a non-listed company, the information must include the Fund's intentions with regard to the company's future business and the likely repercussions on employment, including any material changes in the conditions of employment.

Asset stripping

The AIFMD also contains restrictions on the sale of assets ('asset stripping') that apply if control of a company is acquired In short, the Manager that has acquired such control may not, for a period of 25 months from the acquisition, in any way support any distribution, capital reduction, share redemption and acquisition of own shares by the company, or vote in favour of any such act. The restriction on distributions may prove to be less than meets the eye, at least in the Netherlands. This is because the Directive makes it clear that only certain distributions fall within the prohibition's scope. The prohibition relates, among other things, to distributions made when the company's net assets on the closing date of the last financial year are less than its subscribed capital plus mandatory reserves, or when they would become so after such a distribution. As is the case with the entire Directive, the precise impact of these asset stripping rules will depend on the way they are implemented in national law. Based on current provisions of Netherlands company law which already prohibit distributions if there are insufficient freely distributable reserves, the impact of the restrictions on a typical leveraged buyout transaction in the Netherlands may well turn out to be relatively limited.

A harmonised funds market across the EU

On the lighter side of the AIFMD, once authorisation has been obtained, this serves as a passport to operate in the entire EU. This means that if the Manager wants to manage and market Funds to professional investors in other EU countries, no new authorisation is needed. The general idea is to create a pan-EU harmonised market allowing Managers to manage and market Funds to professional investors across the EU on the basis of an authorisation issued by their home regulator. This is similar to the EU passporting regime familiar from directives that regulate other parts of the financial sector. An advantage of this may be that professional investors worldwide will choose fund managers regulated under the AIFMD over unregulated fund managers, trusting that the Directive will provide a kind of minimum quality standard.

Third country policy

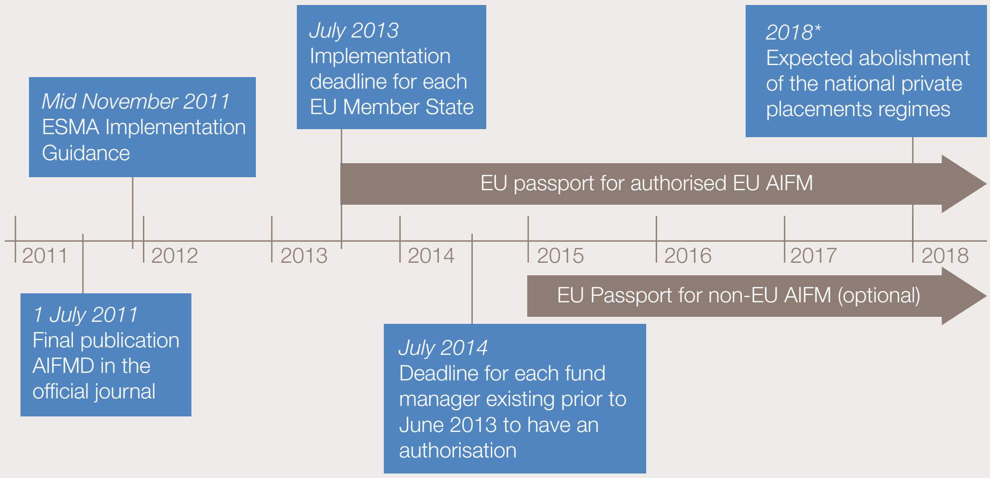
The AIFMD may lead to complications regarding private equity transactions involving Managers or Funds from outside the EU. Both non-EU Managers and Funds will have to wait for their EU passport for a period of at least two years after the implementation deadline of the AIFMD (2013). During that period, the national regimes for Managers and Funds will continue to apply. Once the EC has so decided, it will be possible (until 2018) to opt either for the national regime or for the EU passport. After that period, and again following a decision of the EC to that effect, application of the national regime will no longer be available, and the European passport regime will become the sole and mandatory regime applicable in all member states.

"The general idea is to create a pan-EU harmonised market allowing Managers to manage and market Funds to professional investors across the EU."

When will the AIFMD enter into force?

Member states will be required to implement the AIFMD in their national law within two years from the entry into force of the Directive on 21 July 2011. Hence, the AIFMD must be implemented in the Netherlands by July 2013. From then on, Managers will be required to comply with the AIFMD regime, although Managers already in business are granted a further year to apply for the required authorisation (July 2014). A more detailed timeline is set out in Figure 19.

Figure 19: AIFMD implementation and transition timeline



* *Date not officially established.*

Not only the AIFMD itself, but also the more detailed measures to be adopted by the EC, must be implemented in national law by July 2013. The EC has requested the European Securities and Markets Authority (ESMA) to provide guidance relating to these measures on a large number of topics set out in the Directive. It is expected that these details will become known by November 2011. We expect that over time the implementation measures will influence investments, costs and financing structures which are considered standard in the current market. The measures will in any case provide the regulators with tools to influence the conduct of private equity and other alternative investment sectors.

2. Basel III banking regulation

Basel III, as the new global regulatory standard for the banking industry is known, does not specifically address private equity or highly leveraged exposures, with one notable exception (discussed below). Nevertheless, the new regulations are likely to have a significant effect on banks' propensity to finance private equity deals. The higher capital and liquidity requirements envisaged by Basel III may lead to higher capital and funding costs for banks. Those higher costs may induce banks to curtail lending or, where they continue to finance deals, to pass on the higher costs to borrowers. This may happen even before the final implementation date of the complete package, which is year-end 2018.

Certain aspects of Basel III may in themselves lead to a relative shift in bank lending towards riskier borrowers and projects. The proposed rules, for instance, supplement the risk-based capital requirements by restricting the amount of leverage that banks can use. This amount, expressed as a leverage ratio, is to be determined on the basis of total assets, without taking account of their risk-weights.

The exception mentioned above is that Basel III introduces the requirement that, under the internal-ratings based approach, probability of default estimates for highly-leveraged borrowers must in future reflect the performance of the underlying assets based on periods of stressed volatilities. This is likely to lead to higher risk-weights and therefore to higher financing costs for those borrowers.

3. Netherlands tax initiative: Proposed restriction on the deductibility of interest expense

On 14 April, 2011 the Netherlands government published the Tax Agenda, a policy paper with their future plans to reform the Netherlands tax system. For the private equity market, the most relevant measure is the introduction of rules restricting the deduction of interest expense on (intra-group and external) acquisition debt. More information on the ideas and prospective measures was published in a parliamentary paper of 26 May 2011. Certain plans are already being debated in leading newspapers and legal journals.

Netherlands acquisition companies are often used to structure the acquisition of Netherlands target companies. In such structures, the interest expense payable on the acquisition debt is effectively used to reduce the tax burden on future profits of the target company's operations, by forming a fiscal unity (tax group) between the acquisition company and the target company.

The government's plans aim to end the erosion of a Netherlands target company's tax base brought about by excessive finance structures. In essence, the Tax Agenda proposes to introduce rules that limit the deduction of interest expense to the taxable profits of the acquisition company on a stand-alone basis. Contrary to the existing rules on the deductibility of interest expense, no distinction is made between third party acquisition debt and debt to an affiliated party. The rules will only apply to interest expense that exceeds a threshold of €500,000 and relates to debt above a 'reasonable leverage ratio'.

Although not yet specified in the Tax Agenda, the Netherlands State Secretary for Finance recently indicated that in his view a reasonable leverage ratio would be an equity-to-debt ratio of at least 2:3. The value of equity participations by the target company that are not a member of its Netherlands fiscal unity will reduce the amount of equity that is taken into account when calculating the ratio. For example, any participations held by the target company outside the Netherlands cannot be included in the Netherlands fiscal unity and any such participation will therefore limit the amount of debt eligible for the interest deduction pursuant to the ratio. The amount of equity will be reduced even further if the acquisition company and the target company are consolidated to form a fiscal unity. This is because typically as a result of such consolidation the equity at acquisition company level will be reduced as a result of tax rules.

This can be illustrated as in Figure 20:

Figure 20: Effects of consolidation in a fiscal unity

Acquisition Company

Participation target company	600	Equity	250
		Debt	350

Target Company

Assets	400	Equity	400

Acquisition Company Consolidated

Assets	400	Equity	50*
		Debt	350

* 'goodwill gap' = 200

The goodwill included in the price for the shares in the target company of 200 (i.e. the difference between the purchase price paid for the shares in the target company and the target company's equity) reduces the parent company's equity from 250 to 50 when the target company is consolidated with the acquisition company.

The published tax plans address the effects of this reduction of equity for tax purposes ('goodwill gap') and indicate that the amount by which the equity is reduced in the consolidation may nevertheless be taken into account as equity for the purpose of determining the aforementioned ratio. However, the amount by which the equity has been corrected to bridge this goodwill gap must be gradually decreased over a 10-year period. This means that the amount of debt eligible for the interest deduction will differ each year during that period, assuming that the consolidated equity base remains the same.

The Tax Agenda is still merely a plan, but will become the subject of a bill to be submitted to the Netherlands Parliament later this year. The aim is for the proposed measures to become effective on 1 January 2012. Existing situations that originate from take-overs prior to 1 January 2007 are expected to be spared from the effects of the measures.

5. Conclusions

The clear increase in M&A activity in the Netherlands that started in the second half of 2010 has continued into 2011. Private equity firms are the main contributors to this increase, both as sellers and as buyers. Despite signals that deal activity slowed somewhat in Q2 of 2011 – attributed mainly to market uncertainty caused by the sovereign debt crises in Europe – expectations are that total deal activity in 2011 will be higher than in 2010. Apparently parties are again regularly finding ways to bridge the valuation and negotiation gaps. Although the new norm in M&A transactions is still not fully crystallised, there is a clear trend for sellers to be more willing to 'put skin in the game' by giving business warranties and accepting some kind of actual recourse possibility for the purchaser. On the other hand, seller-friendly terms like those aimed at deal certainty and price certainty have not yet disappeared.

Another important driver for the increased deal activity is the banks' willingness and ability to provide acquisition finance again. All Netherlands-based banks are competing for a share of the leveraged finance market, particularly in the mid-market segment in which most deal activity in the Netherlands takes place. As a result, pricing for leveraged loans has come down recently. In the near future, this trend may reverse. The implementation of the Basel III regulatory regime is expected to have an upward pressure on pricing for leveraged loans. Banks may restrict their lending activities and will try to pass on higher capital and funding costs for leveraged loans to their clients. The liquidity in the leveraged loan market may decrease further when private equity firms and their portfolio companies come to face the wall of maturing debt in 2013 and 2014. The general market view though is that the 'wall of debt' will not be a major disruptive issue in the Netherlands market.

Industry-participants have noticed a quick return to the standards and practices that were common in 2007: leverage ratios in transactions are going up, financing is being structured more aggressively and sponsor-friendly features are re-appearing in documentation. While there is no real concern yet about the 'quality' of current deals, respondents have expressed some doubt about whether market pressures can be kept in check and the excesses that occurred at the height of the private equity boom in 2007 thereby avoided.

With the Alternative Investment Fund Managers Directive about to come into force in the EU, it is clear that the alternative investment industry, including private equity fund managers, will become a regulated industry. The Directive will also create a more harmonised EU alternative investment market. Besides these changes, developments like the proposed restriction on the tax-deductibility of interest expenses and the new Basel III regulation will likely have a significant impact on the way business is conducted and transactions are arranged in practice.

In addition to the impact of new regulation and tax measures, a number of factors may reduce the future returns that private equity firms will generate. They will be less able to rely on the use of leverage and 'financial engineering'. Furthermore, as the current valuations of their portfolio companies are still suffering from past performance during the recession and the global economic uncertainty, sponsors are tending to hold on longer to their assets in order to make a successful exit. These longer holding periods generally result in lower internal rates of return for private equity firms. To compensate for these negative factors, private equity firms will need to depend more on their ability to grow their companies' profitability, either through operational improvements, more focussed and better executed strategies or a successful buy-and-build strategy. But as the quick rebound of private equity after the financial crisis has shown once more, the industry is extraordinarily capable of dealing with adverse circumstances and becoming better as a result.

Short Profiles

NautaDutilh Private Equity and Leveraged Finance Team

NautaDutilh is an independent Benelux law firm and one of the largest law firms in Europe, with over 400 lawyers, civil law notaries and tax advisers in offices in Amsterdam, Brussels, London, Luxembourg, New York and Rotterdam. Although we mainly specialise in corporate law - including private equity, banking and finance law -, we are also known for our expertise in the areas of tax, intellectual property, competition, telecom and media, commercial property and insurance. Our independent thinking and creative ideas, as well as the individual dynamism of our professionals, make the difference between mere competence and true excellence. And that's what distinguishes NautaDutilh from the rest. Nothing more, nothing less.

NautaDutilh has recently received the following awards:
Law Firm of the Year: The Netherlands | IFLR Europe Awards 2011
Law Firm of the Year: The Netherlands | Chambers Europe Awards 2010

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Methodology

Earlier this year, NautaDutilh circulated a survey amongst approximately 500 private equity practitioners, M&A and leveraged finance bankers as well as corporate finance advisers active in the Netherlands private equity and leveraged finance market, of whom more than 15 per cent completed the survey. In addition, we interviewed a number of private equity and leveraged finance experts and asked them to give their perspectives on 'the new norm' in the current market.

Although these interviews allowed us to verify certain key issues and trends identified in the survey, NautaDutilh is solely responsible for the contents of this publication and the views contained in this publication are solely our own.

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Disclaimer

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This publication contains general information on current and upcoming legal and market issues and trends. It is not intended to be comprehensive or to provide legal, tax or commercial advice.

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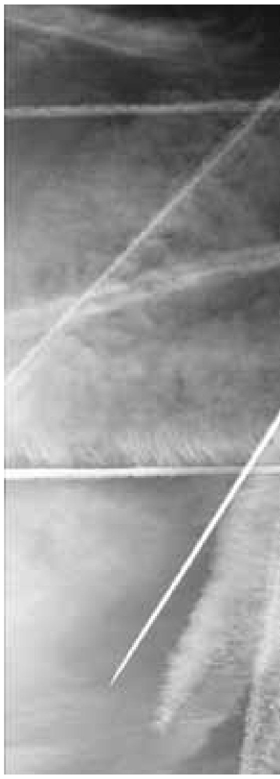

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