

SPECIAL REPORT

PRIVATE EQUITY



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Private equity



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FW moderates a discussion on the private equity industry between Kirk A. Radke at Kirkland & Ellis, Johan Terblanche at Loyens & Loeff, Mounir Guen at Private Equity Advisers Limited, Roger le Tissier at Ogier, and Steven J. Daniels at Skadden, Arps, Slate, Meagher & Flom LLP.

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FW: How would you describe recent buy-out and investment activity by private equity players? What are the general drivers behind recent deals?

Radke: In the US, private equity activity has been robust from mid-2010 onward, and has covered all types of transactions – buying companies, selling portfolio companies, refinancing portfolio companies, and IPOs. Strong capital markets have been a key foundation for this activity and the relative confidence held by most private equity houses has bolstered new deal activity.

Guen: What is driving deals more than anything else is that the environment is stable, allowing PE funds to make proper projections and assessments on what benefits and developments may take place. Also, we are seeing substantial changes in consumption patterns in emerging markets, which is having a positive influence. Interestingly enough, even in Europe, where parts of Southern Europe are under pressure, there are some great opportunities for acquisitions. Much depends, of course, on whether a fund is linked to the international markets or has a more domestic focus. But there is a general feeling of well being. We are now seeing good, consistent performers, and exits are back. There is a strong feeling of confidence among PE practitioners.

Terblanche: Transactional private equity activity continues to trend upwards and there have been a fair amount of transactions, mostly in the secondary market. Deal values increased in 2010, and 2011 has seen similar activity. Some of our clients have recently successfully closed new funds which have been in the making for longer than usual and are now actively deploying capital after a period of consolidation. Contributors to the increase in buyout and private equity investment activity generally include: a combination of the expiration of investment terms of a number of funds

which have not been actively investing, or investing very conservatively; the availability of new capital as funds return money to investors and investors return to the market; the ability to employ leverage at reasonable cost; and more confidence in pricing and earnings forecasts. Capital raising prospects have improved markedly and a number of our clients are taking new offerings to market over the next two quarters and early in 2012.

Le Tissier: Various media outlets have reported that activity is up. In comparison to previous years, we have seen extraordinary activity in acquisitions and exits in all jurisdictions and at all levels. This is clearly set to continue. There is also an expectation that the large volume of cash on corporate balance sheets will result in a significant increase in exits to trade buyers and, on that basis, activity is set to continue.

Daniels: Sponsors are enjoying a resurgence in the leveraged loan market, as well as restoration of rational valuation expectations on the part of sellers. This has translated into increased deal flow across a range of industries and deal sizes, as well as a rise in leveraged recapitalisations and other opportunities to return capital. Auctions have become increasingly robust, although activity has not returned to pre-credit crisis levels. Overall, sponsors appear to be more measured in their evaluation of targets, requiring a clear value proposition and a well established path to growth. Decreased leverage levels and a corresponding increase in equity contributions, coupled with continued emphasis on returns to limited partners, have caused sponsors to approach deals more cautiously and pragmatically.

FW: In what ways have deal structures and financing packages changed compared to previous years?

Guen: Deals are being structured more con-

servatively, with less leverage on them, and there is a greater focus on operational aspects. A little less innovation and a little more conservatism is in the equation today. General partners are focusing on loss ratios at the fund level. They are looking to minimise losses and drive returns utilising the right factors. Their priorities are driven by being able to find good companies which they have the skill to develop, being able to buy those companies at a disciplined price, and being able to contribute to the growth of all their portfolio of companies to generate returns.

Le Tissier: Deal structures and financings inevitably involve more than one jurisdiction nowadays: for example, a fund comprising Cayman and Guernsey and UK limited partnerships will hold an investment through Guernsey and Luxembourg holding structures. When co-investment rights and carry arrangements are added in, the result is a complicated structure that not only needs to be set up but also needs to be effectively administered for its life through reorganisations and exits. Every investment for a fund will also be different. Financing for such structures will also become complicated as a result. One particular development is the increased involvement of the Channel Islands Stock Exchange (CISX) which has seen a dramatic increase in the listing of quoted Eurobonds in connection with private equity transactions. This is an efficient and cost effective option for listing as the CISX offers certainty as to quoted Eurobond treatment and also a relatively low cost regime at relatively low levels. Equally, dealing with a specialist listing agent means that obtaining a listing in an efficient manner will, after the first listing, undoubtedly lead to cost and timing efficiencies going forward.

Daniels: Equity contributions as a percentage of purchase price have increased relative to pre-credit crisis levels and leverage is down overall. Sponsors are generally looking to achieve more conservative post-acquisition capital structures, and banks are not lending as aggressively as in the pre-credit crisis period. At the same time, sponsors are increasingly accessing mezzanine and other less traditional financing sources to augment availability in the leveraged loan market. From a transaction structuring perspective, however, relatively little appears to have changed, with many transactions still embracing reverse termination fee arrangements and other terms favoured in the pre-credit crisis period.

Radke: In the US, recent deal structures and financing packages are very similar to pre-2008 structures and packages, including in many cases, ‘covenant lite’ financings. ►



FW: What strategies are private equity players exploiting to build value across their portfolio and achieve exits with expected returns?

Terblanche: Funds are buying what they believe they can sell and there has been a significant focus on industrial and financial services assets. Emerging markets also continue to see significant private equity activity, with Latin America and India attracting a great deal of attention. Mangers look for stable income flows from multiple sources. While portfolio ages have, on average, doubled since 2007, 2010 showed an encouraging increase in the number of exits. While IPOs are back as a potential means of exit, a secondary transaction remains to be the most likely means of exit.

Le Tissier: In addition to legal services, a large part of our business is fiduciary and administration services to the private equity industry which means we keep a watch on that industry in particular. In recent years we have seen a marked growth in private equity investment in fund administration providers and acquisitions by major institutions; for example, IPES by RJD Partners, Butterfield Fulcrum by BV Investment Partners and previously 3i and Carlyle, Augentius by Core Capital, and JP Morgan acquiring Schroder Fund Administration in Guernsey. For those investors, there is added value in using the fund administrator to administer their own funds.

Daniels: From an operational perspective, sponsors – particularly in the middle market – have been embracing the use of consultants to develop long-term strategic plans for their portfolio companies. There also has been a trend towards creating economies of scale by leveraging the size and breadth of the sponsor's portfolio to access goods and services that span the needs of multiple businesses in the portfolio. With average holding periods increasing, the emphasis is increasingly on

long-term operational improvement, financial discipline and traditional value creation. This translates into strategies aimed at enhancing long-term performance and creating organic growth.

Radke: The private equity corporate governance model aligns the interests of management, directors and shareholders of these different companies to work together and to react to market challenges and opportunities. This model permits private equity houses to bring value added operational and financial expertise to their portfolio companies, creating above-market returns.

Guen: The market has developed quite significantly but the exits are still traditional: going public, a trade sale or a secondary sale. Sales to management are also popular. These exit routes will not go away and the appetite in the market has certainly improved. PE practitioners look for a good price at which they can exit, and an understanding of the liquidity path. A clear liquidity path is the key to driving exits in portfolio holdings. That is not to say there is more certainty about which path to take; general partners are remaining open minded about exit routes. Trying to pick one path over another, and sticking to it inflexibly, can actually do the fund a significant disservice.

FW: What trends are you seeing in private equity fundraising? To what extent has investor appetite for this asset class recovered following the financial crisis?

Le Tissier: A number of large funds have recently announced successful fund raisings and there are a number who will also do so this year. Prequin also estimates that more than 1600 funds globally are vying to raise about \$660bn in capital. Our experience confirms this as we have been involved in a number of fund raises last year and this year. However, it is also interesting to note that institutional in-

vestors recently polled by Collier Capital have predicted that 20 percent of private equity groups will disappear during this decade. Investor appetite has certainly recovered but allocations, possibly larger, may be more thinly spread among GPs. Providing a listing for a fund is of interest to some nowadays as shown by Better Capital's listings on AIM and the LSE. There also appears to be an increase in single investment deals where a GP will source a transaction and offer it to investors as a one-off; that suggests a shift in the usual model of subscribing to a fund.

Daniels: Fundraising is improving but still appears to be relatively anaemic compared to pre-credit crisis levels. Many traditional limited partners have excessive exposure to this asset class and that situation will not be resolved until limited partners' balance sheets strengthen over time. While there is still considerable appetite for private equity investments, the market is more competitive than ever and there will no doubt be consolidation as a result. Limited partners also are becoming more savvy about managing their investments and activism is rising, so managers will need to adapt to these increased expectations and develop ways to differentiate themselves in a competitive marketplace.

Radke: Fundraising has increased so far in 2011 and should continue to increase over the next 18-24 months. Most limited partners have concluded that private equity is a value added alternative investment strategy, with the high quality private equity houses delivering above market returns, on substantial amounts of invested capital.

Guen: Investors are focused on high quality active general partners. They are seeking managers with low loss ratios, consistent performance, an ability to source deals in a disciplined manner, and an ability to make quality investments. Such groups are able to attract a significant amount of capital. Secondly, there is a focus on alignment as investors want GPs to commit more of their own money into their funds. Investor due diligence has become more intensive, but rightly so. Investors have gone to new levels in terms of the detail in which they scrutinise unrealised portfolios. We support this trend; if a general partner is not up to standard they shouldn't even consider coming to market.

Terblanche: Fundraising is significantly easier than it was a mere six months ago and the prospects remain good, notwithstanding the fact that the average time to raise a private equity fund has increased from nine months pre-crisis to around 22 months. Investors crave ►►



returns and are returning to private equity in impressive numbers, with a significant portion of the capital coming from the US. The pendulum is swinging back and a large proportion of investors are actively making commitments, a number of them are expecting to increase their allocation to private equity funds over the next three to five years. GPs' commitments to their own funds are an important factor in providing comfort to prospective investors, with most of the successful fundraisings having significant GP commitment as a common theme. The rollercoaster ride continues however, as concerns about sovereign debt are negatively impacting investor confidence.

FW: *Could you outline some of the key risk management challenges facing fund managers in today's market?*

Daniels: Fund managers today are challenged with a dynamic risk management landscape. Regulatory oversight of the industry and its portfolio companies has increased domestically and abroad, and the industry is faced with considerable negative public sentiment and political attention. Similarly, increasing exposure to emerging markets and associated exposure to political and regulatory volatility have created new risks and uncertainties for fund managers and the portfolio companies they manage. As a result, fund managers need to focus more than ever on developing appropriate governance controls and risk management tools. It also is critical that managers fully understand and balance the risks of investments in emerging markets and develop ways to mitigate the risk of these investments. In addition, fund managers must make compliance a priority and work to instill appropriate compliance cultures at their portfolio companies.

Radke: Many private equity houses have an increasingly global investment outlook. With the global outlook comes many challenges and

risks, including currency exchange issues as well as regional and country specific security and stability issues.

Guen: From a legal and regulatory perspective, there are more requests and requirements directed at the private equity community than ever before. Those demands need to be addressed and met: there is no way around them. In the case of investor demands, this has different criteria. Each investor has its own individualised dynamic that needs to be satisfied, generating a substantial amount of work for general partners. Frankly, general partners do not completely appreciate the nature of that individualisation. The result is that if a fund has a high head count of investors, its back office team could struggle to meet basic requests and needs.

Terblanche: Risk management has, for a while now, been a key point of focus for investors, with a fair amount of attention on low standard deviations. There is high interest in companies that show sustainable returns, especially those that are not dependent on a single or limited market for their returns, as managers and investors alike look for stable returns from a variety of sources. As private equity funds invest more in developing economies, we have noted increased focus on the availability and use of Bilateral Investment Treaties.

Le Tissier: Identifying some of the risks that faced the industry, Edi Truell of Disruptive Capital recently asserted "With markets disrupted following Lehman, opportunities were plentiful for those with the nerve to grasp the nettle". Other than that, legal and regulatory issues must be high on the list within the EU.

FW: *What legal and regulatory issues do you expect to shape the industry over the coming months and years? Will a stricter regulatory environment have a significant impact on the private equity industry?*

Radke: The private equity industry does not present 'systemic risk' issues and concerns to our economic and financial systems around the world. Accordingly, the industry was not a contributor to the economic crisis of 2008-2009. The most significant regulatory challenge facing the private equity industry is educating regulatory agencies and policy decision makers about these two facts.

Guen: If regulators continue to mix the different types of assets within the alternative asset class, we could find regulations, tax and fiscal policies that should not necessarily apply to the whole. There is an unfortunate tendency for regulators to use global leverage asset managers (LAMs) as proxies for the entire private equity industry. Some of the LAMs are listing themselves, hold multiple assets and multiple products, and do not necessarily reflect the same structure and approach as a mid-market PE practitioner. The crucial, and challenging, question is how to avoid those large affluent funds with multiple products being used as proxies for the industry. On a more positive note, however, the industry itself is fundamentally healthy. I am very bullish on private equity as an asset class, and as an investment model. Can it be done better and can practitioners have a more open mind – yes, and perhaps that is where the opportunity lies.

Terblanche: The release of ESMA level two measures will bring the AIFM Directive squarely back into focus, as will the implementation of the Directive by national legislators. In the shorter term, there is likely to be a fair amount of debate following the commencement of the public consultation process in respect of the potential special European regime for venture capital. The US landscape is also evolving, with the SEC recently adopting specific rules aimed at clarifying the recently introduced exemption from registration for managers managing less than \$150m of assets in the US or who advise only venture capital funds, and for extending the registration deadline for managers relying on the exemption in relation to number of clients.

Le Tissier: The AIFM Directive has many implications for the industry which are well discussed and documented. Looking from offshore, the position of third country AIF managers was initially contentious but has now been resolved by creating a dual system of allowing the existing private placement rules to continue until at least 2018, while also phasing in an option for third country AIF managers to qualify under an EU passporting regime. Private placement has been the standard distribution model for the marketing of alternative ►

investment funds both within and outside the EU for a number of years. Jersey or Guernsey general partners of limited partnerships established in the Channel Islands and the Cayman Islands will be able to continue to rely on private placements for marketing of alternative funds in the EU until at least 2018 when the Directive will be subject to review. Jersey and Guernsey incorporated managers of corporate funds set up in the Channel Islands will also have the advantage of continued stability in private placement distribution. However, once

the Directive comes into effect, EU AIF managers will no longer be permitted to use the private placement rules for marketing EU alternative investment funds, even on a domestic EU distribution basis.

Daniels: Private equity will no doubt continue to flourish, as has been the case with other industries that have faced increased regulation in the past. The question really becomes one of cost. The overall impact of the Dodd-Frank Act is likely to be minimal in terms of limiting

investment activity, but there will be associated compliance costs. Similarly, enhanced regulation in the EU and emerging markets, coupled with changes in tax laws domestically and abroad, will increase compliance costs and drive down profitability. In particular, the proposed carried interest legislation in the US, if passed, will negatively impact managers' incentives. The overall effect will be to dilute the earning potential of the industry, but managers will no doubt adapt and investment activity will continue. ■

OPINIONS ARTICLES

Agricultural land: to buy, or not to buy?

BY DEBORAH HICKS MIDANEK

Institutional investors, fearing a future of lower returns and higher volatility, are looking anew at their asset allocations; some are moving funds into the agricultural sector to combine the possible inflation hedge of tangible assets with the appeal of current income from crop yields. Though the arguments in favour of owning agriculture land can be compelling, the nature of the risks involved may not be readily apparent to investors more accustomed to investing in securities and private equity. While not comprehensive, this article reviews some of the issues.

The basic argument

Returns in the agricultural sector have been uninspiring for a long time. There is a case to be made, however, that that trend is reversing and the fundamentals may be in place for a

long-term boom. Underpinning this argument is the measurement of the amount of farmland per person worldwide. In 1960 there were 1.1 acres of arable farmland per capita globally, according to data from the United Nations. By 2000 that had fallen to 0.6 acres, and over the next 40 years the population of the world is projected to grow from 6 billion to 9 billion.

While arable land per person is shrinking, overall demand for food will be increasing, leading to the investment thesis that this combination will inevitably lead to increased valuations for productive land. Add to this the dynamics of growing economies in India and China and elsewhere and the argument becomes even more compelling. As incomes rise, millions of people will be adding meat to their diets. Growth in demand for meat will have a multiplier effect on demand for land because

of the massive amounts of grain used to feed livestock. The USDA estimates that it takes seven pounds of grain to produce one pound of beef. Even with better crop yields from new seed technology, a supply crunch is looming.

Investment strategies

The current cycle of investing in farmland seems to be still in its early stages. The basic strategy, pursued for thousands of years, is to buy and hold land and lease it to farmers for the cultivation of row crops (commodity or vegetable), or permanent crops (grown on trees or vines). Though lease structures vary considerably, the investor receives a current yield and the opportunity for capital appreciation.

Some investors believe they can reduce risk by controlling management, move into owning the actual crops or herds, and from there move on into investing in farm equipment, grain elevators, cotton gins, and other storage and processing facilities. Some use scale as part of their strategy, looking to dominate a production area. Others add a commodity trading strategy, planning to use their knowledge of the crops to heighten their ability to hedge, or even to speculate or control critical commodities.

Keys to success

Given that the population growth cum food demand argument seems compelling, why are all investors not rushing to participate in this opportunity? To paraphrase one fund manager, farming might not look sophisticated, and farmers might drive pickup trucks, but farming is older than Wall Street. Farming is a very difficult business, and success depends to a great degree on judgment and on effective risk mitigation. ►►

Though the arguments in favour of owning agriculture land can be compelling, the nature of the risks involved may not be readily apparent to investors more accustomed to investing in securities and private equity.

To succeed within the time frame most investors use to evaluate their success, farmland must be bought at the right price, which requires significant local and technical knowledge, as production capacity of one field can vary greatly from another. Most farm property does not sell through a third party, but moves among known players in a given area. Outsiders are very conspicuous, and can expect to pay premium prices.

If purchases can be made at a reasonable price, taking into account typical local rents and crop yield trends, where are returns expected to come from? Farm returns are often very volatile, but over the long term research suggests that crop yields of 4 to 6 percent are feasible. In looking at historical trends, agricultural land has not appreciated significantly, and in some areas has dropped. Research by Professors Terry Kastens and Kevin Dhuyvetter cited in a recent Fortune Magazine article suggests that since 1950 the average annual return on farmland, including crop yield and land appreciation, was 11.5 percent, vs. a 12 percent annualised total return for the stock market. Their research suggests that farm returns actually involved about half the volatility of stocks.

Risks involved

Such returns may look acceptable. There is, however, a lot that can go wrong. As stated

above, buying significant amounts of land at the right price is difficult and takes time and patience. Putting together large enough parcels of land to efficiently deploy institutional investor dollars may not easily be possible. The variation in quality and productivity of the land involved may vary significantly. Buying at too high a price will not result in reasonable yield.

The risk of crop failure in the face of natural disaster, a chronic risk, is particularly vivid in the current environment of record breaking floods and droughts as well as earthquakes and tornadoes. While crop insurance is theoretically available, its cost is often prohibitive. Disease is another chronic risk, as is insect damage.

The regulatory framework for farm related assets is dauntingly complex and in many cases institutional investors are actively discouraged from buying farmland, in an effort to protect family farms from large institutional and corporate interests. There are also Federal restrictions on subsidies or disaster relief given to property owners who are not individuals, and the treatment of the crops and the use of various pesticides and fertilisers is also carefully controlled in the US.

Institutional investors who invest in illiquid assets are often eager to be able to see clearly their path to exiting the illiquid investment, which is difficult to do as there is no defined

market for farmland, and there are few benchmarks against which to evaluate returns and pricing. The number of buyers investing in scale may increase but will not likely be a large number.

The above issues illustrate clearly the biggest issue of all. There is a persistent difference in world view between financial investors and farmers. There are currently few investment managers with the ability to take on the responsibility for managing institutional investments in farmland. Beyond that, farming is a treacherous pursuit, and there is a serious shortage of management talent capable and willing to manage such farming assets on a contract basis.

Conclusion

For very patient investors with a long term view and a willingness to invest in the expertise needed to thoroughly understand farm assets, there is a significant opportunity in farmland. The compelling macroeconomic argument is, however, not a substitute for the need to develop a careful strategy and long term view. It is not enough to rely on the projections of financial investors; it is imperative to engage the farmers themselves in the discussion. ■

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Offshore fund structures: the current thinking

BY NICK ROGERS AND ROGER LE TISSIER

J. Paul Getty's formula for success was, famously, "rise early, work late, strike oil". In the glory years of the mid-2000s, running a private equity fund tended to be a pretty good substitute. It's not that there was a Wild West mentality: a seven year relationship with your limited partners tends to act as a natural curb on short-term excess. But even the staunchest supporter of the industry would acknowledge that a results-oriented approach was prevalent, and that any analysis of structuring considerations and process-related issues fell to the bottom of page four of the fund launch checklist.

This attitude now seems as antiquated as the notion that an 'out of office' message will be treated with any respect. Both the current regulatory zeitgeist and the demands of limited partners require sponsors not only to choose the optimum jurisdiction and structure for any new fund, but also to know why they are doing so; and then, of course, to have systems

in place to ensure regulatory and operational compliance throughout the term of the fund.

The bad news is that the speed, complexity and volume of regulatory developments with a direct or tangential effect on the private equity industry following the financial crisis have made it hard to keep up with the current wisdom on structuring. This is exacerbated by uncertainty regarding the scope, timing and detail of many of the key developments. At first glance, future-proofing any structure seems harder than ever.

However, the good news is that the structuring solutions most widely used before the financial crisis remain best practice. Indeed, to an extent there are even more compelling reasons to use the traditional offshore jurisdictions than there were before 2008. Sponsors can therefore have continuing confidence in their existing structures and know that they are justified in replicating them for future funds.

Obviously, the relative significance of individual factors that may influence the initial structure and ongoing operations of any fund will depend on the location of the manager, the status and location of the investors and the sectoral and geographical focus of the fund, among other things. A few key issues and themes are, however, likely to be relevant to the majority of funds.

Reputation. Using jurisdictions that don't have a premier reputation among industry participants is no longer acceptable. Cost is never irrelevant, but it is now unquestionably outweighed by the value of a clean regulatory, anti-money laundering and tax review by the supra-national standard setters such as the OECD, the IMF and the FATF. The Cayman Islands, Guernsey, Jersey, the BVI and a limited number of other private equity-focused jurisdictions have been subject to extensive scrutiny, resulting in very favourable reports. None of these jurisdictions appear on any in- ►

ternational blacklist or greylist, so using one of these jurisdictions eliminates any debate with investors – all managers need to do is to remember what all the acronyms stand for.

Legislative sophistication. While legislative sophistication feeds into a jurisdiction's reputation, it is also a separate consideration for a sponsor and its service providers. Stakeholders' views have evolved, and the commercial desire to have non-restrictive laws has been tempered with a realisation that some certainty is preferable where appropriate, for example in relation to insolvency procedures, limited partner default, activities of advisory committees and the standard of care owed by partners. For jurisdictions such as Cayman and Guernsey, this has led to substantial ongoing legislative review which will enhance their statutory framework to meet industry expectations.

Infrastructure. A 'reliable infrastructure' used to be limited to meaning that local professionals would answer the telephone. Fund sponsors must now have far higher expectations, and demand multi-disciplinary local expertise that is able to service the needs of the sponsor and the fund throughout its term in all situations. Madoff has had an effect even on the private equity industry: with in-house administration of funds increasingly questioned, limited partners now expect sponsors to seek to engage one of the sophisticated private equity fund administrators who operate predominantly in the Channel Islands. Importantly, this is consistent with the OECD's identification of 'substantial activity' in a jurisdiction as being a feature of compliance with international tax standards. With this in mind, some high-profile managers have established

a physical presence in Guernsey or Jersey. It may be expected that a Cayman fund with a Guernsey general partner will become an increasingly common structure given its compelling regulatory and tax dynamic, as well as its EU AIFM Directive characterisation.

AIFM Directive. The AIFM Directive has been extensively analysed and its nuances are many. This may well be the shortest summary to date: (i) any European dimension to the marketing or operations of a fund requires the same close attention as the industry has long been used to for the United States; (ii) the Directive must be implemented into the law of EU member states by 22 July 2013; (iii) EU managers will generally need to be authorised from that date; (iv) non-EU managers (for example, Guernsey, Cayman or Delaware GPs) of non-EU funds will not be required to be authorised while they rely on the private placement regime; (v) the private placement regime will remain available to non-EU managers until 2018; (vi) if a non-EU manager wishes to, or is required to, be authorised (for example, to rely on the passport regime from 2015), then its home jurisdiction must comply with certain conditions; (vii) it is expected that the Channel Islands and Cayman will have no problem satisfying any of those conditions by the relevant date; and (viii) non-authorised managers will be subject to fewer restrictions and requirements than authorised managers. For these reasons, sponsors are not making any AIFM Directive-driven decisions to move away from the traditional offshore centres for their GPs and funds; and, indeed, there may be an advantage to sponsors in domiciling their management entities in the Channel Is-

lands or Cayman so that they can benefit from being non-EU managers.

Dodd-Frank. Like the AIFM Directive, Dodd-Frank may have an important impact on advisers to private equity funds, whether they have an obvious US nexus or not. It will be essential to analyse any fund structure carefully in order either to conclude that Dodd-Frank does not apply, or that an exemption from SEC registration applies. In addition to exemptions based purely on assets under management, Cayman, Guernsey and other non-US general partners may be able to rely on the proposed foreign private fund advisers exemption if they do not have a place of business in the US, have fewer than 15 clients in the US and have less than US\$25m in assets under management in private funds for US clients and investors. So despite its scope, Dodd-Frank's application to offshore funds and managers should not, of itself, influence the choice of structure or jurisdiction for any private equity fund.

With the almost unprecedented (and continuing) upheaval and legislative barrage since the subprime crisis, it seems almost delusional to be reporting business as usual in the fundamental structuring choices for offshore funds. But, if anything, the top tier jurisdictions have become more attractive rather than less. So with domicile taken care of, fund managers just have to rise early and work late. Or was there something else? ■

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Ireland as a domicile for private equity funds

BY DONNACHA O'CONNOR AND SEAN MURRAY

Private equity firms may need to use a wide variety of legal structures and domiciles to conduct their operations efficiently. Ireland is well known as a fund domicile, and though it is perhaps better known as a domicile for UCITS funds and hedge funds, it is home to a growing number of private equity funds. It has been home to a funds industry for over 20 years and hosts or services the funds of over 850 international sponsors currently across all asset classes representing close to €2 trillion in assets.

Limited partnerships have been the historic structure of choice for private equity firms and the Irish Investment Limited Partnership Act, 1994 provides for such a structure in a regu-

lated fund context. Unregulated structures are generally housed within the limited partnership structure established under the Limited Partnership Act, 1907. Irish variable capital investment companies provide a flexible corporate solution to fund sponsors and are the most common structure used by private equity fund sponsors in Ireland. Unit trusts and common contractual funds (a tax transparent contractual based fund based on co-ownership of the fund's assets) are also available structures.

There is a growing realisation among fund sponsors that there are very good reasons for considering a regulated European domicile for their funds, the minimisation of portfolio level withholding tax by accessing a country's

double taxation treaty network being one such reason. Regulated private equity funds in Ireland are not subject to any taxes on their profits or gains. There are no Irish withholding taxes in respect of a distribution of payments to investors who are not resident or ordinarily resident in Ireland provided that the fund has been provided with an appropriate tax declaration signed by the investor. While Irish private equity funds themselves can generally not access Ireland's double-taxation treaty network, a taxable Irish acquisition vehicle can be used while the vehicle's tax bill is minimised through the use of profit equalisation securities. An additional benefit of this structure is that it should eliminate any chance of a foreign ►

tax exposure for the fund as a result of being deemed resident and/or having a permanent establishment in another jurisdiction (where the investment manager is located) by the very reason that the Irish acquisition vehicle will be deemed to be liable to tax in Ireland and a resident thereof for purposes of the relevant treaty. These Irish vehicles can also work as part of a structure involving a non-Irish private equity fund.

Perhaps the single biggest consideration for private equity sponsors in Europe at the time of writing, is the Alternative Investment Fund Managers Directive (AIFMD) – the new law governing the operation and marketing in Europe of non-UCITS funds which has to be implemented by EU member states by July 2013. The Directive will apply to private equity managers with assets under management in excess of €100m, or €500m where the funds are unleveraged and do not offer redemption rights to investors. Once the Directive is transposed into national law in the Member States (i.e., at the latest July 2013), an EU authorised manager will have a ‘passport’ to freely market its EU-domiciled private equity funds to ‘professional investors’ in its own Member State and other EU Member States, subject to a straightforward notification process. This provides a potentially significant means of accessing this investor market without having to deal with the vagaries of national private placement rules and Ireland as a potential domicile should be factored into fund sponsors’ thinking.

The basic framework of Irish fund law and regulation applies equally to private equity funds as to other funds. Given that a portfolio of private equity investments will normally be illiquid, the available Irish regulated fund structures are what are referred to as non-UCITS structures – UCITS structures are not

appropriate given their focus on liquid assets and their requirement to provide at least twice monthly redemption facilities. It should be noted that non-UCITS products, unlike UCITS, do not benefit from the principle of mutual recognition within the European Economic Area and cannot be publicly marketed in most other Member States. The public marketing of true closed-ended non-UCITS within the European Economic Area is possible under Directive 2003/71/EC (the ‘Prospectus Directive’), however, our experience to date is that most promoters of this type of product do not consider the Prospectus Directive regime to offer marketing advantages particularly for the sophisticated or institutional market place.

The Qualifying Investor Fund (QIF) is Ireland’s flagship non-UCITS vehicle. QIFs are authorised and regulated the Central Bank of Ireland, can be marketed solely to ‘Qualifying Investors’ and carry a minimum initial subscription per investor of €100,000. A Qualifying Investor is: (i) an investor who is a professional client within the meaning of Annex II of European Directive 2004/39/EC (Markets in Financial Instruments Directive (MiFID)); or (ii) an investor who receives an appraisal from an EU credit institution, a MiFID firm or a management company approved for the purposes of European Directive 2001/107/EC that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the fund; or (iii) an investor who certifies that they are an informed investor by providing the following: (a) confirmation (in writing) that the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or (b) confirmation (in writing) that the investor’s business in-

volves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the fund; (subject to any exemption therefrom permitted by the Central Bank). An exemption from the minimum subscription requirement and qualifying investor criteria is available to the fund’s managers and a limited number of other persons and entities that are closely connected with the management of the fund.

The ability of a QIF private equity fund to exercise influence over the management of the issuers in which it has invested or to take legal and/or management control of the issuers is subject only to setting out the fund’s policy in its offering document and there are very few other investment restrictions which apply.

Irish regulated funds must appoint a local administrator and custodian and a minimum of two local Irish directors. The principal function of the administrator is to value the fund (and it normally maintains the shareholder register as well). The custodian is responsible for safe-keeping the fund’s assets and for supervising the management and administration of the fund. Irish funds must retain an independent Irish audit firm to audit the fund once each year.

It certainly appears that with the implementation of the AIFMD due in 2013, choosing an EU domicile such as Ireland is becoming increasingly relevant for private equity fund sponsors as this will position such funds optimally to be marketed to professionals within the EU. ■

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Life sciences sector shines in Australian PE and VC industry

BY KATHERINE WOODTHORPE

We believe in the maxim that innovation is the cornerstone of business growth. Both private equity (PE) and venture capital (VC) play an important role in Australia’s innovation ecosystem, albeit often at difference points on the innovation spectrum (VC at the start-up phase and PE at the growth phase).

PE and VC are important sources of funding for capital-hungry innovators wanting to grow businesses and further develop and commercialise their intellectual property into viable products and services. Australia now has just 10 VC firms making new investments out of 30

firms operating here.

If Australia wants to remain an engine room of innovation we need to see some significant changes on the policy front and in the area of tax regulation. We need a national framework in place that makes both PE and VC investment vehicles attractive for investors in an increasingly competitive and global investment environment.

For both PE and VC, we need tax certainty for investors because some of the current arrangements are complex, unclear and subject to interpretation, which is a disincentive to at-

tracting the capital our country needs to fund its growth and prosperity. For VC we need greater policy support to encourage the collaboration between our researchers, the commercial sector and investors.

PE and VC activity peaked in 2007 and, like many industries, suffered heavily from the global financial crisis. For the PE sector there have been signs of this turning around in recent months and the increased activity appears set to continue in the face of the difficulties of raising capital in conservative markets. The investments you see today are mainly from ►►

The global biotech and pharmaceutical industry recognise the quality of products that have been developed in Australia and have paid several millions of dollars for a number of VC investee companies.

'dry powder' that needs to be spent. But the VC sector continues to face significant funding challenges as GFC-affected investors look elsewhere seeking liquidity and stable returns.

As Australian super funds have grown in size they have become less willing to write smaller cheques, given Australian VC is just 0.22 percent of the size funds under management by the Australian super industry. Having domestic institutions invest more locally, rather than offshore, works in the national interest by supporting local innovation and commercialisation initiatives as well as providing returns to local investors. This is a win-win. We need a national effort to incentivise Australian capital staying in Australia, in addition to attracting foreign capital.

In the face of these challenges, one area that has emerged brightly has been the life sciences sector. Research investment in the life sciences continues to grow, and Australian VC has supported many world-class companies including Cochlear, Resmed, Pharmaxis, Neuromonics, CathRx, Verva Pharmaceuticals and Chemgenex.

It is partly due to the support of VC over the past decade that the life sciences industry has grown to the extent that it has. The global bio-

tech and pharmaceutical industry recognise the quality of products that have been developed in Australia and have paid several millions of dollars for a number of VC investee companies, such as Arana and Peplin. Foreign VCs regularly co-invest alongside Australian VCs.

Life science investments have grown in recent years and held up in the face of the GFC. The number of investments has grown from over 50 in FY2006 to about 90 for the first half of FY2010. Unfortunately, however, the total amount of funding has not kept pace and many of these investments are for follow-on funding into existing ventures, not new undertakings.

Life sciences now form the main asset class for VC firms, at approximately 43 percent of funds invested, followed by ICT at 31 percent and energy and environment with 13 percent. For PE, the life sciences sector is also significant. Notable PE investments in life sciences include iNova Pharmaceuticals, medical device company Lomb Scientific and Lifehealthcare.

The recent, independent evaluation of the Commonwealth Government's Innovation Investment Fund (IIF) program, which supports VC funds, found that "in the absence of the IIF program, the needs of these innovative and potentially high impact businesses would remain

unfilled" and "it is likely that fewer businesses would have started up, and of those that did, their activities would have been more limited in both scale and scope."

Unfortunately there has been no indication of any ongoing policy support of this kind once the IIF program concludes this year, notwithstanding the government's own praise for the program and acknowledgement that innovation is central to national prosperity. This is in contrast to VC support initiatives in other countries such as NZ, the UK and the US which have all recently enhanced or extended their programs.

Governments around the world recognise the importance of supporting their VC industries as demonstrated by policies to assist their VC industries to help build a high growth, high value economy for the future. The Federal Government is to be applauded for its recent announcement of a proposed tightening up of the eligibility requirements for R&D tax concessions so that most of the tax breaks will go to genuine R&D initiatives rather than some of the 'business as usual' programs of big business. However, although this assists with cash-flow, it neither provides enough capital for early stage companies to achieve their potential nor all the additional value-add that VC investment brings to a growing company. The imminent ending of the IIF program, with no replacement mooted, is a very worrying scenario for companies which need significant capital to become a sustainable enterprise.

Australia is recognised internationally as attractive for PE and VC investment, and we have a rich history of innovation and entrepreneurship. We need to ensure that Australia remains competitive and attractive in the face of growing competition and to prevent some of our brightest ideas and people going offshore. ■

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The 'FII route' for investing in India – the 'broad-based fund' requirement and other obstacles en route

BY VINOD JOSEPH AND HIMANSHU NARAYAN

India has been a favoured investment destination for international investors since 1991 when it initiated a process of economic liberalisation by progressively relaxing its exchange control regulations. However, even now, exchange controls and other restrictions (such as sector specific limits) on foreign investments

are still in force and foreign investors need to overcome a few hurdles before they can invest in Indian securities.

Prior to India's economic liberalisation, the main driver behind exchange control was to prevent an outflow of foreign exchange. Even after the commencement of economic reforms,

the fear of foreign exchange outflow persisted. It was felt that permitting a sudden influx of foreign investors could prevent Indian businesses from developing to their full potential. This mindset has changed a great deal since 1991 and 100 percent foreign ownership is now permitted in most sectors. These days, ►►

Considering the rate of India's economic growth and the pace of regulatory reforms, it is only a matter of time before the Indian government removes all exchange controls and other restrictions on foreign investments.

the main objective behind exchange controls and limits on foreign investment is to prevent a sudden inflow of foreign investment into India which could drive up prices and result in excess liquidity in the Indian securities market.

Under the regime for foreign investors which is administered by the Ministry of Commerce and Industry and the Reserve Bank of India, foreign entities may invest directly under what is called the Foreign Direct Investment route or, in the case of institutional investors and funds, as a Foreign Portfolio Investment. There are various types of portfolio investments, of which the Foreign Institutional Investment (FII) route is popular. The Securities and Exchange Board of India (Foreign Institutional Investors) Regulations 1995 (FII Regulations) set out the framework and procedures whereby foreign investors can register with the Securities and Exchange Board of India (SEBI) either as an FII or as the sub-account of an FII and invest in Indian securities.

To be registered as an FII, an institution must either be a regulated entity, such as an asset management company, a bank, a pension fund etc., or a university fund or a charitable trust. It is relatively easy for a fund to be a sub-account. Originally (in 1995), a sub-account had to be a 'broad-based' fund. A 'broad-based' fund needed at least 50 investors, with no single individual investor holding more than 5 percent of the corpus. If the fund had institutional investors, it could have less than 50 investors. However, if the institutional investors held more than 5 percent of the fund, then the institutional investor itself had to be 'broad-based'. The idea was to prevent entities controlled by one or a few individuals from acquiring equity stakes in Indian companies which could enable them to create volatility or otherwise manipulate the Indian securities market.

The Regulations were constantly amended to add to the categories of entities which could become sub-accounts. Since February 1997, proprietary funds of FIIs or of a 'broad-based'

fund can be registered as a sub-account. In August 1999, the definition of a 'broad-based' fund was modified – the minimum requirement of 50 investors was reduced to 20 and each investor could hold up to 10 percent of the fund. In May 2008, the requirements were further diluted so that an investor could hold up to 49 percent of the fund. The May 2008 amendment also allows eligible foreign corporates and individuals to register as sub-accounts. To be eligible, a foreign corporate must be listed, have assets of over US\$2bn and average net profits of not less than US\$50m in the last three financial years. An eligible foreign individual needs to have a net worth of not less than US\$50m and must have been a client of the FII for three years prior to the application.

FIIs and their sub-accounts were originally not allowed to invest in unlisted Indian securities. This changed in 1996, within a year of the regulations coming into effect. Government securities and derivatives traded on a recognised stock exchange were later added to the list of permitted investments. Currently, an FII may not invest in more than 10 percent of an Indian company's equity. An Indian company may not have FII investments constituting more than 24 percent of its equity. This limit of 24 percent may be increased up to the limit prescribed for investments under the Foreign Direct Investment route (such as the 26 percent limit for insurance or 100 percent for software companies) if approved by the Indian company's board of directors and shareholders.

Investors who wish to invest in Indian securities through the FII route, but do not want to register themselves with SEBI as an FII or a sub-account, may invest in participatory notes (P-Note) issued by an FII. P-Notes are derivative instruments where the underlying security is an Indian security in which the FII has invested on behalf of the P-Note holder. The price of the P-Note will depend on the price of the underlying security. In 2007, there was a significant rise in investments by FIIs

and their sub-accounts, a big chunk of which came through P-Notes, which resulted in excess liquidity in the Indian securities market. It was also felt that P-Notes allowed anonymous investors to invest in and manipulate the market. It was feared that some of the investments flowing into India through the FII route was untaxed Indian money (referred to as 'black money' in local parlance) which had been parked overseas by tax dodgers, a phenomenon called 'round-tripping'. For these reasons, SEBI banned any fresh P-Note issues by sub-accounts, other than proprietary sub-accounts of FIIs. FIIs were barred from issuing P-Notes which had derivatives as underlying assets and had to wind-up outstanding positions within 18 months. Further, total P-Notes issued by an FII had to be less than 40 percent of assets under its management. SEBI's new rules caused the markets to crash, though they quickly recovered. A few months later, as the global financial crunch took effect and inflows into India slowed down, SEBI revoked many of the restrictions, though only FIIs and not sub-accounts may issue P-Notes. The 40 percent limit has also been revoked. FIIs are required to maintain details of those investing in P-Notes issued by them, to be provided to SEBI if so directed.

In April 2010, SEBI cracked down on funds which are organised as protected cell companies (PCCs) or Segregated Portfolio Companies (SPCs) or as Multi-Class Vehicles (MCVs). PCCs and SPCs have different classes of shares and the assets of each class are ring-fenced. An MCV has different classes of shares and each class may opt for a different investment profile, but assets of each class are not segregated. SEBI was concerned that a fund which is structured as a PCC or an SPC or MVC (and is 'broad-based' as a whole) could permit individual investors to invest in India other than as a part of a pool of investors, an action which would be contrary to the ethos of a 'broad-based' fund. Currently funds that are structured as PCCs and SPCs are not allowed to register as sub-accounts of FIIs. MCVs may register as sub-accounts, provided a common portfolio is maintained across classes or each sub-class is broad-based.

Considering the rate of India's economic growth and the pace of regulatory reforms, it is only a matter of time before the Indian government removes all exchange controls and other restrictions on foreign investments. Until such time, the FII route will offer overseas institutional investors and funds a relatively simple path to making investments in India. ■

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