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UPDATE

Preparing for Exits: Key Issues for Sponsors Across the United States, Europe and Asia

By Christopher Machera, Samantha McGonigle, U-Hyeon Kwon, Sam Blake and Sumit Ram

Introduction

While the pace of private equity deal-making around the world has slowed over the course of 2016, sponsors continue to exit investments at a rapid clip, as the post-financial crisis vintage of deals has generally proven to be a successful one for sponsors. The friendly investing environment has also given sponsors an opportunity to exit some of the more challenging deals that were struck before the financial crisis. While their approaches may differ (as set forth below), the issues that sponsors are focused upon in the United States, Europe and Asia (commentary is focused on China and Hong Kong throughout) are largely the same. We note below some of the interesting trends related to sponsor exits:

Focus on Value

Given the hyper-competitive environment in the private equity industry, sponsors (many of whom are in the middle of fundraising) are correspondingly hyper-focused on maximizing value at exit. In the U.S., increased attention has been paid to tax considerations at exit (for example, being paid for transaction tax benefits and selling blockers). And in Asia, where IPOs have traditionally been the preferred method of exiting an investment, the relatively dormant public equity market has caused sponsors to look beyond IPOs to monetize their investments. We are also seeing a resurgence in staple financing, which in theory facilitates a smoother financing (and hopefully a higher price) on the buy side. In an increasingly competitive environment, sponsors are tapping every tool in the toolkit to bolster returns.

Still a Seller's Market

The tide could turn (and when it does it could turn quickly) but we continue to see evidence of a very strong seller's market. Whether in terms of closing certainty or no-indemnity deals, competition on the buy-side continues to result in very favorable terms for sellers. It will be interesting to see if the tide turns soon though.

Difficult IPO Market

In China and Hong Kong, the IPO markets have been challenging and as a result sponsors have had to look at other exit options. In the U.S. and Europe, where there are generally more alternatives for sponsors looking to exit, the equally challenging IPO markets have not prevented sponsors from finding other ways to realize investment gains. There have however been signs of life recently in the market for sponsor-backed IPOs and this is another trend that could turn quickly and have interesting implications.

Liquidity Rights for Minority Investors

A trend that has taken hold around the world is the rise of non-sponsor investors taking a hard run at private equity investing. Whether through co-investment opportunities in connection with a fund LP stake or entirely on their own, sovereign wealth funds, family offices, public companies and others have been increasingly large players in private equity. An interesting consequence of this is that these investors, which oftentimes have a different time horizon than sponsors, are forcing some sponsors to be more flexible in the manner in which they can force an exit.

Rep and Warranty Insurance

The use of rep and warranty insurance (warranty and indemnity insurance in Europe and Asia) continues to grow and is an effective option in the right circumstances. However, the growing number of claims being made under policies and the desire of sellers to reduce their liability in respect of breaches of representations and warranties to zero could see the market turn, meaning that this ceases to be a cost-effective option.

Summary of Exit Considerations Across Jurisdictions

	U.S.	Europe	Asia
IPOs			
Generally	Sponsors have used the public markets to their advantage over the last several years. That IPOs have not been as common an exit over the last year is at least partially a reflection of the record-setting demand from sponsors and strategic buyers alike. After a tepid start to the year, sponsors appear to be refamiliarizing themselves with public markets and it will be interesting to see how that plays out in the new year.	The European IPO market is highly cyclical in nature. 2016 has been a slow year for IPOs generally, whereas 2015 saw a number of sponsor-backed IPOs get away successfully. Recent indications are that an IPO window is opening again and therefore sponsors are likely to seek to capitalize on this in the near term.	Historically, IPOs have been the preferred exit for sponsors. However, the IPO markets in China and in Hong Kong have been challenging and sponsors have had to consider other exit options.
Dual Track	Given the recent dearth of sponsor-backed IPOs, the dual track process has lost steam. It remains a valuable tool in the toolkit in the U.S., although perhaps not as effective as it was when it first became popular several years ago (many potential buyers today have seen too many companies file an S-1 only to accept an offer during the registration process).	Given the amount of preparation required for an IPO on a senior market (in particular the requirement for consolidated financial statements, on a pro forma basis if necessary, for the past three years), an IPO is not a viable fallback for a failed sale process in Europe. Conversely, sales can be orchestrated relatively quickly if an IPO process is faltering, so flipping into a sale is always an option for a company that is on an IPO track.	The dual-track exit process is not common in Asia. Because many sponsor investments in Asia involve a minority interest, sponsors often cannot, by themselves, initiate an IPO or a sale of the entire company. In addition, local listing rules (e.g., the requirement to “queue” to list in China, or the profit track record required to list in Hong Kong) further limit the circumstances in which a dual track process can be employed.
Force IPO Provision	A force-an-IPO provision is an old standby for sponsors, particularly those who hold a substantial minority of a target company that could be an IPO candidate down the road. Although these provisions are worthwhile, many sponsors in the U.S. are planning for what happens if they can’t “force” an IPO. After all, if the market is not cooperative at the time, there is only so much “forcing” a sponsor can foist upon the market. For example, many sponsors will look at punitive measures that can be employed if the Company is not able to successfully IPO (e.g., add a board seat).	Majority shareholders are often able to cause an IPO without the consent of the minority. It is rare for minority shareholders to be able to cause an IPO, as in European markets an IPO requires conversion of the company to a public company and listing of its entire share capital and subjects the company to listing rules. Given the extent of management involvement required in order to achieve an IPO, even if a sponsor has unilateral rights to force an IPO it will be difficult to achieve against the wishes of management. (This important point is true in the U.S. as well.)	Since sponsors often hold a minority or non-controlling interest and IPOs have traditionally been the preferred exit route, it is common for sponsors to agree upfront to a timeframe and other terms regarding an IPO.

	U.S.	Europe	Asia
Secondary Sales	In the U.S., subject to certain exceptions, all shares that are sold to the public must be registered with the SEC. Therefore, Registration Rights Agreements, which set out demand and piggyback rights, are ordinarily negotiated when a deal is signed up. When sponsors are working together, they generally will agree to sell lock-step or set up a coordination committee that governs post-IPO sales on the market. We are seeing sponsors being increasingly sensitive to the mechanics in these agreements as they increasingly have different time horizons and other considerations once they own public shares.	A typical European IPO sees the entire ordinary share capital being listed and becoming freely tradeable on the relevant market. Consequently, registration rights are not an issue. European IPOs also generally involve a new capital raise and issue of shares to the public. As a result, existing shareholders are typically only permitted to sell down a proportion of their holdings on admission. It is also typical for sponsor sellers and management to agree to both an initial lock-up following admission, followed by a period of "orderly market" restrictions (where they agree to sell in accordance with the advice of the company's financial advisers).	In China and in Hong Kong, the sponsor is likely to be subject to lock-up restrictions for a period of time once the portfolio company is listed. In addition to the lock-up restrictions, in Hong Kong, any preferential rights (e.g. price adjustment provisions, put or exit options, director nomination rights, veto rights, profit guarantees, etc.) that the sponsor has which do not extend to all other shareholders after listing are not permitted to survive after listing to comply with the general principle of even treatment of shareholders.
Sponsor Sales and Strategic Sales			
Sales to Sponsors vs. Strategic Buyers	Sponsor sales, or secondary sales, have become increasingly frequent in the U.S. For several years, strategic buyers had virtually crowded out the market given the war chest that many large public companies had amassed. Recently however sponsors have been competing successfully with strategic buyers. A trend described recently on Weil's Global Private Equity Watch blog is the return of the club deal, where sponsors are teaming up with what are often non-traditional private equity investors (e.g., family offices and sovereign wealth funds).	As in the U.S., in 2016 sponsors have had more success as buyers. Strategic buyers remain active, but secondary sales to sponsors have picked up. On larger deals, sponsors are increasingly teaming up to form bidding consortiums or bringing in minority co-investors to participate in bids.	For minority investments (the majority of PE transactions in Asia), sales of a minority interest to strategic buyers are uncommon, leaving a secondary sale to another financial investor as a more likely non-IPO exit. It will be interesting to see if the rise of strategic buyers in Asia helps to disturb the current state of affairs.
Liquidity Rights for Minority Investors	Sponsors in the U.S. have been increasingly thoughtful about puts and calls and how they play out in the real world. For example, many sponsors now contemplate plans "B" and "C" in the event that the company or a partner cannot come up with the cash to satisfy a put. On the other hand, as with secondary sales, the appearance of non-sponsor investors appearing more frequently in private equity deals has caused sponsors to be more flexible in their ability to force an exit (although ultimately of course there needs to be some fail-safe).	Parties to consortium or co-investment deals rarely agree to put and call arrangements in Europe. Liquidity for sponsors is typically achieved by the majority shareholder(s) having a drag-along right (often subject to a minimum holding period and/or a minimum return threshold for the minority), with minority shareholders having tag-along rights on sales by the majority. Minority shareholders may also be permitted to exit independently, generally subject to a right of first offer and a lock-up period. Buyers are often nervous about the enforceability of drag-along provisions and typically prefer to buy from willing sellers, which sponsor sellers should bear in mind when preparing for a sale.	Since private equity investments in Asia are often minority or non-control investments, sponsors have traditionally focused on negotiating (at the time of the investment) provisions to facilitate an exit, including multiple layers of put options and drag-along rights. Such exit rights often are triggered if an IPO does not occur within a specified timeframe. This is reflective of the mature market for minority investments in Asia.

	U.S.	Europe	Asia
Use of Rep and Warranty Insurance	While rep and warranty insurance continues to remain popular with sponsors, many sponsors have now lived with this product through a cycle, and different sponsors have different views as to its utility. Many sponsors continue to use rep and warranty insurance because it helps them sleep at night, but in the U.S. the market is increasingly top-heavy (in terms of carriers) and some view the cost-benefit proposition to be lacking.	Warranty and indemnity insurance is not appropriate for every deal, but it is a useful tool for sellers to bridge the gap between a seller's desire for a clean break and a cautious buyer's nervousness. In Europe, sponsor sellers are increasingly offering stapled W&I packages in auctions and increasingly underwriters are able to offer cover where the sellers take no liability themselves. Insurers are also beginning to offer synthetic tax covenants, though these are a new product and have not caught on significantly yet.	Though still used in only a minority of transactions, W&I insurance is becoming increasingly common in Asia for sponsors looking for a clean exit. However, the policy terms (including pricing) vary by jurisdiction, so W&I insurance is more attractive in certain jurisdictions (e.g., Hong Kong) than others (e.g., China).
Indemnities	In the U.S., a public-style deal remains the gold standard for sponsor sales. But we are seeing that even in a prolonged sellers' market, the no-indemnity deal is very dependent upon the industry and size of the transaction. For larger deals and in industries that are perceived to be less risky, there is no question that walk-away deals are the norm; however, we have seen buyers successfully negotiate indemnities in smaller deals and in industries that are perceived to be more risky.	Practice in relation to sponsors standing behind representations and warranties varies throughout Europe. In the U.K. and Scandinavia and on larger transactions, sponsors typically give no warranties or indemnities, other than warranties in relation to their title to shares and capacity to sell. In these circumstances, it is common for management to give business warranties, subject to low caps on liability for breach of warranty, in order to give buyers confidence that they have received full disclosure in due diligence. In other European jurisdictions, it is more common for sponsors to stand behind key business warranties to some extent.	Post-closing recourse in Asian deals is still fairly common, with a mix of U.S.-style indemnification and more U.K.-style breach of contract claims. Sponsors have been successful recently in providing post-closing recourse for only a limited set of (or in some cases, no) business warranties. However, it is unusual to see a true walk-away deal unless W&I insurance is used. It will be interesting to see if the market continues to converge with the U.S. and European practice.
Closing Certainty	Sellers continue to focus on closing certainty and in the U.S., it is becoming increasingly rare to see closing conditions beyond the standard bring down of reps, warranties, covenants and any requisite regulatory approvals. For example, it is rare for consents with respect to even material customer or supplier contracts that contain change of control provisions to be closing conditions. The increasingly difficult (and costly) regulatory environment is also contributing to general anxiety regarding closing certainty (e.g., second requests under HSR can cause a sponsor to think twice about a sale to a strategic that may be a competitor).	Closing certainty remains paramount for sponsor sellers. Typically, the only condition to closing is receipt of mandatory antitrust approvals, which the buyer undertakes to procure on a "hell or high water" basis. Bring down of representations, customer, supplier or landlord change of control consents are unlikely to be accepted by any sponsor seller. The typical U.S. condition that there is no order prohibiting closing is also rarely seen. The difficult regulatory environment has affected Europe as well.	Deal certainty is very important to exiting sponsors and additional closing conditions are becoming less common in transactions involving sought-after assets. In addition, sellers often demand (and with some frequency get) termination fees and/or deposits from buyers who are perceived to have lower closing certainty (e.g., PRC buyers who require government approval to close the transaction). As U.S. practitioners are aware, the practice of requiring deposits from PRC buyers perceived as providing less closing certainty extends throughout the world.

	U.S.	Europe	Asia
Certain funds	The “specific performance lite” construct (i.e., use of a reverse termination fee with specific performance granted only where the buyer’s debt financing is ready to be drawn upon) has become the norm for sales to sponsors, and even some strategic buyers that are relying upon debt financing to close a deal may receive the benefit of specific performance lite. It is notable that this construct has not really been tested by litigants since it became popularized in the wake of the financial crisis (i.e., after many deals had been through the litigation ringer).	In Europe, selling sponsors require proof at signing that the buyers have access to the funds required to complete. This includes a commitment from the buyer (or, in the case of a sponsor-backed buyer, the sponsor’s funds) in respect of the equity portion of the consideration and evidence that the buyer has access to any required debt financing on a “certain funds” basis. In general, this means that the buyer has signed debt commitment papers where all conditions to drawdown have been satisfied, other than any conditions set out in the sale and purchase agreement.	The approach in Europe is common in Asia as exiting sponsors would (especially in larger deals) usually insist on “certain funds” commitment from the buyer in the form of agreed form financing documents and signed debt commitment papers from the lending bank(s). In respect of onshore transactions, we are also seeing an increasing trend for buyers to seek financing from PRC banks (rather than international banks), which are offering more competitive pricing and flexible terms.
Tax	Sponsors in the U.S. have always been very tax savvy, but recently sponsors have been increasingly sophisticated in planning for exits on the front end. Two examples of this are contemplating Up-C structures and providing in governing documents the sale of blockers. In addition, Tax Receivable Agreements (put in place to preserve value of tax attributes in connection with an IPO) are becoming increasingly nuanced.	In Europe, sponsors aim to do little tax planning in relation to exits given that their acquisition and holding structure should have been established with a view to mitigating tax leakage on an exit. The key tax exemption for sales remains the participation exemption/substantial shareholding exemption. IPO structuring is more complex and advisers should focus early on identifying the optimum vehicle for listing and adjusting the capital structure so that sponsors and management sit at the right level.	While tax analysis is an important aspect of every transaction and sponsors are focused on making their investment through a tax-efficient structure, it is unusual for transactions in Asia to involve major structural changes for tax purposes (though sometimes there are significant restructurings for other reasons, such as preparation for an IPO). However, certain jurisdictions pose particular tax issues upon exit. For example in China, sponsors and buyers will often negotiate how to address the tax liability that may arise from Circular 698/Bulletin 7 (a tax on indirect sales of PRC companies).

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If you would like more information about the contents of this issue, or about Weil's Private Equity practice, please contact your relationship partner at Weil, or one of the authors below:

Editors:

Marco Compagnoni (London)	View Bio	marco.compagnoni@weil.com	+44 20 7903 1547
Doug Warner (New York)	View Bio	doug.warner@weil.com	+1 212 310 8751

Contributing Authors:

Christopher Machera (New York)	View Bio	chris.machera@weil.com	+1 212 310 8080
Samantha McGonigle (London)	View Bio	samantha.mcgonigle@weil.com	+44 20 7903 1244
U-Hyeon Kwon (Hong Kong)	View Bio	u-hyeon.kwon@weil.com	+852 3476 9233
Sam Blake (London)	View Bio	sam.blake@weil.com	+44 20 7903 1145
Sumit Ram (Hong Kong)	View Bio	sumit.ram@weil.com	+852 3476 9267