

Our private equity practice – at the heart of Europe

February 2006

“Allen & Overy is fast becoming one of the jurisdiction’s leading private equity buyout advisors”

IFLR 1000, 2006

“Czech Law Firm of the Year”

IFLR European Awards 2005

“Central and Eastern European Law Firm of the Year”

Global Counsel Law Firm Awards 2003

Despite the large number of private equity investments already made over the years in Central and Eastern Europe (CEE), the region still has huge potential. In recent years, buoyed by success, many CEE-based private equity investors have raised fund after fund, and Western European investment groups have increasingly raised CEE-focused funds too.

There are plenty of opportunities in CEE to make investments into growing businesses with great potential – businesses which need the capital and the know how that private equity brings to unlock the value inherent in that potential.

However, with an ever-increasing number of funds chasing a finite number of deals, the successful private equity investor is going to be the one which is the most “well-oiled” operation, with the ability to move fast when opportunities arise. To do this, the investor needs to know the pitfalls and quirks in a particular jurisdiction, and needs to be able to structure, present and complete the deal in the shortest possible timeframe.

This requires a comprehensive understanding of the local environment in which the Target is operating, at a “deal culture” level as well as at a legal level. Allen & Overy can offer you expert knowledge and assistance to enable you to move fast on deal opportunities, while at the same time managing risk through careful structuring and thorough preparation.

10 things to think about when doing private equity deals in CEE

1. STRUCTURING THE ACQUISITION FINANCE

We frequently come across private equity investors looking to generate higher returns on their equity investment using a weighted mixture of equity and debt (leveraged finance). Right from the outset, some fundamental questions will need to be answered, such as: Will it be possible for the SPV and Target to offset interest on debt against taxable profits? Are there any thin capitalisation rules in the relevant jurisdiction?

In most CEE countries, thin capitalisation rules apply, usually setting a related-party debt to equity ratio of 3:1 (Poland/Hungary) or 4:1 (Czech Republic). The definition of who is a related person for these purposes varies, with some room for structural planning based on the percentage of voting rights, though in Hungary

the rules apply not only to loans and credits from related parties but also to those from any other companies, except financial institutions. Further, no group taxation currently exists in the Czech Republic, Hungary or Slovakia while in Poland the provisions relating to group taxation are very strict and only a few tax groups have been created so far. Offset of interest on debt in an acquiring vehicle against taxable profits in a Target can be achieved in many countries by: (i) incorporating the acquiring vehicle in the relevant jurisdiction; and (ii) merging the Target into the acquiring vehicle as soon as it has acquired the Target.

2. SECURING THE ACQUISITION FINANCE

Rules on financial assistance vary from country to country in CEE. In most countries, there are financial assistance rules in relation to the acquisition of shares in a joint stock company¹, but not a limited liability company.

The rules on financial assistance are invariably strict, and importantly, there is no equivalent of the UK “white-wash” procedure. As a result, many CEE (joint stock company) Targets may not provide assets as security and/or give a guarantee as collateral under the acquisition loan. However, in Hungary, as a result of a change of law with effect from 1 July 2006, the financial assistance rules will not apply where financing is provided by a bank.

At completion of the acquisition, only the shares in the Target and/or in the acquiring SPV can be used as collateral (with some minor exceptions). This level of security is normally not considered sufficient by the banks and they tend to request that they can access also the assets in the Target. Therefore, in some CEE countries, private equity acquisitions commonly employ a local SPV in acquiring the shares of the Target. Subsequently, as soon as possible after the acquisition, the Target is merged into the SPV. Once the merger is completed, the assets of the Target pass into the acquiring entity and can be pledged in favour of the banks.

3. TAPPING CASH IN THE TARGET

In the Czech Republic, a seller is not liable for either income tax or capital gains tax on the received purchase price where the seller has held the asset for a certain period of time. Though this used to be the case in Slovakia, it no longer applies if the seller has acquired an interest in the Slovak company on or after 1 January 2004, and in Poland and Hungary it does not apply at all. As dividends are taxable in the Czech Republic, a shareholder planning a sale may try to accumulate cash in the Target and use it to increase the purchase price instead of taking a pre-closing dividend.

Unless this issue is carefully addressed, the buyer will have to raise additional funding for buying the excess cash. However, because of the rules against financial assistance applicable in the Czech Republic, this excess cash cannot be used to service the acquisition debt. If the acquisition structure involves a merger of the Target into the acquisition SPV (see above), the cash in the Target can be used only once the merger is completed (typically, six to nine months from completion of the acquisition).

4. MANAGEMENT PARTICIPATION

In a situation where there is the possibility of a “genuine” management buy-out, i.e. the managers are not already selling shareholders, it is possible that managers in CEE could be cautious when offered share participation in the Target. As time goes by, and as managers become more financially aware, this problem is less apparent. However, in some jurisdictions, continuing management are still quite wary of typical incentivisation methods offered/demanded by private equity investors, particularly IRR demands, liquidation preferences and other mechanisms that private equity investors would tend to see as standard. Offering shares to the management may therefore require much more explanation and negotiation than Western private equity houses may be used to from other markets.

¹ Although a joint stock company has limited liability, these are the terms commonly used to differentiate the different types of company in the region.

5. STRUCTURING THE MANAGEMENT PARTICIPATION

Some CEE jurisdictions have rigid corporate laws which can, without careful drafting, make it difficult to ensure enforceability of the key arrangements between the investor and the management. For example, it will be critical for the investor to ensure that it can enforce drag-along rights arising on the investor's exit from the company. Similarly, the investor will want to keep control over the destination of the shares if the manager leaves the company, whether as a bad leaver or as a good leaver.

In common with many other jurisdictions, this is not straightforward, as any transfer of title requires the involvement of the seller in cases where the share certificates have been issued. The seller either has to physically hand over share certificates to the new owner or to initiate a change of the owner in the registry of book-entered shares. As a result, it may not be enough to rely on the traditional drag-along and call option clauses in the shareholders' agreement or on taking "irrevocable" powers of attorney. The ability of the investor to access managers' shares may need to be secured by additional structures such as an escrow or custody arrangement. Local practice varies and this should be addressed up front.

6. PREFERENCE SHARES AND CLASSES OF SHARES

Many private equity structures in Western Europe involve the Target issuing redeemable preference shares and/or shareholder loan to provide further leverage against the ordinary shares. The value of the ordinary shares may be potentially low until the debt and preference shares are repaid, but any surplus value beyond that will accrue to the ordinary shares and generate high rates of return on equity. In some jurisdictions in CEE, although preference shares are possible, redeemable preference shares with, for example, guaranteed levels of dividend or certainty of payment on redemption may not be possible. In addition to that, it will need to be considered whether there would be withholding tax on preference share dividends. Generally preference shares enjoy the same tax treatment as ordinary shares, but reductions in withholding taxes on dividends under relevant double taxation treaties may be conditional only on holding a qualifying share in voting rights instead of equity capital.

Other equity structures may involve the use of different classes of shares, with the private equity investor and the management having different classes of shares. For example, these classes may rank equally on general economic and voting rights, but may provide for a liquidation preference for the private equity investor. This is not possible in most jurisdictions in CEE (Hungary being a notable exception), although it may be possible to provide for liquidation preferences in other ways.

7. MEZZANINE WARRANTS

Leveraged private equity acquisitions sometimes include a mezzanine financing, often involving the issue to the junior lenders of warrants which give them the right to subscribe on favourable terms for a portion of new shares in the Target, usually on the investor's exit. In many jurisdictions in CEE, the concept of mezzanine warrants does not exist, largely because the Target is not legally able to commit itself to issuing new shares to the junior lenders at some point in the future. It is then necessary to create an alternative structure tailored to the specifics of the particular deal in order to achieve a similar outcome.

8. CONTROLLING INTERESTS (OR "LETTING GO" ...)

Despite a strong entrepreneurial culture, shareholder managers in CEE can be quite reluctant to cede control of the business that they have built up themselves and may need to be convinced of the benefits of an approach from a private equity investor. Often, the private equity investment is seen only as a source of funding comparable with bank finance and the shareholder managers will expect to be able to keep control at both shareholder and board levels. If the investor is willing to take a minority stake as well as a minority on the board, it is essential to have a detailed understanding of the powers of the board and the general meeting, and of the most effective way to make veto rights enforceable in practice. Where operating subsidiaries are owned by a holding company in which the private equity investor and the shareholder managers share ownership, it may be important to address these issues of control in more detail, since the area of focus, in practice, may not be with regard to decisions made by the holding company, but with the manner in which decisions are taken by subsidiaries. Investors may be less willing to rely only on contractual undertakings from the holding company to deal with this issue.

9. EXITS

As in other jurisdictions, the investor and the management alike will often be thinking of an IPO as a potential form of exit. A particularly relevant factor in the CEE is the increasing level of activity on the Warsaw Stock Exchange, which is attracting a significant amount of attention from across the CEE region: liquidity is high and the costs of obtaining a listing are now much lower than those in London or Frankfurt, leading to different cost/benefit analyses and a lower valuation threshold for a listing to be regarded as viable.

Given the relative caution of many CEE managers, and the new environment in CEE public markets following implementation of the Prospectus Directive, it may well be worthwhile to address up front with the managers issues regarding responsibility for statements made in a prospectus.

10. AND FINALLY...SOME PRACTICAL POINTS NOT NECESSARILY PECULIAR TO PRIVATE EQUITY DEALS

Heads of Terms/LOI/Term Sheet

It is also vital to take local legal advice before signing any non-binding heads of terms so as to avoid inadvertently creating any unexpected binding obligations. In some CEE jurisdictions, there exists the concept of an "Agreement on Future Agreement". This kind of agreement sets out the basic terms of an agreement which is later to be signed "in full". The danger is that such an agreement can be binding, enabling a party to insist on entering into a proper sale agreement.

Governing law

It will often be assumed by sellers that the governing law will have to be local law, because the transaction involves a local company. This is not the case although unavoidably many of the fundamental provisions of the SPA will need to be *compliant with* local laws. The treatment of remedies for breach of warranty will vary depending on the choice of governing law and there are also concepts which may not necessarily exist under, e.g., English law. For example, in many CEE jurisdictions, it is common, and enforceable, to include contractual penalties as a "stick" to encourage performance.

Governing language

It is sensible, if possible, to avoid agreeing to the concept of "equal force" translations, since this can lead to uncertainty and great additional cost. Similarly, agreeing to draft or negotiate documents in more than one language can add greatly to both time and cost and should be avoided if at all possible.

Slovakia

"Absolutely fantastic service"

Chambers Global 2004

"Legendary" Igor Pálka was hailed by the market as "the best corporate lawyer in Slovakia."

Chambers Global 2005

Allen & Overy's private equity practice in CEE

Our Central and Eastern Europe (CEE) **dedicated private equity practice** combines expertise **across the board** in M&A, equity capital markets, and leveraged finance techniques. We have one of the **largest practices in the CEE** enabling us to deal with the most complex and high-profile transactions. We have offices in four key centres in Central Europe: **Warsaw, Prague, Budapest, Bratislava**.

We have advised on a number of private equity deals in Central and Eastern Europe which have been interesting and challenging in a number of ways.

In **Slovakia**, one of our best known deals was when we advised a **consortium** of over ten private equity investors led by **AIG** on: (i) the US\$180 million acquisition of a 36% stake in **Orange Slovensko, a.s.** from five Slovak utilities companies; and (ii) the exit at a price of US\$628 million, the largest private equity deal to date in Slovakia and one of the largest and most successful in CEE. We advised the consortium for over four years during its investment.

Czech Republic

“According to clients, the partners at this firm offer a vast array of experience. In addition to corporate/M&A and joint ventures, the team has been involved in privatisations, restructuring and insolvency. The firm can also boast some unique mandates”

Chambers Global – The World’s Leading Lawyers 2004-2005 edition

“Central and Eastern European Law Firm of the Year”

Global Counsel Law Firm Awards 2003

Poland

“from a business perspective it’s the best” a client talking about our Corporate/M&A practice

Chambers Global – The World’s Leading Lawyers 2004-2005

Hungary

“The corporate practice group of Allen & Overy’s Hungary office is well established in the region and boasts an impressive list of clients”

IFLR 1000 (2004)

In the **Czech Republic**, Allen & Overy advised **Pamplona Capital Partners I, LP**, a UK private equity house, on a unique leveraged buy out of **Pegas, a.s.** The target is one of the leading European manufacturers of non-woven textiles, selling its products mainly to leading multinationals for use in personal hygiene products. The transaction required the acquisition vehicle to raise senior debt financing from a syndicate of banks, mezzanine financing, as well as several shareholder loans. The current management will continue to run the business under a new and sophisticated arrangement with Pamplona. For the deal, a multilevel structure of acquisition vehicles had to be set up in a number of jurisdictions. The combined corporate and banking teams of Allen & Overy in Prague, London, Warsaw and Luxembourg were handling all aspects of this complex deal, the first project of its size and nature in the Czech Republic that we are aware of.

We advised **Bank Austria Creditanstalt AG** and **CA IB Merchant Banking** in connection with two private equity financings of €10,000,000 each, for **SkyEurope Airlines, a.s.**, Central Europe’s first low cost airline. These were pioneering transactions involving syndicated participation warrants with exposure to a very exciting company whose position is unique in the region. We acquired a detailed understanding of the airline’s activities in and across Central Europe (including Hungary and Poland and its “home” country, Slovakia), as well as examining the implications of EU Accession around that time on the airline industry. A shareholders’ structure was put in place that carefully balanced the needs of the investors with the ongoing participation of the founders of the airline, who remained in key management positions. At the same time the overall structure needed to preserve flexibility to allow the parties to prepare for the intended, and now successfully executed, IPO.

We are also proud to have advised **Enterprise Investors** on its acquisition of a 47.65% stake in the leading Slovak electrical retail group **NAY**. The transaction represents something of a watershed in the Slovak private equity market, which until recently has been slow to provide the same number of deals as the rest of Central Europe. The deal was therefore not only interesting because of the usual transactional and structural complexities involved, but also because of the confidence which Enterprise Investors showed in the Slovak market for private equity deals and the underlying message to Slovak business, that private equity has something to offer a growing business in terms of know-how and experience, as well as capital.

In **Poland**, we advised **Bank Austria Creditanstalt AG** in connection with its investment in **Bioton S.A.**, the leading manufacturer of human insulin. **Bioton S.A.** was subsequently listed on the Warsaw Stock Exchange, and Bank Austria Creditanstalt AG recently exited from the investment by selling its stake through an accelerated book-building process to domestic and foreign financial investors. Allen & Overy also advised Bank Austria Creditanstalt AG on this sale process. The deal was interesting since, despite being structured as an equity investment, in practice it involved a mezzanine element and mezzanine structures are not commonly used in Poland. Secondly, it involved advice in relation to the exit by a private equity investor through a secondary public offering.

In **Hungary** we advised on the IPO of **Állami Nyomda Nyrt.** (State Printing House plc) where Royaltan, a private equity investor, sold part of its interest in the company. This was the only IPO in Hungary in 2005 and the first equity deal following the implementation of the Prospectus Directive in Hungary. In order to maximise the tax benefit for the selling shareholders, Állami Nyomda Nyrt. was first listed on the Budapest Stock Exchange and then offered its shares to the public. The structure, which included the settlement of the result of the bookbuilding process and running a public auction on the stock exchange, was available to be used from 1 July 2005 only.

Contact members of our CEE private equity group

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“Led by Jane Townsend, the practice continues to offer an excellent service.”

European Legal 500 – 2004 edition

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“Hugh Owen is one of the firm’s most prominent partners. Peers described him as “highly capable and versatile”.

Chambers Global 2005/2006



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“Jarosław Iwanicki embodies everything that is positive about Allen & Overy”

a client quote, Chambers Global – The World’s Leading Lawyers 2004-2005

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Zoltán Lengyel “is, as always, praised by his peers for his technical skills”

IFLR 1000 (2004)



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