

# AMAGAZINE

Aon Mergers and Acquisitions Group

Winter 2008

## Where's the exit?



The options for private equity investors to realise exits have been almost swept away by the autumn financial storms. Given this slowdown, investors are even more compelled to get under the hood of their existing portfolio businesses and fine tune them, writes **Stuart Rock**.

Exits are more likely to be achieved through the meticulous grooming of portfolio companies. This may well require new additions to the private equity toolkit.

Tool one is enterprise risk management (ERM). It's a powerful analytical tool that increases a company's understanding of its overall risk portfolio - such as business continuity, supply chain risk management and product liability - and the connections between them.

This enables investors and managers to identify and assess their major risks. They can understand which risks must be embraced and retained - and thus are liabilities on the bottom line - and those that can be outsourced or

ring-fenced. Significantly, Standard & Poor's has added ERM assessments to their credit scorings and other agencies are likely to follow.

Transaction liability insurance, used at the sharp end of sale negotiations, is creative tool number two.

It allows risks to be ring-fenced or transferred, and can unlock those deals where previously there was a price or risk impasse. Now becoming increasingly popular, transaction liability has been used by **Aon** on more than 30 deals in 2007 across multiple sectors in more than 20 countries.

Vendor due diligence (VDD) is tool number three. It can deliver real value

by decreasing the level of uncertainty and bridging the gap between buyer and seller expectations. While buyers will still conduct their own due diligence, VDD does provide an opportunity to reduce volatility and speed up the transaction process. It can also be used to illustrate to prospective buyers the quality of the asset for sale and justify price expectations.

These are just three of the many solutions to problems that, in the months to come, may well prove the difference for private equity between the door marked "exit" and the door marked "shut."

*Stuart Rock is Editorial Director of Caspian Publishing*

### Renewable energy

The technologies are multiplying and growing. And so are the risks  
Page 4



### CEE overview

The region is luring private equity but there are pitfalls  
Page 5



### Interview

Jonathan Russell of 3i and current EVCA chairman  
Page 7

# M&A: after the peak

The plunge in corporate valuations ought to be an ideal opportunity for healthy companies to buy competitors and strengthen their position. But, says **Christopher Brown-Humes**, the reality is tougher.



M&A activity always falls sharply when stock markets dive - and it's no different this time. CEOs lose confidence. Financing becomes harder. Valuations become problematic - the target may be cheap today but even cheaper tomorrow. The frustrating truth: the higher the market, the greater the amount of takeover activity.

At the peak of the cycle, companies could access cheap debt and had a currency to be used freely to pay for acquisitions - their own share price. It is now hard to access bank debt at the right price and rights issues are a problem without accepting a discount. Cash therefore becomes more important as a payment mechanism.

With the banks reluctant to lend at the same levels, there will be more club deals. Earlier this autumn, France's EDF ended up recruiting three additional banks to add to its existing quartet to support its £12.5bn takeover of British Energy.

Short-term refinancing costs have shot up. This is one reason why Xstrata, the mining company, walked away from an indicative £33 a share bid for the LSE earlier this autumn. Although it had bank commitments for a £15bn loan, a large portion of the debt was only offered for one year.

Will takeover activity dry up completely? It never does. A crisis like this forces some smaller, weaker companies to recognise deficiencies and act accordingly. Frank Chapman, BG Group's chief executive, said recently that the credit crisis had helped to persuade Queensland Gas Company to agree to being taken over by BG because it felt it needed to be part of a bigger group.

For private equity, today's climate creates tough challenges. For LPs, cheaper public markets can become a more attractive investment arena than the more illiquid private equity marketplace. The slide in corporate valuations is leading to write-downs of the value

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of private equity portfolio companies. Secondary assets are typically changing hands at 40-60% below cost, according to some sources, creating difficult decisions for LPs and GPs.

Falling asset prices create the same “buy now or wait?” uncertainty among private equity investors as among public company CEOs - and there are few private equity GPs whose experience of investing goes back to the recession of the early nineties.

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Of course, the private equity model is not dead. It is just going to change the way investors structure and price deals. “In future takeover deals, there will be less emphasis on financial leverage and more on operational turnaround skills,” predicts one senior executive in private equity. There will also be a shift to larger equity injections as a proportion of deal value and more minority equity growth capital deals.

When will M&A activity start to pick up? The experience of two previous peaks in takeover activity is not encouraging. Those peaks came in 1990 and 2000 respectively and it was

not until three years later in both cases that things began to improve. The peak in the current cycle was June 2007, suggesting it might not be before 2010 before M&A activity revives. Cross-border activity may be affected. Given all the volatility in foreign exchange markets this autumn, it would not be surprising if some chief executives stick to domestic deals to mitigate currency factors.

Will such caution prevail in private equity M&A? Historically, firms make their biggest returns in the wake of substantial market corrections, as they can buy at attractive entry prices. As Blackstone chairman Stephen Schwarzman recently noted: “This is actually, from a historical perspective, a very interesting time to be investing capital.” Private equity with a lower debt component - “unleveraged private equity” - is likely to be an important source of capital for deals in the months ahead. We may also see more deals led jointly by private equity and corporates.

But their real focus is not going to be on deal-doing but on generating shareholder value out of their current investments - and that will require more imagination and boldness than before.



*Christopher Brown-Humes is markets editor of the Financial Times*

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If ever there was a time for the private equity’s advisory community to step up to the plate, this is it. The crisis in the debt market, the difficulties in the insurance world and powerful economic headwinds are combining to put severe operational pressures on the industry.

It is precisely in that spirit that we are launching AMAGAZINE. Aon will support its clients even more energetically and our advice will be even more aligned with the major economic challenges.

In this issue, we consider how world-class operational risk management including tools such as ERM, transaction liability and intelligent portfolio management, can drive measurable value and deals made in tough times. Some innovative investors are already using these and other tools to enhance returns and meet regulatory pressures or to obtain advantages working in growth areas such as CEE or renewable energy.

We recognise the vital role that private equity can play in pulling companies and entire economies in to the next upswing. At Aon, we stand ready to help in every way we can.

A handwritten signature in white ink on a dark red background, appearing to read 'Mark Roberts'.

**Mark Roberts**  
CEO Europe/Asia Pacific  
Aon Mergers & Acquisitions Group

# The renewable demand



## The rapid growth of renewable energy is a huge opportunity for private equity - but not without particular risks in this fast-changing sector.

Governments and individuals are increasingly anxious for a secure supply of cleaner and cheaper options to fossil fuels. With its capacity increasing, renewable energy is becoming more efficient and contributing more power. Wind power, for example, is showing an annual global growth rate of 25%.

While solar and wind farms may be the cornerstone investments in renewable energy portfolios, investments can range from contractors to component manufacturers, from geothermal and biomass to tidal and hydro projects.

Within such portfolios lie many distinct risks - from marine transit, construction, start-up delays, operating risks,

### Did you know?

*The leading wind turbine manufacturer in the world had a balance sheet provision of €232m for defect warranties in 2007.*

*Insurance is the largest single operating cost for offshore wind farms, accounting for over 50% of the total.*

*Supply chain constraints for wind turbines are dramatically increasing the potential for significant loss of revenue.*

mechanical breakdown, business interruption and loss of profits. There is also the question of who is best placed to manage these risks and who should be responsible for procuring insurance to cover them. Is it the contractor, technology suppliers, operator, developer or owner?

The market may be growing fast but the technologies are still new and evolving. One key area is design risk: if one wind turbine goes down as a result of a design fault, there is a danger of a serial loss affecting all.

Insurance can be designed, where possible, to wrap the manufacturers' warranties and availability guarantees. So private equity owners of wind farms can insure themselves against damage to turbines that results from faulty parts, workmanship or design, and can also take out business interruption cover to protect them from any subsequent loss of revenue.

The length and extent of the warranty cover offered by suppliers is crucial: private equity firms have to be comfortable with the risk for a portfolio company once the warranty cover has expired. In other cases, the warranties may be set to expire when a private equity investor wants to sell the asset, causing issues during asset valuation negotiations for potential purchasers.

"We have to understand what the manufacturer is offering," says Tom Sexton, of Aon's renewable energy practice, a team that manages all facets of risk throughout the life-cycle of renewable energy assets, "and to ensure that there is no gap between the warranty cover and the insurance cover."

Despite these varied challenges, Sexton says that private equity companies "want economies of scale rather than having to manage insurance on individual projects. Ease of administration, breadth of cover and certainty of insurance costs are important to them. That means procuring the widest cover at the cheapest price across the portfolio, at a time when there is considerable speed of change in the technologies. The skill is to identify insurance markets willing to cover this - and there is growing specialist and dedicated knowledge in this field."

"With our deep understanding of the market, we are well placed to identify new, often prototypical risks and bring them to insurers, ensuring our clients get the most comprehensive and innovative cover" concludes Sexton.

To find out how Aon can help you with renewable energy risk, email Tom Sexton [tom.sexton@aon.co.uk](mailto:tom.sexton@aon.co.uk)

# The central attraction

Private equity is investing billions in Central and Eastern Europe.

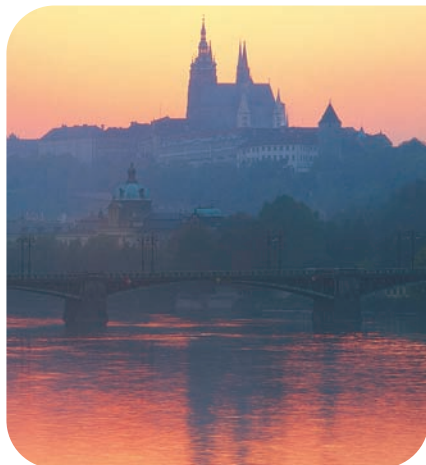
But can investors safely mitigate the inherent risks and make Western European-style returns?

Across the region, GDP growth has been consistently strong; a burgeoning middle class has wielded greater spending power; EU investment has poured in to transport and infrastructure renewal; and a new generation of sizeable, indigenous enterprises has emerged. Investors such as Advent International and Mid Europa Partners are keen to invest more.

But the current cold economic winds and the changing nature of available assets create inherent risks that need to be priced and mitigated.

“What this next period will bring home is that it is not possible to look at CEE as a single entity,” says Chris Mruck, who heads up Advent International in the region. “Each country has its own economic drivers and is at a different point in the development curve.”

“Deal activity has slowed, vendor’s price expectations are still high and deals are cratering because of this,” says Aon’s Marc Bennett-Coles.



“We are in the phase where buyers are re-evaluating their willingness to pay high prices and sellers are hoping they might again get high valuations in six months’ time,” comments Mruck.

Due to the relative nascence of deal flow in the region, many deals tend to be conditional. “Buyers are looking for warranties and indemnities from vendors but they are either unable to or reluctant to provide them,” says Aon’s Marc Bennett-Coles, “so W&I insurance really does have a part to play in helping deals complete and/or put the bidder in a better position at auction stage.”

Aon has also been developing solutions for issues such as the CEE’s heritage of environmental damage (see ‘Indigenous hazards’ box).

In addition, local attitudes to buying insurance protection are low compared to Western standards. For example, the levels of business interruption and liability cover are often limited.

But the managerial culture is improving. “The criteria for EU entry drove the adoption of improved governance, and private equity played its role,” says Mruck. “There are really talented management teams - just far fewer of them - and identifying them is not always easy.”

Aon has 47 offices throughout the CEE region.

For help with your next deal contact: [marc.bennett-coles@aon.co.uk](mailto:marc.bennett-coles@aon.co.uk)

## Indigenous hazards

*With privatisation gathering pace, two distinct environmental liabilities need creative solutions:*

**1. All liabilities, as a general rule, are transferred with the assets and, ideally, away from the state.**

*In practice (and subject to country-specific rules and regulations), the “ownership” of future liability for past actions, events and pollution will be allocated through contract between the parties. Significance: the full environmental legacy and knowledge of previous practices at the time of privatisation cannot always be fully known.*

**2. EU environmental laws are being implemented into national laws.** This can create new material liabilities for these historic conditions. Actions that were not contemplated at the time of a transaction may have to be taken in the future. The redevelopment of assets may be hit by significantly higher remediation costs. In many CEE countries there are significant environmental regulations that have not yet been fully enforced through the relevant agencies.

# The new payoff

## Can you reduce your insurance cost base whilst being better equipped to manage operational and financial risk? Yes - says Aon.

There are very few businesses not looking at ways to improve their operational efficiency across the board. A growing number of private equity houses are adopting a portfolio management approach for insurance. This pioneering co-operative programme is not only delivering cost savings but also transforming the way that private equity houses see, plan and react to operational risks during their holding periods. "It's enabling private equity to take a holistic view of their portfolio," says Aon's Walter Craft.

According to Lewis Claxton, head of procurement and property at 3i, which has introduced a portfolio programme

### 7 easy steps to portfolio management

- 1 Aon assessment of portfolio and potential benefits
- 2 Formal report to GP including timeline
- 3 Assessment of each portfolio company with individual CFO/COOs
- 4 Summary GP report (macro and specific portfolio company risks)
- 5 GP commitment to proceed
- 6 Report back to each portfolio company with bespoke (leveraged) insurance solution and saving
- 7 Implementation (conversion) and roll out

with Aon, "the take-up and the response among investee companies has been very positive. Companies are consistently saving 20-30% on insurance costs. Of course, all FDs want to save money but with this programme, they are also being helped to assess and mitigate risk. It's a really constructive way in which 3i can add value to our portfolio."

Buy-in was gained from the portfolio FDs, he believes, because the programme was positioned as non-obligatory. "We identified a number of companies in the portfolio with substantial insurance requirements but we wanted the programme to be attractive on its own terms. So we made the introductions and let the parties get on with it."

Craft explains "We have a model which allows us to identify which GPs would benefit most by this initiative. We're looking for baskets of 5-50 portfolio companies with some commonality in terms of region and sector. We then do all the hard work for the GP and their portfolio companies."

Using state of the art global risk data unique to the sector/geography of the portfolio company, the focus is on creating a bespoke, optimised insurance programme with 'best in class' cover and reduced premiums (through bundling).



3i uses Aon RiskConsole™, a web-based risk management information system that uses claims, exposure, policy and other risk-related information to provide them with a consolidated dashboard view of their portfolio companies' risk.

"Our dedicated European team has been on the forefront of devising portfolio management strategies across the region putting us into the leading position", says Craft.

Aon has reviewed and advised on portfolio programmes for 45 private equity investors globally. This represents over 1,000 investee companies, combined turnover of over €50bn and insurance premiums of over €100m.

The sector risks reviewed include major operational risks, biggest threats to company value, top claims criteria and practical insights as to how to avoid the pitfalls, threats to reputation, business interruption, supply chain issues, legislative and regulation threat for all portfolio companies who opt in.

For more information, email:

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# The single voice

This year's chairman of EVCA, 3i's global head of buyouts Jonathan Russell talks to **AMAGAZINE** about heading the industry's response to its political critics.

Take intense media scrutiny, mix with union and party political pressure, add in the credit crunch - and stir. That's a powerful recipe of problems for the private equity industry. So it's vital, says Jonathan Russell, that the industry speaks with a single voice.

"We have to be consistent," he says. "Private equity is capable of creating and building world-class businesses that generate employment and wealth. It is a force for good."

"But the outside world is sceptical. Negative stories grab the headlines. Local politicians and MEPs are influenced by those stories. We have to make up for lost time."



One major initiative is the formation of a special "Brussels task force," which Russell chairs, which has the specific role of proposing how the industry should react to the European Parliament's resolutions regarding private equity.

"The task force is vital," says Russell. "It's our best way of talking to Brussels with a single voice. There's a lot of energy and willingness behind it."

The stakes are high. Russell wrote recently to EVCA members about the European Parliament's two resolutions lobbying the European Commission to review the regulation of private equity. He wrote:

*The Commission does not intend to impose regulation as a result of these two reports, but events in the wider financial marketplace have increased the political will to regulate. There is a real danger that private equity may get swept up in the general hardening of sentiment towards oversight of the financial services industry.*

Russell is clear that he is not anti-regulation. "Legislation need not be unwelcome," he says. "It's when it has unintended consequences or tackles areas that don't need fixing that problems arise, potentially harming efficiency and competitiveness. The EC needs to maintain the constructive approach that it has been taking so far."

In the midst of this 'politicking', the industry also has a credit crunch to address. What does Russell believe will be the long-term outcomes of the financial crisis for private equity?

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*We have to be consistent. Private equity is capable of creating and building world-class businesses that generate employment and wealth. It is a force for good.*

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"Where do you start?" he asks. "I think that it will provide LPs with a better gauge of the quality of GPs. In recent years, everyone has looked pretty good."

"It will accelerate the need for investment in the capabilities of GPs. Making money in a tougher, more globally competitive environment means that GPs can't just rely on a few bright guys in a room; they must have access to deep resources and skills."

# Responding to AIG

The sudden and dramatic events of September and October continue to reverberate throughout the insurance industry. Investors, directors and managers around the world have scrambled to understand their exposures, particularly in relation to the fluid financial situation at AIG and other carriers.

A leadership role was needed - and was taken by Aon. Its response had to be immediate and fact-based.

In the first phase, a global team was assembled. This team established broking "war rooms" in Chicago, London, Rotterdam and Hong Kong to develop strategic solutions and monitor the changing situation.

An Aon Situation Room web site was created, aggregating rating agency data, financial news and market security updates to provide clients and Aon staff with around-the-clock, highly

If you would like further guidance on any aspect of risk management throughout the fund cycle, you can talk to an M&A specialist at one of the following numbers.

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pertinent information. To date, the site has had more than 115,000 page views and nearly 40,000 unique visitors.

Multiple conference calls have been conducted with clients, AIG leaders and US Federal Government officials. Thousands of questions have been answered.

The second phase of the response is now in full swing, developing new global insurance solutions and addressing issues such as carrier insolvency protection.

"I believe that our strong and capable response demonstrates that we are much more than an insurance broker. We are a trusted partner that can provide critical guidance and support for businesses to navigate their way through these tough times," says Mark Roberts, CEO Europe/Asia Pacific at Aon Mergers & Acquisitions Group.

For more, go to the situation room at [www.aon.com](http://www.aon.com)



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