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AUTUMN 2018 EDITION

Introduction

In our Autumn 2018 edition of the Herbert Smith Freehills European Private Equity Review we highlight legal developments with particular significance for European financial sponsors and share our experience of trends across the European private equity landscape and opportunities for potential growth.

In the following articles we highlight the latest market trends, with a particular focus on the pitfalls that might confront private equity sponsors, such as growing protectionism among Western governments, structuring issues when dealing in niche sectors, and the continuing challenges and opportunities of doing business in India.

With public interest scrutiny in the M&A process increasing globally, in our first article Veronica Roberts, Nico Abel and Joe Falcone examine the key trends in government intervention in Europe and the USA and the impact that this is likely to have on private equity deals.

Our second article, by Roddy Martin and Siddhartha Shukla, provides an overview of the private equity market in India and recent developments including the major deals, key market trends, recent regulatory changes and the common pitfalls that investors should seek to avoid. They also provide their own predictions of how the private equity market will develop in India over the year to come.

In our third article, Christoph Nawroth and Christian Johnen outline the opportunities currently offered by the German insurance run-off market and discuss the key structures and issues which require consideration on a typical German insurance M&A transaction.

The final article, by David Lacaze and Claire Le Louam, traces how the private equity real estate market (**"PERE"**) has developed in France in recent years and outline common structures used in PERE deals.

Although many questions about how Brexit will take shape still remain, some clarity has been brought to the issue of how the UK proposes to leave the EU in recent months. With the benefit of this improving visibility, the sixth edition of our legal guide, looking at the implications of Brexit in light of recent actions by the UK Government, Parliament and the courts, can be found on our website at https://www.herbertsmithfreehills.com/latest-thinking/brexit-sector-and-legal-perspectives

BREXIT

LEAVING THE EU

LEGAL GUIDE

AUGUST 2018

Political intervention in M&A: overview and implications for private equity

Public interest scrutiny in the M&A process is on the increase globally, against the backdrop of protectionist rhetoric and concerns about the impact of foreign direct investment (**"FDI"**) in traditionally open economies. From enhanced review by the Committee on Foreign Investment in the United States (**"CFIUS"**) culminating in President Trump blocking China-backed Canyon Bridge's bid for Lattice Semiconductor and Broadcom's bid for Qualcomm, and the 2018 collapse of Ant Financial's acquisition of MoneyGram, to the recent expansion of the German FDI regime and the current proposals to overhaul national security review at the UK and EU level, the regulatory climate can present additional hurdles and uncertainties for private equity investors.

From top

Veronica Roberts
Nico Abel
Joe Falcone

Although political interventions have traditionally tended to focus on national security, defence, critical infrastructure, access to sensitive information and employment, the scope of many FDI regimes is being extended to cover high tech industries and critical technologies. For example France has recently indicated that it will broaden the sectors covered by its regime to cover data and artificial intelligence (**"AI"**). There has been some frustration that there is no level playing field when it comes to FDI restrictions: EU countries collectively have tended to have the fewest restrictions on FDI, whereas countries in Asia have tended to have stricter regimes. But the tide seems to be turning: Asian countries, and in particular China and India, have progressively opened parts of their economies to FDI and have streamlined their screening processes. At the same time, we are seeing a reverse trend in the EU, including in some of the individual EU Member States and more active enforcement in the US and Australia.

The key impact of all this on private equity investors is that the requirement for FDI approvals will need to be considered alongside any merger control filings, although the FDI regimes are more unpredictable, as governments tend to have much broader discretionary powers. This may have implications for the timing of a deal, as many regimes are suspensory, and could even jeopardise the deal itself if the assets involved are particularly sensitive.

We expect that the main impact for private equity investors will be seen on the sell side, where FDI issues could affect the potential buyer spectrum, deal certainty and the timeline to closing. FDI issues will also be relevant on the buy side for those private equity investors based in countries that tend to give rise to concerns under FDI regimes. A key concern on both sides is the lack of transparency in decision-making: many FDI authorities, including CFIUS, do not publish their approval or prohibition decisions, which can make it more challenging to predict whether certain investors and/or sectors will raise concerns.

Recent proposals for a new EU-wide regime

After much debate and disagreement between Member States, draft legislation in relation to FDI screening on public security grounds has now been tabled by the European Commission and is currently being considered by the EU institutions and Member States (see box: The draft EU FDI Regulation).

The draft does not propose a power for the European Commission itself to screen and block foreign investments (which would have been very difficult politically), nor does it mandate EU Member States to introduce FDI controls. Instead, it proposes a set of minimum requirements for such controls as Member States choose to put in place – for example as to transparency, timing and

The draft EU FDI Regulation

The draft EU FDI Regulation does not require Member States to adopt or maintain a screening mechanism, but proposes the following minimum requirements:

Screening factors

When screening FDI on grounds of security or public order, Member States may consider the potential effects on:

- Critical infrastructure, including energy, transport, communications, data storage, space and financial infrastructure, as well as sensitive facilities;
- Critical technologies, including AI, robotics, semiconductors, technologies with potential dual use applications, cybersecurity, space and nuclear technology;
- Security of supply and critical inputs; and
- Access to sensitive information and the ability to control sensitive information.

General requirements for screening mechanisms

- Any screening mechanisms in place will have to be transparent, setting out the timeframes, grounds of and circumstances triggering the screening;
- There must be no discrimination between different nationalities of investors' countries and judicial redress must be available; and
- Member States will also have to report to the Commission annually on FDI, whether or not they have adopted screening mechanisms.

Commission screening powers

- The Commission itself will be able to screen FDI that is likely to affect EU projects and programmes on grounds of security and public order. In these cases, the Commission can issue an opinion to the Member States where the investment is planned or completed and the Member States concerned must take utmost account of the Commission's opinion and provide an explanation to the Commission in cases where its opinion is not followed.

judicial review. It also proposes coordination and cooperation mechanisms between Member States and the Commission, including a power for the Commission to review investments in projects of EU interest and issue an opinion to the reviewing Member States which, while not binding per se, seems very likely to be followed.

These proposals were introduced against a backdrop of pressure from France and Germany to take action in this area, at least partly as a result of:

- the GE/Alstom deal in France in 2014 and the subsequent overhaul of the French FDI review regime, significantly broadening the sectors for which pre-approval from the French Ministry of Economy is required; and
- Germany revising its own FDI regime more recently, as outlined later in this article.

Although Spain has not changed its regime recently, the Spanish government has also been increasingly prepared to flex its muscles within the constraints of the existing regime. This is exemplified by its approach to two rival bids for control of Spanish infrastructure group Abertis. Atlantia, an Italian group, and the German subsidiary of the Spanish construction conglomerate ACS both submitted bids. Although the Atlantia proposition included commitments to Spanish employment and investment, Madrid nevertheless raised concerns about Italian ownership of what it says is a strategic asset. The German subsidiary of ACS was not subject to the same level of political scrutiny and ACS and Atlantia went on to submit a joint bid, which was welcomed by the Spanish government.

The proposed EU FDI framework provides for intervention on the grounds of security and public order rather than to protect wider strategic interests. However, Member States may consider the effects of the deal on a range of sectors, both in relation to critical infrastructure (such as energy, transport, communications, data storage and financial infrastructure) and critical technologies (such as AI, robotics, semiconductors, cybersecurity and nuclear). The inclusion of critical technologies is seen by many commentators as a reaction to mainly Chinese attempts to buy up key European IP assets (such as the 2016 takeover of KUKA by Midea).

It remains to be seen whether, and in what form, the legislation will be adopted, in particular given potential opposition from Member States, such as Greece and Portugal, who see FDI as key to their economies.

The new German foreign investment restrictions

Germany has meanwhile revised its own FDI regime (the Außenwirtschaftsverordnung, "**AWV**") as of July 2017.

The regime, which was introduced in 2009, allows the German government to block the acquisition of 25% or more of the voting rights of a target business if (a) the investor is located outside the European Union or the European Free Trade Association (Iceland, Liechtenstein, Norway and Switzerland) and (b) the acquisition poses an "actual and sufficiently serious threat to a fundamental interest of society" such that it "endangers public order or security". The one exception to this was investments in the military sector, where restrictions may also be imposed to safeguard national security interests.

> We expect that the main impact for private equity investors will be seen on the sell side, where FDI issues could affect the potential buyer spectrum, deal certainty and the timeline to closing.

The 2017 reforms do not expand the basic grounds on which FDI may be restricted. They (a) set out a non-exhaustive list of businesses where the government considers an acquisition could pose a particular threat to public order or security;

and (b) provide that the signing of a purchase agreement for the acquisition of such businesses must be notified to the Federal Ministry for Economic Affairs (**"BMWi"**).

Since it was previously difficult to assess if a particular acquisition could be subject to intervention – both as a result of the generic nature of the term "public order and security" and the lack of precedents – the list of example businesses is helpful, in that it provides some degree of clarification as to what kind of businesses the government views as potentially critical. On the other hand, the list is a lot wider than many would have expected. It covers operators of "critical infrastructures", developers of software used by such critical infrastructures and providers of cloud computing services, if the infrastructures used for these services exceed certain thresholds. "Critical infrastructures" are defined in detail by reference to certain thresholds and particular sectors, including energy, water, food, information technology, telecommunication, health, financial services, as well as transport and traffic. For example, "critical infrastructures" include power generation plants with a net performance of 420 MW or more, networks of gas stations distributing 420,000 tons or more of fuel per year, hospitals with 30,000 or more in-patient cases per year, or food retailers or wholesalers with 434,500 tons or more of food sold.

In light of this relatively broad range of businesses, we expect that a considerable number of acquisitions will in future need to be notified to the German government. There will also be acquisitions where the parties will have an interest in notifying voluntarily, either because they are uncertain about the duty to notify or they would like comfort that the government will not intervene in the transaction, even in the absence of a duty to notify.

This will affect M&A processes and their timing. The BMWi has three months from obtaining knowledge of a signed transaction to decide whether it wishes to examine a transaction and, if so, it has a further four months from having obtained complete documentation on the acquisition to impose restrictions. Slightly different deadlines apply if a buyer chooses to voluntarily notify a transaction and apply for a clearance certificate (which may, within appropriate limits, be carried out before signing). Upon such application, the BMWi has two months to decide whether a closer examination is required, failing which clearance is deemed to be granted. However, if a buyer fails to notify a transaction and the BMWi does not otherwise obtain knowledge of it, the BMWi can intervene up to 5 years after the signing of the deal. While these timelines appear manageable, sellers and buyers are well advised to conduct an early review of the need to make a notification, consider the option to file voluntarily and align timelines with other mandatory filings (such as merger clearance filings) and the overall process.

What is more difficult to assess is to what extent the recent amendments to the AWV will lead to an increase of substantive restrictions imposed on M&A transactions.

We expect that a considerable number of acquisitions will in future need to be notified to the German government. There will also be acquisitions where the parties will have an interest in notifying voluntarily, either because they are uncertain about the duty to notify or they would like comfort that the government will not intervene in the transaction, even in the absence of a duty to notify.

While the amendments do evidence an enhanced desire to monitor FDI and its effects on critical business areas, the basic grounds on which the government may

intervene have not changed. In particular, the amendments did not introduce any powers to restrict FDI into critical technologies (such as AI, robotics, semiconductors or cybersecurity, except where expressly listed as a military application) or for reasons of industrial policies or lack of reciprocity. Recent developments show, however, that the changes are very likely to go hand in hand with a broader interpretation of "public order and security" and of what may pose a threat to it. In August 2018, the German government for the first time voted to prohibit a transaction under the German FDI regime. Chinese investor Yantai Taihai Corp. intended to acquire the shares in Leifeld Metal Spinning AG, a manufacturer of high-strength materials for the aerospace industry that are also usable in the nuclear sector and had applied for a clearance certificate with the BMWi. Following a vote by the German government authorising the BMWi to veto the transaction, the investor withdrew from the transaction. Another example is the events surrounding the acquisition of a 20% stake in the transmission systems operator 50Hertz. State Grid Corporation of China had expressed the intention to acquire such stake, but failed after the majority shareholder of 50Hertz exercised its pre-emption right following which the German government owned development bank KfW took over the stake. This marks a particular shift in paradigm, in that such actions occurred outside the scope of the German FDI regime which requires the acquisition of 25% or more of the voting rights of a target business.

It does therefore not come as a surprise that it is currently considered to lower the relevant threshold to extend the scope of the German FDI regime.

Where critical assets are concerned that obviously fall within the categories triggering a filing obligation, private equity sellers should consider carefully and early in the process whether the potential spectrum of buyers includes candidates that could attract political or public attention and therefore be in the spotlight for closer scrutiny.

A more interventionist approach from the UK?

The UK government currently has powers to intervene on national security grounds only in those mergers that meet the jurisdictional thresholds of the UK (or EU) merger control regime (subject to limited exceptions).

In October last year the government published a Green Paper for consultation, proposing to extend its powers of national security review (initially announced following the investment by the China General Nuclear Power Group in the Hinkley Point C new nuclear project).

In June 2018, the government reduced the jurisdictional thresholds for certain transactions in specified sectors: military, quantum technology and computer hardware. There has been one governmental intervention under these rules so far: the acquisition by Gardner Aerospace of Northern Aerospace from Better Capital. Both parties manufacture and supply parts used in the manufacture of aircraft. Herbert Smith Freehills acted for Gardner Aerospace (which is ultimately controlled by a Chinese listed entity) in obtaining clearance for the deal in July 2018.

Also in July 2018, the government published a White Paper setting out its proposals for a more significant overhaul, enabling the government to call in transactions that may give rise to national security risks on an economy-wide basis, although it has indicated that sectors most likely to give rise to national security concerns will include national infrastructure, advanced technologies, direct suppliers to government/emergency services and dual use technologies.

CFIUS proceedings

Covered transactions

While CFIUS regulations leave the term "national security" largely undefined, a foreign investment will likely have US national security implications where, for example, the US business to be acquired:

i) maintains classified or sensitive information;

ii) deals in technology or information subject to export controls or else is part of critical technologies or infrastructure (eg major energy assets, communications or information technology services, telecommunications, transportation, mining, manufacturing, chemicals, ports, food and agriculture);

iii) has contracts (particularly sole source contracts) with US federal or state agencies;

iv) owns real estate near sensitive US government facilities; or

v) otherwise operates in an area of clear interest to CFIUS.

Timing

Generally, CFIUS review arises once the parties to a transaction jointly file a voluntary notice with the Committee. Filing a voluntary notice triggers a 45 day review period, at the end of which many reviews are concluded. At this point, CFIUS can either clear the transaction outright or initiate a subsequent investigation which is to be completed within an additional 45 days.

Mitigation

If a transaction still presents national security concerns after this subsequent investigation, CFIUS may enter into an agreement with the parties that requires them to adopt "mitigation" measures to alleviate these concerns (including, for example, deal restructuring that limits non-US control over critical technologies).

Blocking

Finally, if the security risks cannot be resolved through an agreement with the parties, CFIUS will refer the case to the President and recommend that the transaction be blocked or unwound. Presidential action is usually rare, however, as most parties will elect to withdraw from a transaction that does not receive clearance from CFIUS.

The proposed national security review will be a distinct regime with no turnover/market share requirements, so it has the potential to capture smaller transactions. The regime would be triggered by share acquisitions of 25% or more, or the acquisition of significant influence over an entity or asset and the government has published draft UK guidance to explain the circumstances in which these criteria would be met. The government is proposing a voluntary notification system, reserving the right to intervene where parties choose not to notify, with a six month call-in period post-completion. It expects that it will receive on average 200 notifications per year: of these, it expects 100 notifications will qualify for further investigation and 50 may raise national security issues requiring remedies to address concerns.

In the longer term, a more significant overhaul is proposed, potentially involving the mandatory notification of transactions (including those outside the scope of the merger control regime, including acquisitions of bare assets and data) involving "essential functions" in respect of key critical infrastructure. This would cover at least certain aspects of the civil nuclear, telecommunications, defence, energy (including production and generation) and transport sectors.

Whilst the government has stressed that the UK remains open for investment (particularly important post-Brexit) and emphasises in the White Paper the narrow national security grounds for review, there are questions about the possibility of such a regime deterring FDI and distorting bidding processes. This includes the question of whether, in practice, the national security test will allow other public interests to be introduced by the backdoor (in particular in light of the previous comments made by Prime Minister Theresa May about the need for a "proper industrial strategy" to protect such strategic interests, citing the proposed acquisition by Pfizer of AstraZeneca). The UK government is currently consulting on these proposals and we expect it to introduce a new regime from early next year.

CFIUS intervention is on the rise

In the United States, CFIUS—an inter-agency US government body comprised of various US departments and agencies charged with national security, foreign policy and economic responsibilities, including the Departments of Defense, Homeland Security, State, Energy and Commerce, among others—is tasked with reviewing acquisitions, known in CFIUS parlance as "covered transactions", that could result in control of a US business by a non-US person, to determine whether

the acquisition presents a threat to US national security.

In particular, CFIUS pays close attention to deals in which non-US persons would acquire US businesses with significant technology portfolios, including semiconductors and other technologies that may have military applications in addition to civilian/commercial ones. Recent cybersecurity threats and intrusions, by private as well as alleged state actors, have only heightened CFIUS review in the IT and cloud-related arenas.

CFIUS also gives greater scrutiny to "foreign government-controlled transactions" that could give control of a US business to a non-US government or someone acting on its behalf and regulations generally require an investigation where the transaction would transfer control to a foreign government. This includes transactions involving non-US entities controlled by a non-US government, even if such entities operate on a commercial basis, as well as non-US entities that are only indirectly controlled by a non-US government through a person controlled by or acting on behalf of such government.

Recent trends in the US

Recent years have seen an increased level of direct investment into the US from China (though reports indicate that escalating trade tensions between the two nations may have slowed investment flows from China in the US over the past few months). From 2013 through 2015 (the most recent year for which statistics are publicly available), Chinese-based acquirers were the most active foreign investors in terms of CFIUS covered transactions, accounting for a total of 74 deals, or nearly 20% of the acquisitions submitted for CFIUS review (for comparison, Canada was next with 49, with the United Kingdom following with 47 submissions) (see Committee on Foreign Investment in the United States, Annual Report to Congress CY 2015, September 2017, at Table I–8).

This increased investment activity has been met with increased concern by some in the US government, who view Chinese-based investment, especially into US technology sectors, as potentially leading to US security and economic vulnerabilities.

Underlying these concerns is the perception by some US officials that: (i) Chinese entities will use the transfer of US intellectual property and leading-edge technologies to shortcut the development of China's own expanding tech industry; (ii) this investment reflects a coordinated Chinese government strategy to promote its political and military aims, not just commercial goals; and (iii) that even ostensibly private investment emanating from China invariably supports this government-sponsored campaign. Thus, although investment by private Chinese investors has surpassed investment by state-owned entities, CFIUS may still give heightened scrutiny to deals involving private Chinese investors based on a lingering perception that such investors are subject to significant state influence.

Given these perceptions, it is perhaps not surprising that various transactions, including several fairly recent high-profile deals, have been abandoned due to the deal parties' inability to secure CFIUS approval. Some examples include, as noted, a proposed acquisition by Ant Financial, a subsidiary of China's Alibaba Group Holding, of Texas-based MoneyGram International, which was terminated by the parties after CFIUS approval was withheld, and the abandonment of a proposed disposal of Global Communications Semiconductors, LLC, a California entity, to San'an Optoelectronics Co., Ltd., a Chinese semiconductor company. And, while formal Presidential action on CFIUS matters is rare, occurring only five times since CFIUS was created in 1975 (four times involving a Chinese acquirer), last year President Trump blocked the acquisition of the US semiconductor firm Lattice Semiconductor Corporation by Canyon Bridge Capital Partners, a private equity firm apparently owned by Chinese state-owned entities. According to a statement released by US Treasury Secretary (and chair of CFIUS) Steven Mnuchin, the "national security risk posed by the [Lattice Semiconductor] transaction relates to, among other things, the potential transfer of intellectual property to the foreign acquirer, the Chinese government's role in supporting this transaction, the importance of semiconductor supply chain integrity to the U.S. government, and the use of Lattice products by the U.S. government" (see Statement On The President's Decision Regarding Lattice Semiconductor Corporation, 13 September 2017).

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More recently, the Trump Administration prohibited Broadcom's contemplated acquisition of US-based telecom leader Qualcomm, finding "[u]pon review of a recommendation from [CFIUS]" that Broadcom "might take action that threatens to impair the national security of the United States" were it to gain control of Qualcomm (see Presidential Order Regarding the Proposed Takeover of Qualcomm Incorporated by Broadcom Limited, 12 March 2018). As part of its national security analysis, CFIUS examined the potential that Broadcom's takeover of Qualcomm would weaken the latter's technological competitiveness and its standing as "the current leading company in 5G technology", and in a 5 March 2018 letter to the deal parties (subsequently included in a public filing by Qualcomm), CFIUS noted its concern that the deal could bring about "a shift to Chinese dominance" in 5G technology, with resulting "substantial negative national security consequences for the United States." While Broadcom's well-publicised pledge to redomicile in the United States would have removed it from CFIUS jurisdiction, CFIUS reviewed the matter on the facts then before it, with Broadcom incorporated in Singapore. Of particular concern to CFIUS was the "'private-equity'-style direction" that Broadcom's statements indicated it would take were it to acquire Qualcomm, a direction that in CFIUS' view emphasises cost cutting, high debt levels, and short-term profits at the expense of R&D and long-term investment in 5G technology, which investment CFIUS deems critical to US security. While the CFIUS/Presidential action regarding the Qualcomm acquisition is notable in several respects, including the fact that the President intervened to block what was a hostile bid by Broadcom rather than an actual acquisition, it also serves to demonstrate how an acquirer's post-closing plans for the US target business can feature into the CFIUS national security assessment.

CFIUS also focuses on transactions that do not directly involve US deal parties, to the extent the target company has affiliates or assets in the US, especially where such transactions include the sale of US subsidiaries with significant technology portfolios. The abandonment, in 2016, by Royal Philips NV of its plan to sell one of its business units, Lumileds, to Chinese investor Go Scale Capital, highlights the wide application of CFIUS authority to the acquisition of non-US-based businesses. In that instance, the deal parties apparently could not overcome CFIUS concerns that the deal would give Go Scale a stake in Lumileds'

US operations, which included various US technology patents and its California-based product development and LED manufacturing facilities. Though CFIUS decisions, and indeed the overall CFIUS review process, are not made public, the deal may have foundered on the fact that certain semiconductor technology used in LED production also can have military applications.

All this does not mean, however, that acquisitions falling under CFIUS jurisdiction, including those involving Chinese-based investors, cannot secure the necessary approval.

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As noted, the number of deals from China that are submitted to CFIUS now outstrip those from any other jurisdiction and the majority of those receive clearance. Indeed, Chinese investors have secured approval of high-profile acquisitions, most notably Shuanghui International Holdings' 2013 acquisition of Smithfield Foods Inc., which was cleared despite significant public and Congressional interest around issues of food security and related critical infrastructure concerns and, in January 2018, CFIUS cleared the takeover of Akrion Systems LLC, a Pennsylvania-based company that makes cleaning equipment for semiconductors (but not the chips themselves), by NAURA Microelectronics Equipment Co., Ltd. Thus, while CFIUS will continue to examine transactions closely, Chinese investors and others can still hope to secure approval of their US investments, depending on the type, nature and scope of the proposed deal.

Recent reforms widen scope of CFIUS jurisdiction and authority

Enactment of the Foreign Investment Risk Review Modernization Act ("FIRRMA") on 13 August 2018, following bi-partisan concerns over Chinese investment in key US technology companies, significantly expands the jurisdiction and powers accorded to CFIUS. Among other reforms, FIRRMA broadens the definition of a "covered transaction" to include (i) non-controlling "other investments" in US companies holding critical technology and infrastructure or personal data of US citizens, which investments grant US investors (from countries, to be defined, that pose a particular national security concern), access to material non-public technical information of a US business, membership on the board of directors, or other decision-making rights (other than through voting of shares); and (ii) any change in a non-US investor's rights that result in control of a US business or of an "other investment" in certain US businesses.

FIRRMA also makes various changes to the CFIUS filing and review process, including the imposition of potentially significant filing fees (1% of the deal value, capped at US $300,000); the extension of the initial review period from 30 days to 45 days; an abbreviated filing process through a new declaration procedure that will allow deal parties to receive CFIUS feedback without engaging in a full notice and review process (which will most likely be useful for deals that are subject to CFIUS jurisdiction but do not appear especially sensitive); and a mandatory declaration process required where the non-US investor is state-owned and the acquisition would give a non-US government a "substantial interest" in US critical infrastructure or technology, or personal data. In addition, and as a clear response to concerns regarding Chinese investment, FIRRMA requires the US Department of Commerce to issue a report to the US Congress and CFIUS in 2020 (and every two years through to 2026) on foreign direct investment transactions into the US made by Chinese entities, which will analyse the extent to which "patterns" in Chinese investments align with the objectives outlined by the Chinese government in its "Made in China 2025" plan.

Certain investment fund transactions, however, are excluded from FIRRMA's wider net. FIRRMA provides that an indirect investment by a non-US person in a US business, via an investment fund that affords the non-US person membership as a limited partner or equivalent on an advisory board

or a committee of the fund, will not be considered an "other investment" for CFIUS purposes, provided that the fund is managed exclusively by a US general partner or managing member; the advisory board or committee does not have the ability to control investment decisions of the fund or decisions made by the general partner or managing member; the non-US person does not otherwise have the ability to control the fund; and the non-US person does not have access to material non-public technical information as a result of participation on the advisory board or committee.

Many details regarding the implementation of FIRRMA must await the issuance of new regulations by CFIUS, a potentially lengthy process. Moreover, in the wake of FIRRMA's enactment, CFIUS emphasised that the US continues to welcome foreign investment, including in the technology sector, and that CFIUS review will continue to focus exclusively on national security (as opposed to economic) issues. Notwithstanding that, FIRRMA has codified into US law the recent heightened CFIUS scrutiny of transactions by non-US deal parties, particularly in the technology, telecom and infrastructure sectors.

Impact on private equity

On the sell side, private equity investors must consider early in the transaction planning process whether FDI issues could arise for foreign bidders and whether these could threaten the deliverability of the deal.

In some cases (such as for transactions involving military or dual use products) this will be obvious. Identifying sensitivities in other cases will be more unpredictable. Sectors of potential interest will vary from jurisdiction to jurisdiction, but are likely to include key infrastructure and technologies.

The applicable substantive test and the degree of discretion left to the decision-maker in the relevant jurisdiction(s) will also be key – in particular, whether intervention is limited to national security grounds (which can still be interpreted widely), or whether other national interests can be taken into account (including the impact on the economy and employment).

Planning will help to mitigate potential issues. For example, potential buyers can be asked about their willingness to agree to commitments to remedy any FDI concerns and how far they would be prepared to go on this front. Previous commitments which have been made include putting restrictions in place on access to sensitive data and also granting the relevant authorities access to a sensitive site, if requested. Divestments may also be required in more difficult cases. FDI concerns could also impact transaction structure on the sell side, for example where successful mitigation may be achieved through the inclusion of domestic co-acquirers or a reduction in the level of control acquired, or where carve-out or hold separate arrangements may allow a transaction to be completed globally while FDI issues for a particular jurisdiction or business unit are assessed. Reverse break-fees reflecting regulatory risk may also be warranted.

Where potential FDI concerns do arise, a regulatory strategy will need to be formulated and coordinated across all relevant jurisdictions. In some countries, it will be possible to seek confidential guidance as to the likelihood of issues arising for certain foreign investors at an early stage. In others it will involve taking into account previous interventions and regulatory trends. It will be important to consider the position in all countries potentially affected by a transaction, as we have already seen examples of FDI authorities and governments liaising with each other behind the scenes (such as when the US successfully persuaded the German government to withdraw its earlier approval for the acquisition of chip equipment maker Aixtron by Fujian Grand Chip Investment Fund).

CFIUS is certainly the most interventionist regime at present and, despite the exclusions for certain investment fund transactions, should be an area of focus both for US transactions and also non-US transactions that have even a small US angle.

Other regimes should be considered carefully depending on the jurisdictional scope of the transaction (for example the FIRB regime in Australia and the Investment Canada regime): even if they do not give rise to any difficult issues in most cases, they may have an impact on process and timeline.

India private equity update: steady progress

Prime Minister Modi's government has made a number of structural changes to the legal and regulatory landscape since being elected in 2014, which has helped India increase its attractiveness as an investment environment for both domestic and foreign investors. In fact, in 2017 India moved up in the World Bank's Doing Business rankings from 130th position to 100th position. Corruption and bureaucracy, which have historically been considered to be the primary factors for India's low rankings, are the subject of serious focus and India is currently aiming to be in the top 50 nations to do business in. Market commentators anticipate that 2018-19 could be very strong years for the PE industry in India, provided that policymakers (and implementers) continue to build on recent progress and the general elections in 2019 do not result in a fractured verdict.

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Roddy Martin
Siddhartha Shukla

The state of the market

Private equity activity in 2017 remained steady, with management buyout deal values (US$9.6bn) recording the second highest annual total in the last five years. Exit deal values (US$5.1bn) fell from the previous highs of 2016 (US$6.3bn) and 2015 (US$8.1bn, a record year).

The first half of 2018 has been consistent with the overall activity last year. The year so far has seen investments worth US$15.2bn across over 350 deals. Strong growth continues to be driven by large deals, with the first half of 2018 recording 36 deals of value greater than US$100m, with particularly significant investments in infrastructure and real estate asset classes.

Recent highlights have been as follows:

Technology (including e-commerce)

46% of all PE investments in 2017 were in the technology sector, which grew by 140% to US$11.4bn. This was followed by the financial services sector, which increased by 56% to US$4.4bn and the healthcare sector, which grew by 10% to US$1.3bn. Sectorally, technology (including e-commerce) and financial services continue to constitute a large share of deal activity in 2018.

Exits

Whilst secondary and strategic sales increased in the last two years, IPO exits were less popular, primarily because of the onerous listing requirements applicable to certain PE owned companies which have recently changed (see below). The increase in exits is an important indication of confidence in the market, although the overall market share of exits in India within the Asia-Pacific region is still relatively low at 19.3% (as compared to China's 31%).

Increased venture capital investment

Although there has been a decrease in the number of investments in the market, 67% of all private equity and venture capital sector investments by value have been in venture capital, despite speculation that venture capital firms would face a difficult year for fundraising.

Recent developments

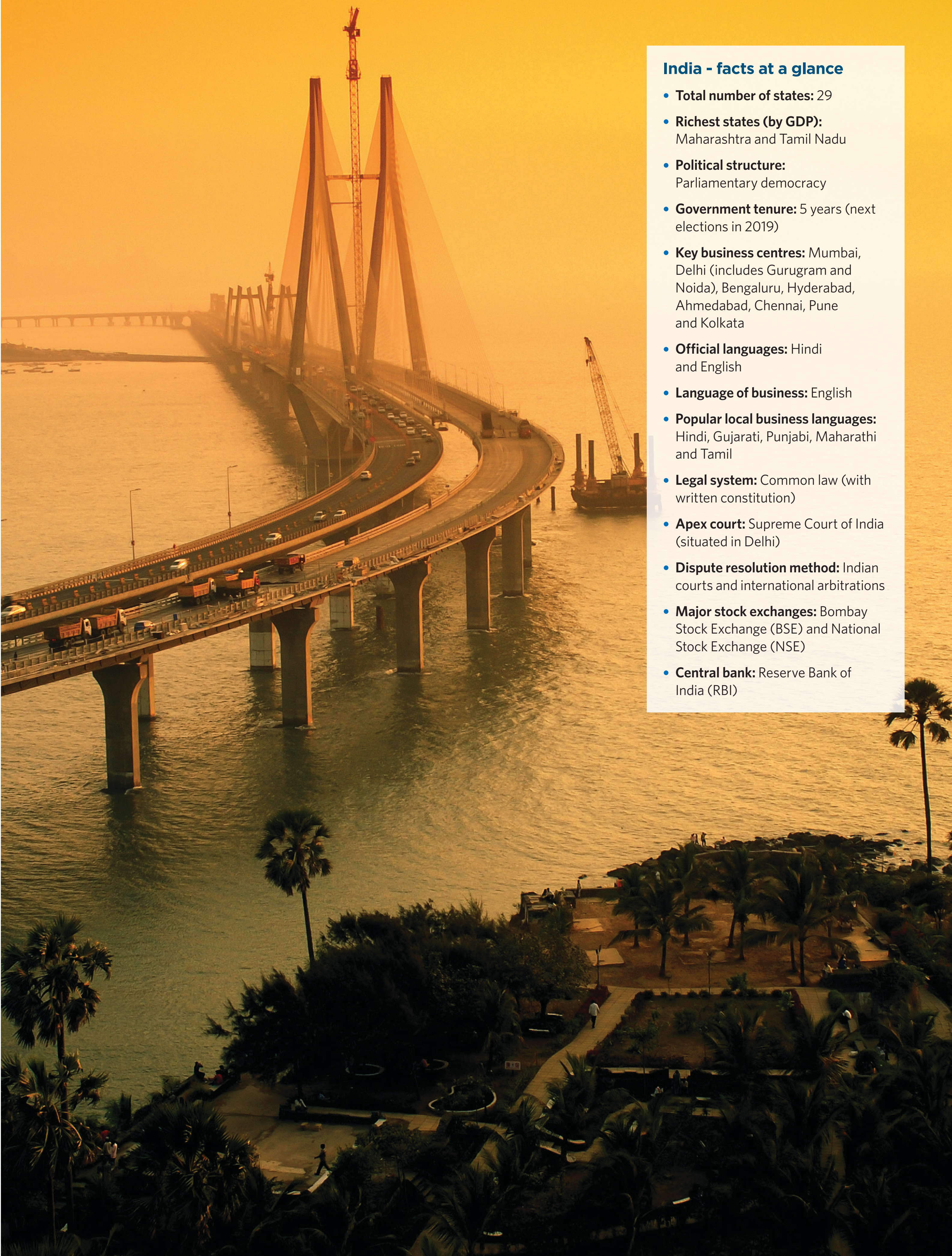
Regulatory reforms

The Indian securities regulator (**"SEBI"**) has recently eased restrictions for PE investors looking to use the IPO exit route. Previously, the entire pre-IPO shareholding of PE investors would have to be the subject of a lock up of at least one year after the listing. This had seriously impacted the ability to use an IPO as a means of exit.

India has also replaced its numerous federal and state tax laws with the much awaited single harmonised Goods and Services Tax ("**GST**"). Aimed at reducing administrative burdens and increase tax revenues, implementation of GST was not as smooth as had been hoped for, resulting in a temporary slowing of the economy. However, a responsive Modi government has taken corrective measures to ensure its effective implementation.

In addition to the ground breaking GST reforms, India undertook a significant relaxation of its FDI laws between January and July 2018 which included (i) abolition of the main regulatory body dealing with foreign investments ("**FIPB**"), (ii) introduction of a standard operating procedure for clarity in procedure and timing, (iii) introduction of easier reporting requirements with the consolidation of various forms into a single master form, and (iv) removing/increasing approval thresholds for various categories such as manufacturing, civil aviation and single brand retailing.

Under the new regime, FDI approval applications are being processed at a much faster pace and the list of sectors/ activities that require prior government approval continues to reduce as the government sustains its direction of travel towards de-regulation in order to promote

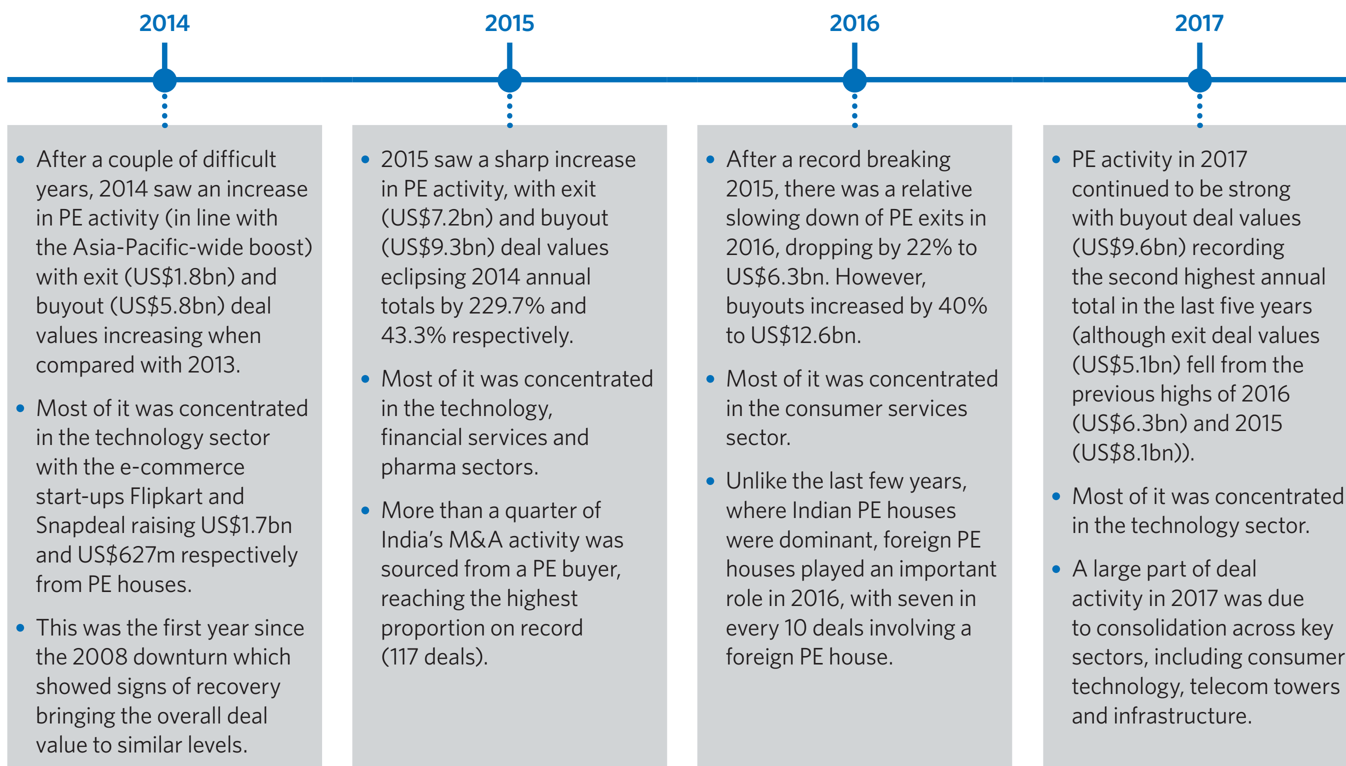


India - facts at a glance

- **Total number of states:** 29
- **Richest states (by GDP):** Maharashtra and Tamil Nadu
- **Political structure:** Parliamentary democracy
- **Government tenure:** 5 years (next elections in 2019)
- **Key business centres:** Mumbai, Delhi (includes Gurugram and Noida), Bengaluru, Hyderabad, Ahmedabad, Chennai, Pune and Kolkata
- **Official languages:** Hindi and English
- **Language of business:** English
- **Popular local business languages:** Hindi, Gujarati, Punjabi, Maharathi and Tamil
- **Legal system:** Common law (with written constitution)
- **Apex court:** Supreme Court of India (situated in Delhi)
- **Dispute resolution method:** Indian courts and international arbitrations
- **Major stock exchanges:** Bombay Stock Exchange (BSE) and National Stock Exchange (NSE)
- **Central bank:** Reserve Bank of India (RBI)

PE activity in India

Snapshot of the last four years



2014

- After a couple of difficult years, 2014 saw an increase in PE activity (in line with the Asia-Pacific-wide boost) with exit (US$1.8bn) and buyout (US$5.8bn) deal values increasing when compared with 2013.
- Most of it was concentrated in the technology sector with the e-commerce start-ups Flipkart and Snapdeal raising US$1.7bn and US$627m respectively from PE houses.
- This was the first year since the 2008 downturn which showed signs of recovery bringing the overall deal value to similar levels.

2015

- 2015 saw a sharp increase in PE activity, with exit (US$7.2bn) and buyout (US$9.3bn) deal values eclipsing 2014 annual totals by 229.7% and 43.3% respectively.
- Most of it was concentrated in the technology, financial services and pharma sectors.
- More than a quarter of India's M&A activity was sourced from a PE buyer, reaching the highest proportion on record (117 deals).

2016

- After a record breaking 2015, there was a relative slowing down of PE exits in 2016, dropping by 22% to US$6.3bn. However, buyouts increased by 40% to US$12.6bn.
- Most of it was concentrated in the consumer services sector.
- Unlike the last few years, where Indian PE houses were dominant, foreign PE houses played an important role in 2016, with seven in every 10 deals involving a foreign PE house.

2017

- PE activity in 2017 continued to be strong with buyout deal values (US$9.6bn) recording the second highest annual total in the last five years (although exit deal values (US$5.1bn) fell from the previous highs of 2016 (US$6.3bn) and 2015 (US$8.1bn)).
- Most of it was concentrated in the technology sector.
- A large part of deal activity in 2017 was due to consolidation across key sectors, including consumer technology, telecom towers and infrastructure.

Key PE deals in 2017

SOFTBANK/FLIPKART
SOFTBANK'S ACQUISITION OF A 20% STAKE IN FLIPKART FOR US$2.5BN (THE LARGEST PE DEAL OF 2017).

BAIN CAPITAL AND THE CAPITAL GROUP/AXIS BANK
ACQUISITION OF A 5.55% STAKE IN AXIS BANK BY BAIN CAPITAL AND THE CAPITAL GROUP COMPANIES FOR US$1.1BN (THE LARGEST PE DEAL IN THE FINANCIAL SERVICES SECTOR IN 2017).

and accelerate further international investment into India.

For more details on foreign investments regulation in India (and other countries), please see our guide here: www.herbertsmithfreehills.com/where-we-work/india-group.

Distressed assets and IBC

Distressed assets (particularly real estate assets) have also become a focus area for PE houses. Many PE houses have established, or are in the process of establishing, specific funds or asset reconstruction companies (**"ARCs"**) to invest in such assets. This is similar to the arrangements that have been successfully adopted in a number of European countries.

The Insolvency and Bankruptcy Code 2016 (**"IBC"**), which is aimed at significantly improving the speed and transparency of the insolvency system and debt recovery in India, is likely to improve investor confidence in seeking such distressed assets. At a time when domestic lenders continue to struggle with bad loans, foreign PE players have started looking at India more seriously, with KKR becoming the first foreign investor to set up a 100% foreign owned ARC.

The recent relaxation by the SEBI of regulations relating to mandatory tender offers in the case of distressed acquisitions is another welcome change, which will boost investments in this area.

Improving corporate governance standards

Improvement in Indian corporate governance over the last few years (in particular, since the enactment of the new Companies Act in 2013) has bolstered the confidence of foreign PE houses. Whilst SEBI has followed through with positive practical measures for listed companies, there appears to be some scope for further improvement of corporate governance standards for private companies which suffer from a lack of accountability and awareness of Indian promoters (ie the controlling shareholder/founder) thus making them a more challenging proposition for foreign PE houses.

Introduction of the 2017 Amendment Act to the Companies Act in respect of a simplified private placement process, rationalisation of provisions relating to loans to directors, alignment of prospectus disclosure requirements with SEBI regulations, as well as the introduction of rules around transparency in relation to beneficial ownership (in line with the global trends), are examples of India's continued attempt to improve corporate governance.

India is also seeing a change in culture, with shareholder activism gaining more prominence which , in turn, has built confidence amongst foreign PE houses and helped ensure that they will not be side-lined by strong promoter groups.

Structuring and documenting cross-border deals

Any cross-border PE deal in India would require that Indian exchange control regulations and tax implications are carefully considered. India has recently notified the relevant laws allowing cross-border mergers in relation to both inbound and outbound mergers.

Any inbound merger (ie a merger, amalgamation or arrangement between an Indian company and a foreign company where the resultant entity is an Indian company) will require compliance with the FDI laws, so entry routes, sectoral caps (if relevant), pricing guidelines, additional conditions and notification requirements under the FDI laws will apply to such cross-border mergers. The resultant entity will also have to comply with the External Commercial Borrowings Regulations where the foreign company had any guarantees/borrowing, within a two year period.

Any outbound merger (ie a merger, amalgamation or arrangement between an Indian company and a foreign company where the resultant entity is a foreign company) will require compliance with the foreign security regulations and the liberalised remittance scheme, as well as any special requirements in relation to guarantees/borrowings of the Indian company under Indian law.

TEMASEK/LARSEN & TOUBRO
PARTNERING WITH SCHNEIDER ELECTRIC, TEMASEK'S US$760M ACQUISITION OF A 35% STAKE IN THE ELECTRICAL AND AUTOMATION BUSINESS OF LARSEN & TOUBRO.

BLACKSTONE/MPHASIS
BLACKSTONE'S ACQUISITION OF MPHASIS FOR US$1BN (THE LARGEST PE INVESTMENT IN INDIA'S OUTSOURCING SECTOR AND BLACKSTONE'S LARGEST ACQUISITION IN INDIA).

In terms of the documentation, the key transaction documents (and the provisions contained therein) in a cross-border PE deal in India are similar to those that one would see in the UK or the US. There is now an emerging trend in India (in line with the practices in the UK and the US) to obtain W&I insurance, which was not so common until recently. In addition, promoters/existing management are now being asked to remain involved in the target business more than ever, and are being offered incentives in the form of earn-outs and milestone-based returns or compensation.

Alternative Investment Funds ("AIFs")

The Indian PE market has recently seen the emergence of a new structure for investments; alternative investment funds (also known as AIFs). These are basically privately pooled investment vehicles which must register with SEBI. The regulations relating to AIFs provide regulatory clarity on the operation of private equity and others funds, making them popular amongst sophisticated investors.

In 2016, the Indian government allowed foreign investments into AIFs, with AIFs having raised commitments of approximately US$11bn during 2016, and about half of that again in 2017.

Foreign investor and enforcement issues

Foreign investors in the past have faced serious issues in ensuring that their Indian counterparty complied with the contractual obligations and in enforcing awards in India in the case of any breach. However, a couple of recent high court rulings are a positive indication of things to come.

In April 2017, the Delhi High Court handed down a ruling (in the case of *Cruz City 1 Mauritius Holdings v Unitech Limited*) which rejected objections to the enforcement of a US$300m LCIA award. This was followed by another successful enforcement case in India in January 2018 by Daiichi against the Singh brothers, where the Delhi High Court allowed enforcement of a US$550m arbitral award. These decisions are not only a clear indication that Indian courts are now taking a more commercial approach to uphold the sanctity of contractual arrangements between parties but also an endorsement of the Indian government's pro-investor and non-interventionist approach.

Predictions

Our key predictions for private equity in India for the short term are as follows:

Deal activity and top sectors

Overall, we are optimistic about stronger deal activity following significant build-up of investment capacity in the recent years.

We anticipate continued focus on consumer services (as well as consumer discretionary) this year. Private funds are also showing an increased interest in retail real estate assets. Banking, financial services and insurance are other areas to watch, with growth expected to be bolstered by strong macroeconomic progress, rising incomes and a growing middle class. The increased deal activity in the healthcare sector in 2017 is also likely to continue through into 2018 and beyond.

We expect to continue to see the sale by promoters of non-core assets and of strategic stakes to raise funds to reduce borrowings and invest in core assets. This will be an important deal driver for the PE industry, alongside investment in distressed assets.

Increased protectionism

In 2017, the Indian government had red-flagged the biggest 2016 M&A deal (Rosneft's acquisition of Essar Oil) on grounds of national security concerns. Whilst the deal completed in early 2018, this is perhaps the first significant indication by the Indian government of increased protectionism of high profile assets (in line with the current global trend).

For more details on increased protectionism, please see our latest thinking here: www.herbertsmithfreehills.com/latest-thinking/hubs/future-of-global-trade-investment

With constant threat from neighbouring countries and emerging global consensus against terrorism, India is likely to increase monitoring big ticket M&A and PE deals in certain strategically important sectors. Whilst it may be important for the Indian government to track deals from an internal security perspective it is hoped that any intervention is supported by clear guidelines and avoids unpredictable implementation.

Hands-on approach and alignment with promoters/management

PE has traditionally been a minority equity story in India. However, this seems to be changing. PE houses in India are increasingly seeking either significant minority or controlling stakes in order to exert greater influence rather than remaining a passive investor or merely relying on the growth wave.

Such an approach has been coupled with an increased focus on due diligence of founding shareholders/promoters and management. The alignment between the promoter and the investor is absolutely key to running a successful operation.

Changing investment strategies

We anticipate that investors will become increasingly creative with their investment strategies. For example, Goldman Sachs has recently executed its Indian investments through a buy and build investment strategy, whereby it either acquires a large stake in a small business or sets up a business from scratch and brings in a professional team to scale up the business.

An increase in the cost of equity investment has contributed to a new trend for venture debt structures in the Indian market. Venture debt is used to fund capital expenditure, finance working capital requirements, fund mergers and acquisitions, or finance specific projects. Venture debt is likely to grow in popularity and we anticipate that venture debt investors will focus on established internet companies that are in need of additional cash.

Summary of key pitfalls in Indian PE deals

- Lack of due diligence on the target.
- Nonalignment of incentives of the promoter/management of the target.
- Poor/ineffective corporate governance structures of the target.
- Failure to track the covenants and undertakings in effect during the life cycle of the investment.
- Lack of careful consideration of:
  - structuring issues, in particular in relation to debt; and
  - the evolving tax aspects (eg minimum alternate tax, pass through for AIFs and implementation of the General Anti-Avoidance Rule), in particular tax treatment on exits.
- Choice of law and dispute resolution mechanism (and related enforcement issues).

German disposals of life insurance portfolios

Recent years have seen an upturn in M&A transactions in the life insurance sector. Many have been strategically driven and involved acquisitions of discontinued insurance businesses by "run-off" companies dedicated to operating legacy insurance portfolios. Many of these deals have been completed in North America and the UK, jurisdictions with well developed markets in this area. However, a number of recent surveys, as well as some recent transactions, have indicated that the run-off market in continental Europe, and in particular in Germany, could soon see a significant increase in activity.

From top

Christoph Nawroth
Christian Johnen

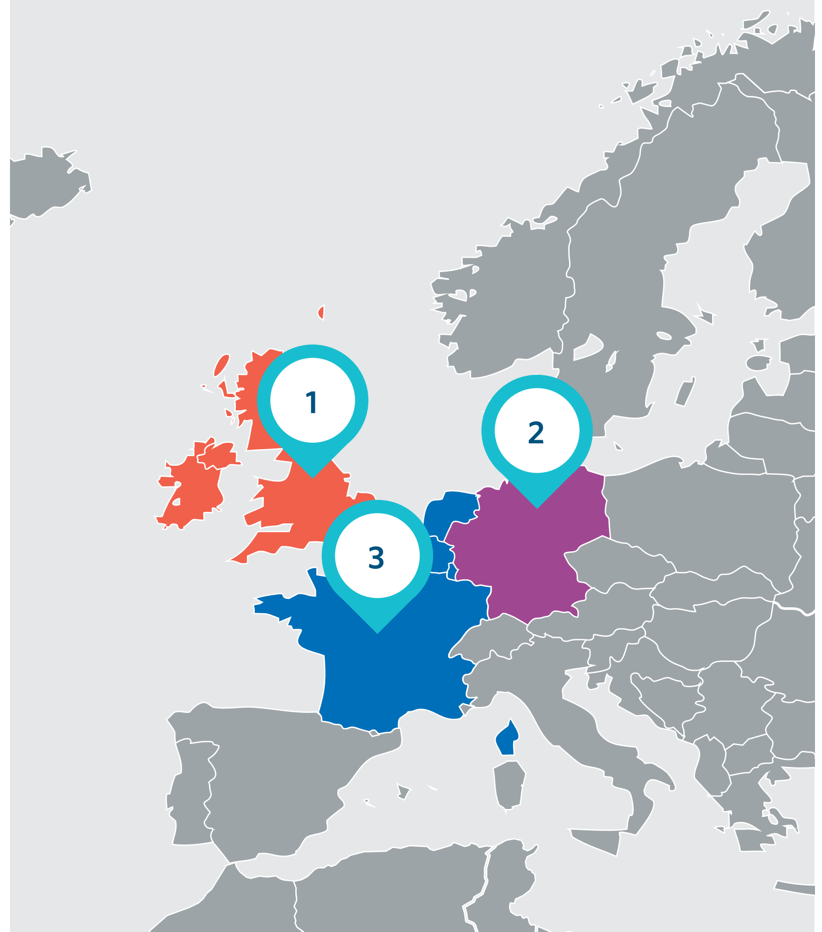
Run-off vehicles: the business model

There are many reasons an insurer may choose to cease underwriting a given insurance portfolio (making it a 'run-off' portfolio). The key drivers are often to improve shareholder returns (by releasing capital) or to deliver a strategic reorientation of the insurance company's business. Other drivers include those which result from consolidation in any industry: the dedicated run-off insurer will be better placed to reduce complexity and risk and cut costs across a larger portfolio.

In recent years, German life insurers have struggled to pay guaranteed returns on their insurance policies – traditionally a feature of such policies – due to consistently low interest rates. In addition, the introduction of stricter regulatory standards, in particular the risk-based approach to capital requirements in Solvency II, has put further pressure on life insurance companies. As a consequence, a number of German insurance companies have discontinued their underwriting businesses for traditional life insurance policies, while some have disposed of their portfolios entirely.

Such disposals offer opportunities for private equity investors, who use the run-off vehicle structure to acquire life insurance

Potential for future run-off activities by region



portfolios and see them through until the end of the policies. The administration of run-off businesses offers synergies of scale, as multiple run-off portfolios may be aggregated. Other areas for portfolio optimisation include improving run-off management, introducing more efficient administrative processes (such as cutting edge IT systems), and switching to more profitable investment strategies. In addition, run-off specialists expect that higher profits can be made once interest rates pick up again.

Current market and investment opportunities

December 2017 saw two significant run-off insurance deals in the UK. Swiss Re's closed book business ReAssure acquired a 1.1 million portfolio of with-profits and unit-linked life insurance policies from Legal & General. In the non-life sector, Generali entered into an agreement to sell the non-life run-off portfolio of its UK branch, consisting of approximately EUR 300m of liabilities, to Compre Group, one of the leading discontinued business specialists.

Germany saw one major run-off insurance deal in June 2018 as Generali sold 89.9% of its subsidiary, Generali Leben, to Viridium (held by Cinven and Hannover Rück) for an aggregate consideration of EUR 1.9 bn. Generali Leben administers around 4.2 million insurance policies and holds assets with a total value of approximately EUR 42 bn. The German life insurance market also offers further opportunities for run-off specialists. With approx. 80 million German life insurance policies in place (around one per German citizen), this market is significant.

However, while investment vehicles can promise attractive returns, investors and run-off specialists will need to take a long term view rather than look for "quick money". German run-off vehicles must be authorised by a financial regulator in the EEA, before they can operate in the German market. When considering whether to approve run-off vehicles any such regulator will consider the proposed long-term strategy and, in particular, will want to be satisfied that any acquisition of a portfolio will not adversely affect the interests of policyholders. Obtaining authorisation can take time and, by way of example, the German regulator BaFin authorisation takes several months and approval for some recent high profile acquisitions has taken up to a year and a half.

Future outlook

Predictions of an increase in run-off activity in Germany were fulfilled with the June 2018 transfer of the majority stake in Generali Leben to Viridium. Beyond this, it has been rumoured since late 2017 that Axa is considering a disposal of its German life insurance portfolio. This is likely to be just one of several future investment opportunities as sell-offs continue.

As can be seen from the run-off vehicles currently doing business in Germany (see box: German Run-Off Vehicles), consortium run-off vehicles are the norm – ERGO recently cancelled the envisaged outright sale of its discontinued life insurance portfolio in favour of a joint venture vehicle with IBM, pending the possible involvement of third-party investors.

Political context and public policy

German life insurance portfolio disposals have garnered significant media and political attention. Consumer bodies have criticised the lack of any requirement for policyholder consent and have suggested that a disposal by an insurer could constitute a breach of its customers' trust. Concerns have also been raised that customers could face lower standards of service and receive a lower return on their investment following a transfer to a run-off vehicle.

In practice, there has so far been very little hard evidence to support these concerns. Certainly, the experience of customers and run-off consolidators in the UK is not necessarily worse than that of those who have stayed with the original insurer. There is some political discourse as to whether the applicable laws should be amended to introduce a policyholder consent requirement, but this has yet to gain momentum.

Due diligence – key aspects

Commercial and Legal Considerations

In addition to the standard due diligence concerns in every M&A transaction, due diligence on a run-off disposal has to put particular focus on the insurance related aspects, not only from a legal but also from an economic perspective. Economic specifics include aspects such as capital resources, the effectiveness of "matching" portfolios and reinsurance under Solvency II, and the quality of the investments held by the insurer. From a legal perspective, particular attention should be put on regulatory issues, on the specific legal risks associated with the sale of insurance policies and on insurance specific disclosure restrictions. Regulatory due diligence should involve a review of all correspondence between BaFin and the insurer, as well as BaFin reports on special audits, if any. However, an understanding of both the current regulatory regime and the

German run-off vehicles

There are currently three main run-off vehicles in Germany dealing specifically in life insurance: Viridium, Frankfurter Leben and Athene. These run-off vehicles have acquired six life insurance portfolios in total, five of which were acquired by way of share deals.

1. Viridium is held by private equity investor Cinven and Hannover Rück *excluding the Generali Leben portfolio (cf. above) Viridium*, has EUR 15bn of assets under management, administers one million insurance contracts and employs 430 people.
2. Frankfurter Leben , controlled by Chinese based investor Fosun (75%) and by BHF-Bank (25%), administers around 400,000 life insurance contracts, employs 200 people and has stated an intention to acquire investments of EUR 20bn to 30bn in the coming years.
3. Athene, is owned by Apollo and administers approximately 290,000 insurance contracts.

regulatory horizon is also important. A good example of this occurred recently in a UK context, where several live sale processes running in the UK in 2016 were affected when the FCA announced it was looking into fees being charged to run-off customers. This presented the sellers with additional execution risk.

Statutory Duties

Particular attention should be paid as to whether the insurance company has complied with its statutory duties when entering into insurance contracts. Such duties include clearly disclosing information to the potential policyholder prior to entering into the contract. Another risk is the provision of incorrect revocation instructions, which may entitle policyholders to revoke their insurance contracts even if such contracts were entered into several years ago – successful revocation would require the return of all premiums paid under the relevant insurance policy, plus accrued interest.

Secrecy

From a practical perspective it should be noted that under German law, any insurance related due diligence must be performed in accordance with the principle of insurance secrecy. This principle prohibits disclosure of any insurance related data, including the mere fact that a person has entered into an insurance contract or is entitled to insurance premiums under certain circumstances. In practice, so-called "red data rooms" are commonly put in place on M&A transactions, with only "clean teams" of professionals, subject to professional duties of confidentiality (eg lawyers or certified accountants), being allowed access. Further requirements may be imposed under applicable data protection rules, such as the redaction of any personal information from documents .

Typical transaction structures

German insurance portfolios are typically transferred by way of a share deal or by way of a portfolio transfer (*Bestandsübertragung*) pursuant to sec. 13 of the German Insurance Supervision Act (*VAG*). A portfolio transfer aims to transfer specific insurance policies entered into by an insurance company. On a portfolio transfer, the insurance policies that are in run-off will be identified and aggregated before being transferred. By contrast, on a share transfer, all policies entered into by the insurance company would be acquired. Generally both transfers, a share deal and a portfolio transfer, are subject to BaFin approval but not subject to approval of policyholders.

Regulatory criteria

In determining whether its approval is required on the sale of a portfolio or business to a run-off vehicle, BaFin will assess whether any individual, corporation or partnership alone, or "acting in concert" with other investors:

- holds, directly or indirectly, 10% or more of the capital (*Kapital*) in the insurance company;
- holds, directly or indirectly, 10% or more of the voting rights (*Stimmrechte*) in the insurance company; or
- has other means of exerting significant influence on the insurance company's management in respect of the investment (irrespective of votes or capital).

It is common to see "whole business" reinsurance put in place in advance of a portfolio transfer, so that economic risk (but not legal title or regulatory responsibility) in the run-off book passes to the purchaser immediately whilst regulatory approval is obtained.

Avoiding change of control filings with BaFin through split contributions

If the run-off vehicle or any of its shareholders fulfils one or more of the regulatory criteria (see box: Regulatory criteria), they will be subject to filing obligations with BaFin. This includes both direct shareholders in the run-off vehicle and any indirect shareholder, up to the ultimate beneficial owner.

Some investors may seek to avoid regulatory filings with BaFin, eg by way of split contributions so that their participations in capital and voting rights remain below 10% but their economic participation exceeds 10%. Such higher economic participation may be achieved, for example, by providing additional funds through loan instruments.

On a portfolio transfer, the insurance policies that are in run-off will be identified and aggregated before being transferred to another insurance company. By contrast, on a share transfer, all policies entered into by the insurance company would be acquired.

Structuring such investments to avoid regulatory filings with BaFin is a sophisticated exercise. This is particularly the case as the capital provided by way of loan instruments needs to qualify as "own funds" tier two capital for the run-off vehicle in accordance with Solvency II capital requirements (see box: "Own funds under Solvency II"). On this basis, the terms of such loans require a long term commitment from the respective investors and the funds are in some respects like traditional equity capital. Usually, investors will require certain protection before granting such loans, eg rights to influence business decisions in the platform vehicle or at least extensive information rights. However, such additional investors' rights would be taken into account by BaFin when assessing whether an investor holds a significant participation in the platform. Ultimately, such additional protection could trigger the same filing obligations with BaFin that the investor initially sought to avoid by choosing split contributions.

Own funds under Solvency II

In order to qualify as "own funds" under Solvency II, loans will need to be assessed against a number of criteria such as the loan's term (which must be at least 10 years at issuance), subordination (ie is repayment subordinate to other obligations, including policyholder liabilities) and availability (ie will it be available to absorb losses on both a going-concern and winding-up basis).

As such structures will always be subject to BaFin's scrutiny and approval, it is advisable to open dialogue with BaFin at an early stage in respect of any structuring considerations. However, investors should note that BaFin cannot issue binding assessments of any investment until the official application for approval is filed.

Structuring such investments to avoid regulatory filings with BaFin is a sophisticated exercise. This is particularly the case as the capital provided by way of loan instruments needs to qualify as "own funds" tier two capital for the run-off vehicle in accordance with Solvency II capital requirements.

Implications of extended investment control mechanisms

Acquisitions of German life insurance portfolios may be subject to German foreign investment control procedures, which would trigger notification obligations
with the Federal Ministry for Economic Affairs and Energy. Whether investment control procedures apply largely depends on the size of the insurance portfolio and whether the transaction comprises a contract management system, a performance system or a payout system for life insurance policies that process 500,000 or more insurance payouts (Leistungsfälle) per year. For further details on German foreign investment control procedures please refer to the article "Political Intervention in M&A: Overview and Implications for Private Equity" earlier in this edition.

Outlook

German life insurance portfolios that are currently in run-off amount to only 3% of the German life insurance market. The introduction of run-off vehicles in Germany can be seen as the first test of this market. Public discussions clearly indicate that there are significant opportunities for investors who acquire run-off portfolios. However, recent statements by BaFin suggest that BaFin will carefully and rigorously assess new investors and run-off vehicles in the market, with a focus on consumer outcomes.

At the same time BaFin has made very clear that it will approve transfers to run-off vehicles in cases where it is convinced that such transfers are not to the detriment of the policyholders. From a regulatory point of view, there is a desire to have a good home for legacy insurance portfolios which might not be the focus of an insurer which continues to write new polices and push into new markets. As such, the run-off market provides a valuable source of capital and expertise in dealing with legacy portfolios which are relied upon by so many for an income in retirement.

Private equity real estate: the new trend for real estate investment in France

The French Private Equity and Real Estate ("**PERE**") market is becoming increasingly more sophisticated. For years the PERE market centred on the US and the UK, while in France, indirect investment was seen as a mainly opportunistic strategy restricted to non-French investors. Now US investment funds have become regular investors in the French market, making both direct and indirect investments, and they are not alone – French investors too are increasingly relying on indirect and/or structured investments. As a result, structured investments are on the upsurge, beyond the hospitality sector that was traditionally the mainstay of these deals, in sectors such as retail and warehouse property, office buildings and shopping centres.

From top

David Lacaze
Claire Le Louarn

Typical transaction structures

Broadly speaking, PERE refers to any pooled investment vehicle that allows investors to invest in real estate. In France these tend to be structured as joint ventures between a handful of large investors. The joint venture vehicles will generally seek to acquire the company owning the property in question; a structure that is both beneficial from a tax and regulatory perspective and commensurate with the size of the average deal in the French market.

When forming pooled investment vehicles, investors should consider the usual range of corporate governance issues, such as how the vehicle will manage liquidity issues or a deadlock situation. However, a number of pure real estate issues will need to be addressed in the transaction and investment/joint venture documents. These will include asset and property management arrangements as well as ensuring the liquidity of the real estate asset itself.

Particular attention should be paid to the leasehold arrangements with respect to the property, as these may affect the structuring of the deal. For instance, in the hospitality sector, operative companies do not always own the building where the business is operated. At an early stage in the transaction advisors should address whether the leases will need to be modified, terminated or renewed –especially when drawing up the business plan and/or in relation to any major decisions requiring the investors' consent. The advisors should also identify any other potential issues regarding the lease agreements (termination date, rent, etc.) and address them as soon as possible in the deal process.

Structuring a French PERE vehicle

Over the last 10 years, the French legal system has evolved to favour indirect and pooled real estate investments. Various forms of investments vehicles have been created, such as the organisme de placement collectif en immobilier ("**OPCI**") or the société de libre partenariat ("**SLP**"). Traditional open-ended retail funds, the société civile de placement immobilier ("**SCPI**"), have also been amended to favour PERE transactions. All these vehicles, whether purely dedicated to real estate investment (such as the OPCIs or the SCPIs) or not (such as the SLPs), have the status of an alternative investment fund ("**AIF**") within the meaning of the

Alternative Investment Fund Managers Directive 2011/61/EU (the "**AIFMD**") and as such, they are regulated by the French financial markets regulator (the "**AMF**").

The choice of the vehicle is a key decision for an investor. A number of different issues should be taken into account when making this choice:

Tax Issues

Choosing a tax efficient vehicle will be one of the primary concerns for any investor. The main constraint of PERE is that real estate investments are taxable in the country where the assets are located according to most tax treaties.

Investing using an OPCI, however, is tax transparent. Accordingly, no taxation applies at the OPCI level and instead investors will be taxed directly under their own applicable tax regime. This therefore avoids a double taxation between the vehicle and the investors.

A preferential tax regime may also apply to investors in a French Fonds Professionnels de Capital Investissement, subject to certain conditions. The "quota fiscal" for this structure is particularly tax efficient for an investor seeking to take advantage of dividends and capital gains.

The international tax treatment of each vehicle may also have an impact on the choice of the structure. The possibility of withholding tax being imposed on revenues paid into overseas accounts should be closely examined.

Applicable Regulations

Not every vehicle is subject to the same legal constraints. Accordingly, depending on the strategy and purpose of the investment, some vehicles will be more suitable than others.

Some investors may specifically seek to invest in regulated vehicles, especially if they need to demonstrate compliance with French anti-money laundering and terrorist financing requirements (les obligations LAB-FT). An AMF regulated vehicle remains the best guarantee that such requirements are fully complied with. It provides any potential lenders additional comfort and considerably eases the "Know Your Customer" process.

An OPCI will be subject, pursuant to articles L. 214-36 and L. 214-37 of the French Code monétaire et financier, to (i) an exhaustive list of assets it can invest in, and so will be limited in some of its investment decisions; and (ii) specific minimum ratios for each asset class it can hold, for example a minimum of 60% in real estate assets and 5% in liquid assets. These limitations will apply to any investments made through the OPCI structure.

Meanwhile, French Fonds Professionnels Spécialisés can invest in a far wider variety of assets. However, in order to benefit from the quota fiscal mentioned above, investors must comply with strict and specific retention and investment allocation commitments.

Regulatory implications

Any regulated vehicle will be subject to monitoring, and potentially prior authorisation, by the AMF. This can have a significant impact on the timetable of a deal. For instance, an "other AIF" (Autre FIA) cannot market its own capital securities to non-professional investors without specific authorisation from the AMF. This takes around three weeks from notification, but can take even longer should the AMF request any additional information. In the context of a swift and competitive process, such a delay, if not factored into the deal timetable, could have serious consequences for a given bidder.

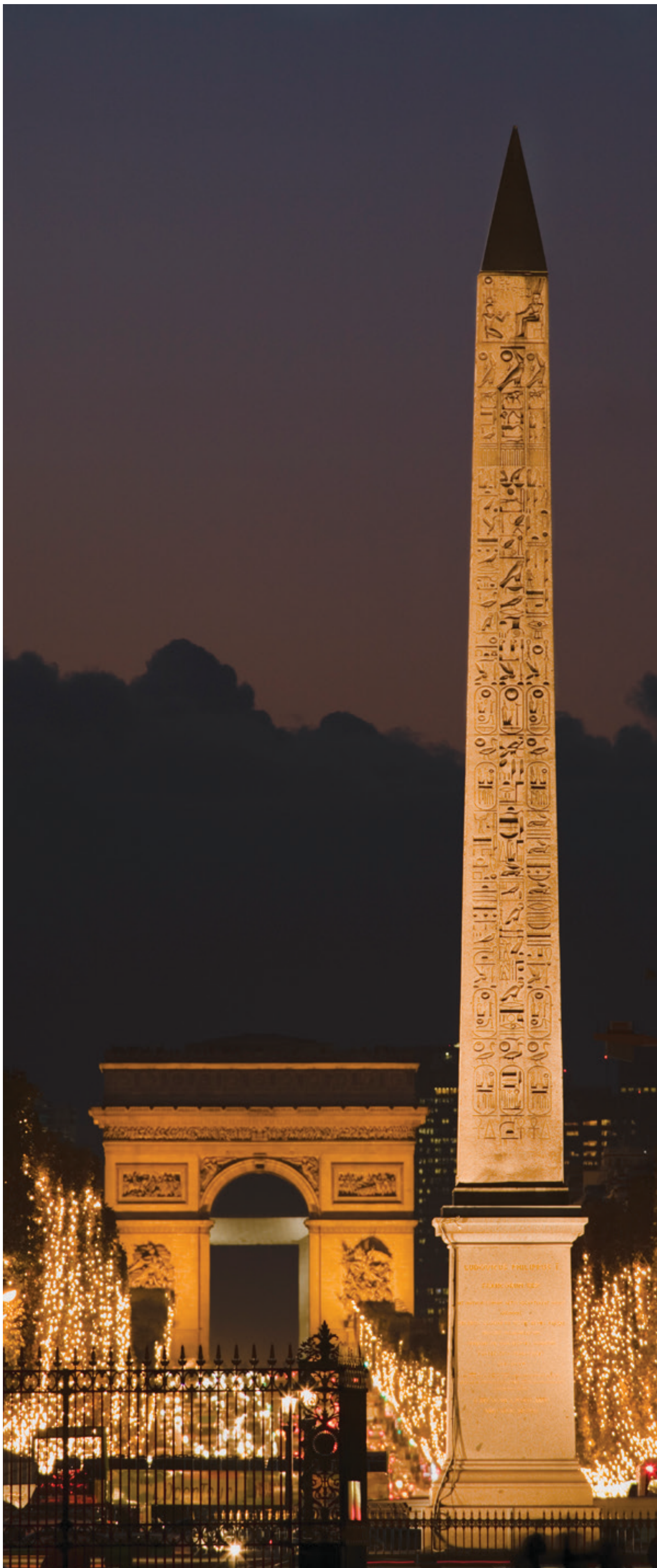
AMF regulatory considerations will also affect the structuring of deals. For example, the management company of a French OPCI is normally entitled to delegate financial and accounting functions to third parties, but can in no event delegate any asset management functions. Consequently, an asset manager participating in an OPCI joint venture will be unable to handle the asset management of the property itself. Instead, the joint venture entity will have full control over the asset management process, and the asset management company can have no greater role than that of a service provider. All contractual relationships between the shareholders in the deal, such as the asset management agreement, shareholders' agreement, management company agreement and so on, will need to be drafted with this prohibition in mind.

French legislation is otherwise quite liberal in its regulation of pooled investment vehicles. The French Monetary and Financial Code does not provide for any restrictions as to either the form of the investment vehicle or its jurisdiction of incorporation. Any investment into a regulated AIF would fall within the scope of this legislation to the extent that the purpose of such AIF is to acquire, manage and subsequently dispose of real estate assets. The main restrictions on the investing powers of an SCPI relate to short term buying and selling transactions (short term transactions are completely excluded from the permitted investments of an SCPI – though neither the French Monetary and Financial Code nor the French tax authorities have ever given a precise definition of a short term transaction).

Further liberalisation came from the transposition of the AIFMD into French law. As of 2013, SCPIs have been allowed to make certain indirect investments, whereas previously such vehicles were only entitled to make direct investments since their official creation in 1970. SCPIs are also able to invest into unlimited liability partnerships, other SCPIs, OPCIs and any other form of investment vehicle having a purpose equivalent to an SCPI or an OPCI (pursuant to Article L 214-115 of the French Monetary and Financial Code).

Case study: Coeur Défense

The largest single asset transaction of 2017 in France, the acquisition of Coeur Défense building in La Défense (Paris) by Amundi, Crédit Agricole Assurances and Primonial, is a typical example of a French PERE transaction. This €1.8bn transaction involved the creation of a joint venture between the three investors in the form of a French closed-end fund (an organisme de placement collectif en immobilier/ OPCI (a form of French non-listed REIT).



Outlook

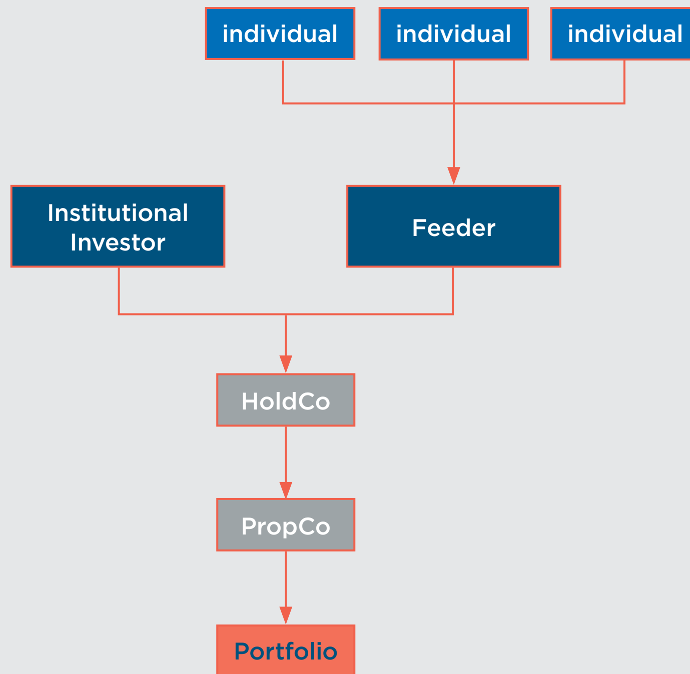
Encouraged by more liberal regulation, SCPI managers have begun to develop aggressive expansion strategies in France and abroad.

For example, in September 2017 Immorente, one of the largest French SCPIs (gross asset value as of 31 December 2017: €2.72bn), indirectly acquired 25 prime retail parks next to IKEA stores in eight European countries. Immorente is managed by Sofidy, a licensed French management company, but was able to acquire an interest in the parks by investing in a Luxembourg law acquisition vehicle. Immorente relied on the criteria of equivalence to perform its investment into the Luxembourg vehicle (Pradera European Retail Parks SCSp, a Luxembourg société en commandite spéciale).

Other evidence of increased PERE activity in France is a buoyant market of club deals set up by high net worth individuals. These investment vehicles have been active in the hospitality and office sector. For example, in July 2017 Mata Capital and Eternam purchased a portfolio of forty-five hotels from the Blackstone Group. This transaction was the largest portfolio acquisition closed in France during the course of 2017. Most of the equity was raised through a feeder vehicle, allowing various individuals to participate in the venture. Club deals by individuals have clearly become a credible and complementary source of equity for institutional investors, either for direct investments, through the club deal entity, or for more structured transactions in which retail money would be raised by a feeder entity (see box: Structure plan for a typical deal involving high new worth individuals for an example of a typical structure).

PERE has become a substantial source of investment and risks diversification for French retail funds. France has entered a record period for investments by French real estate investment vehicles and the use of pooled vehicles or club deals has become a lucrative potential source of returns for investors. French investors who are no longer fringe players in this market will increasingly look beyond France for joint venture partners or limited partnership arrangements, both for inbound and outbound PERE investments.

Structure plan for a typical club deal involving high networth individuals



Club Deals – Structuring Issues

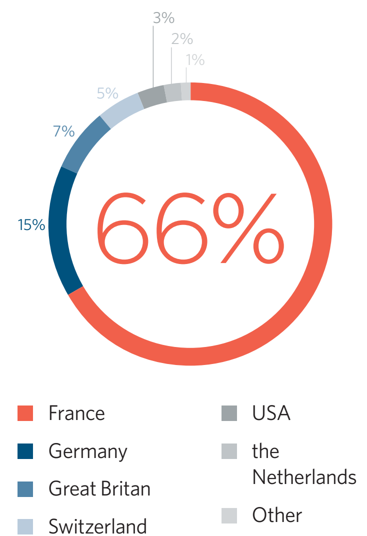
When properly structured a club deal can avoid the following issues:

- the investment vehicles do not need to be regulated, thereby avoiding the need for specific authorisation from the AMF; and
- the deal qualifying as a "public offering" under the meaning of article L. 411-1 of the French Monetary and Financial Code and the consequent heavy information formalisation requirements of the AMF.

In order to avoid these regulatory constraints, the amount invested in the deal by each individual must always exceed the threshold defined by article 211-2 of the AMF's General regulation (currently, €100,000).

Overview of the Paris and France real estate market (Q3 2017)[5]

- **50 deals over 5,000 sq m** (unprecedent level since 2012) in Paris;
- **28 deals over €100,000,000** in Paris;
- **66% of deals entered into by French buyers:**



France
Germany
Great Britan
Switzerland
USA
the Netherlands
Other

- Investment funds remain the most active vehicles on the retail market in France (**71% of the investments versus 60% in 2016**); and
- Private investors - such as high net worth individuals - are increasingly active in France (**7% of the investments**).

N.B.: no statistics are available as to the split between direct and indirect investments.

[5] Source : JLL

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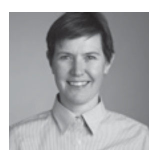

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Joseph Dennis

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