DIRECTIONS IN PRIVATE EQUITY 2018

MinterEllison

INTRODUCTION

Welcome to the fourth edition of MinterEllison's Directions in Private Equity report, which provides our observations of trends in Australian private equity in the financial year to 30 June 2018 (FY18) and our predictions for FY19.

FY18 has seen a number of key themes emerging in Australian private equity and venture capital investment. As entire industries are facing technology disruption and changing consumer behaviour, managers with specific technology and consumer related skill-sets are in more demand.

While we have seen purchase price valuations on an EBITDA-multiple basis rise over the last 12 months, Australian private equity funds are still paying reasonably modest multiples by global standards and, rather than there being too much 'dry powder' in the market as some have claimed, we are still seeing a reasonable volume of deal opportunities and good levels of capital deployment. These opportunities are playing out in a number of key sectors identified in our report.

In our report we will also cover emerging trends that will effect investment in FY19 including a changing debt landscape, tax reforms and changes in deal holding structures and holding periods.

TRENDS IN FY18

- FLEXIBLE INVESTMENT STRUCTURES
- FOOD, BEVERAGE AND AGRIBUSINESS REMAIN ATTRACTIVE
- MORE 'BUY AND BUILD PLAYS'
- OPPORTUNITIES AFTER ROYAL COMMISSIONS
- EXPANDED UNIVERSE OF BUYERS
- SURGE IN PUBLIC M&A

TRENDS IN ACQUISITION FINANCE

- MEZZANINE LOANS
- DEBT FUNDS AND HEDGING

SECTORS TO WATCH IN FY19

- NON-BANK FINANCIAL SERVICES
- OPERATING INFRASTRUCTURE
- IT SERVICES
- SMALL-MID CAP LISTED COMPANIES

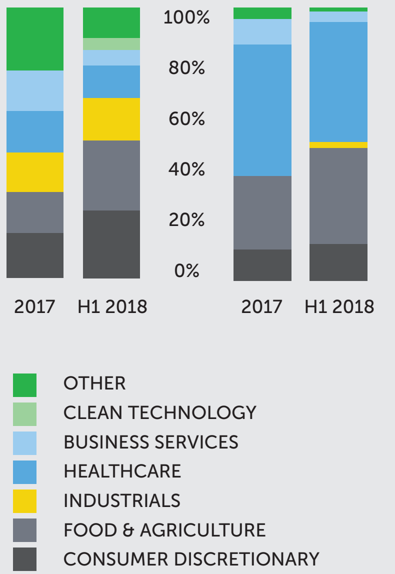
TRENDS IN PRIVATE EQUITY IN FY18

By Number of Deals

AVCAL 2018 Yearbook

By Aggregate Deal Value

AVCAL 2018 Yearbook



Proportion of Exits

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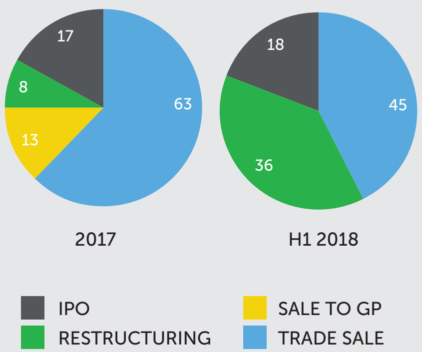

1

Flexible investment structures becoming more important

While asset prices and competition for assets remained healthy throughout FY18 with many vendors opting to run competitive sale processes, savvy private equity funds continue to find compelling proprietary opportunities, particularly where a fund was willing to take a non-controlling interest or provide a more flexible funding solution. Where owners of high-quality assets may be reluctant to part with control, some private credit and special situations funds are overcoming this by offering a debt-driven solution with real or synthetic minority equity exposure. Our view is that more traditional buyout funds may face increased competition for assets from investors who are willing to invest across the entire capital structure.

2

Food, beverage and agribusiness remain attractive targets

Australian food, beverage and agribusiness assets continue to enjoy a strong global reputation and demand, particularly from Asia. Packaged food and meats accounted for the majority of private equity activity in the sector. The ROC Capital/Wattle Hill proposed scheme of arrangement for Capilano Honey is an example of private equity interest in an iconic Australian food brand with potential for Asian growth. With the exception of The Carlyle Group's acquisition of Accolade Wines and Advent Partners' investment in Tribe Brewing, strategic buyers largely dominated activity in the beverage and craft brewing sub-sectors, with synergies justifying higher multiples to acquire brands that can be integrated into their existing distribution channels.

While private equity funds typically remain uninterested in investing in primary agricultural assets, we see strong interest from private equity funds in businesses on the 'other side of the farm gate', i.e. transport, logistics and agricultural supplies.

3

'Buy and build' plays on the rise

Private equity funds continued to look for 'buy and build' opportunities in FY18. This means that they sought to acquire businesses below their ideal 'equity cheque' size, but suitable for thematic investment in fragmented sectors such as travel and tourism, child care, food and agribusiness. Next Capital's acquisitions of artisan bread makers Brasserie Bread and Noisette Bakery, and Pemba Capital's acquisitions of complementary 'auto-tech' businesses under the Marque Group banner are examples of this continued trend.

4

Royal commissions – an opportunity for private equity?

The implications of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry are yet to play out in full. However, private equity funds are positioning themselves in proximity to major financial institutions as divestment of non-core assets looms as a likely consequence of these institutions' diminished risk appetites and renewed focus on their core business.

Another sector to keep an eye on will be the aged care sector. While private equity has previously bought (and largely sold) these assets, the Royal Commission into Aged Care Quality and Safety may lead to further industry consolidation and opportunities for private equity to partner with incumbents needing capital to meet rising social expectations about the quality of aged care.

TRENDS IN PRIVATE EQUITY IN FY18

5

An increased universe of buyers the new normal

Until recently, the range of potential buyers for a given asset was reasonably predictable, and depended on the size of the opportunity and whether the opportunity represented a turnaround, conventional growth capital or buyout opportunity, or infrastructure play. Now, however:

- more traditional private equity funds are eager to participate in auctions for soft infrastructure assets or government privatisations
- super funds continue to increase their lead participation in buyouts and 'take-private' opportunities
- specialist funds are demonstrating the flexibility of their mandates by competing for assets with conventional buyout funds
- smaller or mid-market funds are able to execute larger transactions than their usual equity cheque-size with the help of co-investors
- as noted above, larger funds are open to smaller transactions as part of a 'buy and build' strategy.

Family offices (private wealth management advisory firms serving elite investors) have not yet turned up to sale processes in significant numbers. However, they are increasingly showing an appetite to organise in consortia behind a manager on an asset-by-asset basis. We expect this trend to continue in FY19, driven by boutique fund managers looking to give their clients access to a different asset class.

Fortunately for private equity acquirers, the influence of Chinese competition for assets has softened in recent times with restrictions on capital outflows causing real issues for Chinese buyers. This however has been balanced by increasing inbound interest from Asian private equity funds.

6

Surge in public mergers and acquisitions

Private equity was a driving force in Australian public M&A across a wide range of industries. Many private equity firms are looking to acquire strategic assets – including intellectual property – with untapped potential. An example was the acquisition of Sirtex Medical Limited by the CDH Investments, China Grand Pharmaceutical and Healthcare Holdings Limited consortium. Oaktree Capital Management also acquired Billabong to combine its brand portfolio with Oaktree's portfolio of action sports brands, including Quiksilver and Roxy.

Private equity suitors submit many indicative proposals, many of which fail to mature into formal offers. Target boards are sometimes wary of approaches from private equity, often slow to respond or rejecting the approach outright. In one example from FY18, BGH Capital's first proposal to acquire Healthscope was rejected by the Healthscope board, which also refused to grant due diligence access.

The approach by BGH Capital to partner with AustralianSuper on its Healthscope takeover proposal is likely to be replicated, with large superannuation funds likely to see take privates in partnership with private equity as attractive investment opportunities – these funds will also be able to play king-maker in situations where their support is critical to the success of a private equity takeover proposal.

The high level of private equity interest in ASX-listed companies should continue into FY19. We are seeing this with targets such as Scottish Pacific Business Finance, MYOB, Navitas, Zenitas Health and Greencross already in play. While the mega buy-out funds will continue to target opportunities at the bigger end of town (partly because debt funding remains comparatively cheap and these funds are actively seeking assets of an appropriate scale in which to invest capital), we are seeing more interest from mid-market funds in exploring take-private opportunities in the small-cap (and even micro-cap) sector, particularly in companies with limited liquidity who are seeking growth capital.

KEY FUNDRAISING THEMES

Rise of alternative debt funds

FY18 set a new record for the amount of alternative debt funds raised by Australian and foreign fund managers operating in Australia. For example, Metrics Credit Partners raised almost $800 million for its listed fund. Several other unlisted debt funds raised in excess of $2 billion in Australia by our estimates, including Intermediate Capital Group, Tanarra Capital, Perpetual Limited, Gryphon Capital Investments, Stamford Capital Investments and a host of others.

The rise of alternative debt funding represents a great win-win for all involved. Funds providing a capital stable yield in a low-yield environment appeal to a wide universe of investors ranging from 'mums and dads' to institutions. Borrowers also benefit from the competition between debt funds and banks, and gain a precious source of capital if the banks have tightened credit or pulled out of a relevant sector.

We believe alternative debt funding will continue to grow, not only filling the gaps left by the major retail banks but also providing continuing competition. The size of the alternative debt market compared to the bank lending market means there is still a long way to go before alternative funding sources reach capacity.

Positive fundraising environment

The fundraising environment is as strong as it has been within the last decade, as shown by the latest AVCAL data.

Fundraising

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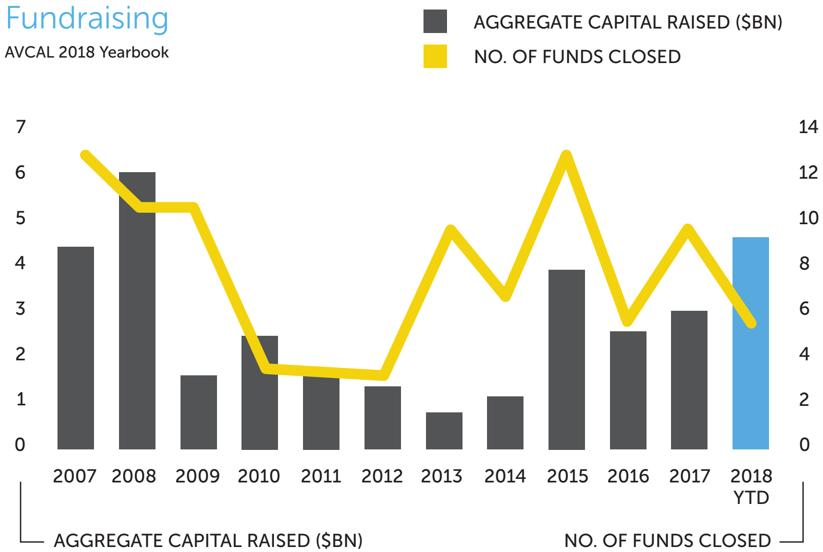
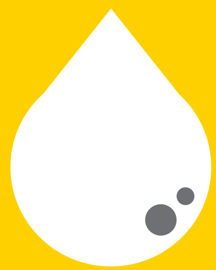


WHAT TO LOOK OUT FOR IN FY19



Liquidity: One reason alternative debt funding is growing is that the fund structure 'technology' now exists for open ended products. Historically, debt funds have been fixed-term in nature, similar to private equity funds. However, the scale of some of these funds, combined with new fund structures developed since the 2008 global financial crisis, has meant they can be offered in a semi-liquid format. This same trend is starting to be seen in private equity where retail and wholesale investors will have several new choices in semi-liquid format (for example, with quarterly 'gate' provisions). We can expect a number of new funds along these lines in FY19.

Deceleration in secondary fundraising activity: We previously predicted an increase in secondary fundraising activity. This has not only transpired during FY18, but it has increased so much that fund and portfolio secondary trade discounts have narrowed to close to zero, and in some cases, a premium to net asset value. This compares with historical discounts in recent years of 5–15 per cent, depending on the market. We expect this to slow down secondary activity in FY19.

More 'hold and love' investments: These are venture capital and private equity investments that are held indefinitely. As we predicted, this category grew in FY18 and several large investors are now attracted to them because of cost, tax and carry efficiencies. This has necessitated the development of new fund structure technologies to provide an incentive to general partners. It also ensures they are rewarded in situations where the investment has performed well and the investor wants to continue to hold it.

Debt funds and hedging – conundrum solved!

With alternative debt funds winning an ever-increasing market share in FY18, a conundrum can arise if one of the debt terms requires the floating interest rate exposure to be hedged. This occurs where term debt is the only debt required and is being provided by the fund on a secured basis. Under a traditional senior debt facility or even a super senior revolving facility, one or more of the lenders will also be keen to provide hedging. This will typically involve an interest rate swap, with the potential for credit exposure on the borrower should the swap move out of the money. Pricing for this risk (or the 'credit margin') will be built into the price of the swap quoted by the hedge counterparty and the resulting credit exposure will be secured alongside the senior facilities on an equal basis.

When only alternative debt funds are providing the debt, an issue arises because they do not traditionally provide hedging products. Borrowers can find it hard to persuade a hedge counterparty that is not participating in the term debt to get its head around the security structure and to share in the security when its overall participation in the transaction is small.

The solution is an interest rate cap, which traditional hedge counterparties would provide. The borrower pays an upfront premium in return for the hedge counterparty being responsible for any increase in the floating rate exposure above an agreed cap. Because the borrower pays for the product upfront, the hedge counterparty carries no credit exposure on the borrower and does not need to be secured. The lower the cap and/or the longer the period of cover, the higher the premium. Under its base case modelling, the debt fund will need to be comfortable that the borrower can manage any increase in the floating interest rate before the cap is reached and the hedging provides cover. The biggest downside for the borrower is that it must meet the cost of the hedging upfront. However, it can weigh this cost against the benefit of the debt fund terms, which is often attractive.

> "The solution is an interest rate cap"

Mezzanine loans are back

In the years following the global financial crisis, senior loan spreads widened to the extent that lenders were no longer incentivised to provide mezzanine (mezz) loans at the operating company level. The resulting vacuum was filled by specialised debt funds providing structurally subordinate, and more expensive, mezz loans at the holding company level. Under this latter type of loan, the mezz lender is not restricted by the senior lenders when it comes to enforcing mezz security (over the holding company); nor do senior lenders have restrictions on as many terms of the mezz loan. Rather, it is a case of 'never the two shall meet'. There are no contractual intercreditor terms between the two sets of lenders, only structural subordination, which ensures senior debt gets paid out first on any enforcement.

With senior loan spreads contracting in FY18, lenders are once again searching for higher yields at the operating company level, so it is back to the future with senior/mezz intercreditor terms. But the space has largely been filled by the debt funds that were providing the mezz holding company loans (together with super funds and family offices). Given those debt funds became used to not being restricted on enforcement or loan terms when providing a mezz holding company loan, it is not surprising they have pushed intercreditor terms in their favour at the mezz operating company level. Some of the top concessions, compared to the industry-wide intercreditor principles that some banks circulated just after the global financial crisis, include:

- **more open payment gateways that can be paid to mezz without restriction, including mezz work fees on a debt restructure, which are sometimes subject to a cap**
- **narrowing the gap between any senior suspension of a financial covenant and the equivalent mezzanine covenant, to reduce the chance that mezz interest payments will be suspended**
- **a cap on the number of times senior can stop cash interest payments to mezz if a senior event of default has occurred (for example, a limit on the number of 'stop notices' that can be issued)**
- **restrictions on senior lenders issuing successive stop notices in respect of other senior financial covenant breaches, in some circumstances**
- **a shortening of the mezz enforcement standstill period, to as short as 120 days for payment defaults and insolvency events and 10 days if payment to mezz is unrestricted and not paid**

> "It is back to the future with senior/mezz intercreditor terms"

TOP 3 ISSUES FOR FUND STRUCTURING

Australia's taxation environment continues to evolve and private equity funds are not immune to having to ensure certainty for investors. Achieving that certainty will remain a challenge, particularly given that many key Australian tax regulatory issues regarding fund structuring remain unresolved. The following are hot topics for private equity managers and investors, relating to fund structuring and transactions for the year ahead. We hope to see them all resolved by mid next year.

ATO reporting requirements for large companies

The ATO's Streamlined Assurance Review program, which aims to ensure Australia's 1,000 largest corporate taxpayers are reporting the right amount of income tax, is relevant to larger private equity portfolio companies or targets. For portfolio companies that fall within this category, the ATO will likely seek significant amounts of information in connection with the target's effective tax rate over several years. This may extend to periods prior to private equity ownership. Private equity managers should ensure that senior management teams at portfolio companies are adequately resourced to deal with the ATO's often tight reporting deadlines.

Don't forget stamp duty!

The ongoing requirement to pay stamp duty, or more specifically landholder duty, remains a source of exposure in surprising transaction scenarios. Private equity managers need to model these obligations to ensure certainty of funding for the duty amount. Further exemptions to stamp duty, such as the 'primary producer exemption', which exists in certain states, should also be considered by governments. This is particularly important given that private equity is now looking to agribusiness as investment opportunities.

1. The evolving meaning of 'control'

The Australian Taxation Office's (ATO's) draft Privatisation and Infrastructure – Australian tax framework document (originally published in January 2017) does not specifically focus on the Australian private equity industry. However, its views on what constitutes 'control' of trading businesses for the purposes of the public trading trust rules (which are an integrity measure) are highly informative for Australian private equity managers. This is vital as private equity managers seek to maintain the expected 'flow through' and deemed capital account status for the managed investment trust vehicles they have used to house investors.

Broadly, the ATO considers that control is not confined to objective concepts such as the percentage of economic ownership. Instead, it may extend to circumstances where various fund vehicles act together or have 'veto' rights in connection with the ongoing business decision-making of a trading enterprise.

Many aspects of the ATO's approach are considered to be inconsistent with the longstanding industry approach (both in private equity and other industries such as infrastructure and property). Private equity managers should be comparing their existing arrangements with the current draft ATO views, pending their finalisation.

2. Taxation of limited partnerships

Australia is a global outlier in how it taxes limited partnerships. The Federal Court's decision in *Resource Capital Fund IV LP v Commissioner of Taxation*, handed down in February 2018, departed significantly from industry and ATO practice. It found broadly that limited partnerships are not taxable entities; rather the partners are taxable and those who reside in a treaty jurisdiction may be entitled to treaty protection.

The decision is widely considered to be inconsistent with the law, the ATO's concessional position for foreign limited partnerships, and current industry practice. An appeal is currently being considered by the Full Court of the Federal Court.

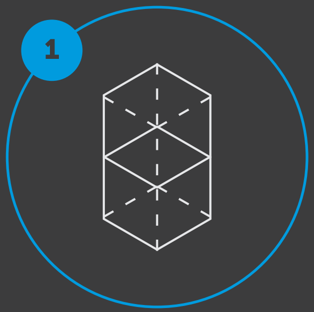
In the interim, the ATO has not withdrawn its concessional ruling issued in 2011. This states that general partners of limited partnerships should seek specific advice, having regard to their own circumstances and the extent that an exit is planned in the near future. They should also engage early with the ATO to obtain a degree of certainty on the likely Australian taxation outcomes upon exit.

3. Scope of multinational anti-avoidance legislation

Australia's multinational anti-avoidance legislation applies to 'significant global entities'. Under the current definition, this means either global parent entities or a member of a group headed by a public company or a private company that is required to prepare consolidated financial statements, and has an annual global turnover exceeding A$1 billion. In FY18, the Australian Government announced that the definition would be broadened to include members of large multinational groups headed by private companies, trusts, partnerships and – critically for the private equity industry – so-called 'investment entities'. This is also relevant for foreign cornerstone investors who take controlling stakes in Australian assets that are managed by private equity.

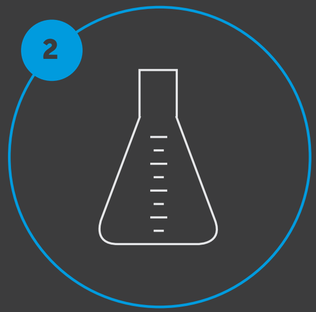
As with all inbound structuring, private equity managers and investors should consider the full kaleidoscope of Australian taxation issues upfront as part of their transaction planning. These issues will inevitably emerge during the ATO's review of the Foreign Investment Review Board application process.

TOP 4 TAX ISSUES FOR TRANSACTIONS



STRUCTURING RISKS

Private equity managers should be wary of structural risks associated with investing in the typical small and medium-sized enterprise market. Vendors with structuring arrangements that appear to lack a dominant commercial purpose present a red flag to transacting. Accordingly, understanding the legacy tax risks associated with unwinding such arrangements as part of pre-transaction planning should be made the subject of full due diligence.



IMPROPER RESEARCH AND DEVELOPMENT CLAIMS

Improper research and development claims made by targets frequently emerge during due diligence activities. Given the cash tax impact, private equity managers should plan steps to mitigate this risk (where identified) in advance of acquisitions.

NON-COMPLIANCE WITH EMPLOYMENT TAXES

Another surprising risk that continues to emerge is the target's poor compliance with employment taxes, including both payroll tax and fringe benefits tax. The definition of who constitutes an 'employee' in the context of the 'gig' economy presents unique qualitative challenges that can quickly become material.

SHORTCOMINGS IN TAX GOVERNANCE

Poor tax governance is often evidenced by the inability of senior management to adequately explain the effective tax rate of the target. This remains an issue as the ATO's expectations in this regard have changed in recent years.

SOME OF OUR RECENT WORK

ADAMANTEM CAPITAL Investments in **HyGain**, **Mitavite** and **Servian**	ADVENT PARTNERS Investment in **SILK Laser Clinics** and fundraising for **Advent Partners 2 Fund**	AFFINITY EQUITY PARTNERS Confidential transactions	Allegro Acquisitions of **Endeavour Learning Group** and **Everest Ice Cream**	ARMITAGE ASSOCIATES Investments in **Sentral Education, BlueFit Group**, **Iron Capital** and **Nuix**	American Industrial Partners Acquisition of **CQMS Razer**	Anchorage Capital Partners Acquisitions of **South Pacific Laundry** and **Contract Resources** and exit from **Acrow**
BainCapital Acquisition of **Little Learnings** and investment in **Hirepool Group**	Blackstone Acquisition of **La Trobe Financial**	BRIDGEPORT CAPITAL Confidential transactions	CDH INVESTMENTS 鼎晖投资 Acquisition of **Sirtex Medical Limited**	CITIC CAPITAL 中信資本 Acquisition of **Trilogy International Limited**	mercury capital Investment in **MessageMedia** and fundraising for **Mercury Capital 3 Fund**	NEXTCAPITAL Exits from **Infinite Aged Care** and **Forest Coach Lines**
OPTrust Confidential transactions	PALLADIUM EQUITY PARTNERS Acquisition of **Kymera International**	Pemba Capital Partners Acquisitions of **Smart Trade International Limited** and **Elearning Australia Pty Ltd**	QUADRANT PRIVATE EQUITY Fundraising for **Quadrant Private Equity Fund 6**	ROC PARTNERS / WATTLE HILL RHC FUNDS Acquisition of **Capilano Honey Limited**	ROC PARTNERS / first state super Acquisition of **ProTen Limited**	Yorkway Co-investment in **Fitzpatricks Private Wealth** and **Retirement Victoria** and investment in **Insurance House**