EYES ON WORLD MARKETS

Europe

"Emergers" & Acquisitions:
Deals Still Flow East

Levered Best:
Risk/Reward Balance

Tour(ism) de Force:
Opportunities in the Region

Tax Assessment

Euro Deal Flow

A supplement of
The Deal
CUSTOM MEDIA

Summer 2007

EYES ON WORLD MARKETS

Europe

CONTENTS

Publisher's Letter

Dear Readers,

We are again pleased to present this latest issue of *The Deal's Eyes on World Markets*, a series of special supplements exploring dealmaking activity and trends in converging and emerging markets worldwide, produced by The Deal LLC's Custom Media division. This issue of *Eyes on World Markets* explores the significant investment trends and issues in Europe, and most specifically in so-called Emerging Europe.

As we continue headlong into a raging European bull market for mergers and acquisitions, there are cautionary signs ahead. Many see subtle indications that M&A and private equity activity has peaked, and whether we are in for a soft landing or a more wrenching downturn will be a critical question for dealmakers in the months ahead.

Our first article in this supplement provides a brief overview of the booming European market for mergers and acquisitions and explores the maturing of Emerging Europe, where some of the historical gaps between East and West are closing. Investors looking to avoid the inevitable downturn as the European bull runs its course should find opportunities in Central and Eastern Europe (CEE).

Few have uncovered as many opportunities in the region as Peter Goldscheider, who founded the European Privitisation & Investment Corporation nearly two decades ago to help structure the former Soviet block's transformation from communism to capitalism. In a candid Q&A, he identifies opportunities and keys to finding emerging-market returns in this maturing region.

Next, we explore the growing market for leveraged finance in Emerging Europe, where bankers and M&A practitioners see credit standards and deal structures becoming more like the West without the overheated aggressiveness that have some bracing for downturn.

One emerging industry that has plenty of room to run is travel and tourism, where the southeastern corner of the continent, in particular, offers Europeans alternatives to $500 hotel rooms and $10 cappuccinos. We look at the Balkans and its Mediterranean jewel, Croatia, which won the lion's share of the coastline in the breakup of the former Yugoslavia, where the boom still has legs.

As if you needed more reasons to look to East, we note that the current negative spotlight on private equity's tax treatment started in London rather than Washington. Our look at whether London's role as a European and global hub of high finance could be threatened by the specter of higher taxes on investment partnerships includes a sidebar on the Germans, who have their own lobbying effort underway to win simpler tax treatment across all forms of private equity, and don't like what they see across the Atlantic or the English Channel.

Finally, data, compiled by PricewaterhouseCoopers, shows the European deal flow, including in CEE, is on pace to reach all-time highs in 2007, fueling the increasingly conventional wisdom that a peak may be in sight.

We hope this issue of *Eyes on World Markets* helps prepare dealmakers throughout the globe foresee and profit from Emerging Europe's endless opportunities. In addition, I would like to thank all our expert contributors who make this a comprehensive overview of dealmaking in this promising region.

Sincerely,

Lisa Balter

Lisa Balter
VP Publisher, International and Custom Media, The Deal LLC

The Deal CUSTOM MEDIA

Eyes on World Markets: Europe is a **sponsored supplement** produced by the Custom Media division of The Deal LLC.
105 Madison Avenue, New York, NY 10016
107– 111 Fleet Street, London England EC4A 2AB
www.TheDeal.com

VP Publisher, International and Custom Media: Lisa Balter
European Sales: Graeme McQueen, Managing Director
Editor & Writer: Rob Garretson
Editor & Project Manager: Marielena Santana; Project Manager: Mark Bailey
Design & Production: Paul Colin, Cezanne Studio
For more information on The Deal's custom media supplements and reports,
contact Lisa Balter at +1.212.313.9326 or email lbalter@TheDeal.com

As some see an end to the raging bull market in European M&A, the smart money continues to look east toward Emerging Europe.

"Emergers" & Acquisitions

There is little doubt that the European market for mergers, acquisitions and private equity investments is enjoying a bull run of historic proportions. Last year more than 12,900 publicly disclosed transactions across Europe totaled more than $1.6 trillion in value, according to figures compiled by PricewaterhouseCoopers. Though the countries of Central and Eastern Europe (CEE) still account for a single digit percentage of those deals–reaching 1,760 transactions valued at more than $95 billion in 2006–their growth is on a similar trajectory and the gap in the average deal value continues, in general, to shrink.

The region commonly called Emerging Europe includes the former Eastern block countries of Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Bulgaria and Romania, plus the Baltic states of Estonia, Latvia and Lithuania, all of which gained European Union membership within the past three years. It also includes EU candidates Croatia, Macedonia and Turkey, plus Russia, Ukraine and other former Soviet republics.

A key driver of Emerging Europe's sustained success over the past 10 years has been the process of integration with the European Union, according to the International Monetary Fund's 2007 World Economic Outlook report. This enlargement process has brought huge economic benefits to the new member countries, both by opening up new trade and investment opportunities and by anchoring macroeconomic and institutional reforms. Over the past 10 years, GDP growth in these countries has averaged around 5 percent, supported by rapid increases in total factor productivity, raising per capita income levels closer to the EU average.

"Commercial real estate is screaming hot," says Ken Lefkowitz, managing partner of New Europe Corporate Advisory (NECA), a corporate finance and consulting boutique based in Sofia, Bulgaria. "Energy and infrastructure is getting attention, along with consumer-oriented sectors, especially food and beverage distribution, because southeast European markets are growing extremely fast. Purchasing power is also growing fast."

There's also an "EU ascension play," attracting investors into markets where the perceived country risks have dropped by virtue of EU membership. "There's also an index effect, as well," Lefkowitz adds. "Now that we're in the European Union, companies or investors who wouldn't have invested before can now 'tick the box' and look at us."

Aside from the current economic boom, the Emerging European markets hold other attractions for investors, notes Peter Goldscheider, managing partner of the Vienna-based European Privatisation & Investment Corporation. (See sidebar, next page.) "For many people it's diversifying your portfolio, and for Europeans, it's something which they understand well, where they don't have so many cultural problems," he says. "And they are young economies–young also as far as population ages is concerned," noting that Turkey, in particular, has a youthful demographic profile. "It's one of the youngest countries you can find in the world. And that plays a big role."

Yet because of the relatively small size of the markets, companies and resulting deals, Emerging Europe has yet to attract the European and global private equity giants, keeping it a relative greenfield for mid-market players with the local connections to find the deals.

"Private equity is starting to make an impact. The big players, not so much," Goldscheider says, noting that the KKRs and the Blackstones of the world only look at deals with values of 500 million and above. "There are no deals of that size in the region," he says. "But in the field of 10 million to 50 million, some up to 100 million, private equity plays a big role."

EAST MEETS BEST

A conversation with privatization pioneer Peter Goldscheider, founding partner of the European Privatisation & Investment Corp.

Since he and his partner, Gustav Wurmböck, founded the European Privatisation & Investment Corp. (EPIC) in 1989, Peter Goldscheider has earned a reputation as the as the investment banker to Emerging Europe. A Vienna-based lawyer by training, Goldscheider, in the 1990s, helped structure Eastern Europe's transformation from communism to capitalism. His key innovation was a voucher buyback system that brought liquidity to government privatization efforts and speed to the restructuring of ailing companies, first in the Czech Republic and then across Central and Eastern Europe. Now EPIC's investment banking and advisory business may soon be eclipsed by its own private equity investments in assets throughout the region—Romania Cable Systems; Valamar Hotels & Resorts and Iskon Internet in Croatia; KDK Cable Co. and Atlas Internet Portal in the Czech Republic; and Slovakian construction company, LSH, just to name a few. Rob Garretson speaks to Goldscheider about how these once-emerging markets have matured and where the opportunities still exist for emerging-market returns in Europe.

Q: Where is the smart money—presumably yours—and best opportunities for M&A and private equity among the Emerging European countries?
Peter Goldscheider: Southeast Europe clearly is very hot at the moment–Croatia, Serbia, Bosnia. Turkey, which is obviously not post communist, is enjoying a big, big boom as well, and, as far as we can see, has long-term potential. Ukraine, not withstanding the political problems, is very interesting from a commercial point of view, and will go places. It is really following suit with Russian development. The other markets are getting quite normal—the Czech Republic, Poland, Hungary—these are [European Union] members and are no longer so much emerging markets.

Q: Is leverage becoming more important in these maturing markets as the economies mature and become more like the West?
Goldscheider: Yes, because the sensitivity for deals is the margins. There are lower risk factors, and obviously when you have lower risk factors, you have lower margins. So the leverage factor becomes very important. You cannot load private equity deals as much as we used to see in those countries.

Q: How about in those still-emerging markets to the east and south?
Goldscheider: There's such a wide gap on interest rates [in those markets] that people are ready to swallow rates that we haven't seen in the U.S. or Europe for a long, long while–13 to 15 percent interest rates–so their junk is *real* junk, [laughs] like it used to be in the good old days.

Q: Who's providing the debt for those deals?
Goldscheider: The big commercial banks—mostly European—but Citi is very much plugged into Central and Eastern Europe as a lender as well.

Q: And how is the debt structured, compared with the West?
Goldscheider: This is done very traditionally, so 20 percent equity, 80 percent debt, from different layers and mezzanine and everything. It's pretty straightforward. What you'd expect. About 20-80 and a good mix between short-term, long-term and mezzanine.

Q: And the multiple you expect, compared with the West?
Goldscheider: This depends, obviously, on country risk. Discount factors are different in Romania and Bulgaria than in Austria, for instance. So there's still some premium on the emerging market situation and risk factors.

Q: What are the hot sectors?
Goldscheider: Emerging markets follow certain rules, and the first wave is always asset driven—like, cement and assets in the ground that you cannot lose if the economies develop. Then consumer products, cable television and media assets. Then you follow with everything that is new economy. Some of those countries are very far ahead on infrastructure, because when you start from scratch, you can jump over one or two generations of technology, and then go to triple play [of bundled cable TV, phone and Internet access] immediately.

Q: What are some examples?
Goldscheider: One of the hottest companies we co-own—with one of the Soros funds—is Romania Cable. Everybody wants to buy it. We've considered an [initial public offering]. All the big [investment banks] wanted to do the IPO. This is a real success story.

Q: And there's sufficient disposable income in these countries for such spending on consumer goods and entertainment?
Goldscheider: First of all, there is still, in some of those countries, a lot of income that is not taxed fully. So the tax system has to develop over the years. And second, the big, big difference kicks in when there is a middle class that can support [such things].

Q: Other hot industries?
Goldscheider: Tourism and real estate. We have so much pent up demand in real estate. Everything that has to do with mortgages, everything that has to do with consumer lending and consumer finance, is very hot.

Q: Yet no concern about a real estate bubble or sub-prime mortgage lending?
Goldscheider: Not yet. We don't have the same debt ratios as in the U.S. We don't have the same credit card situation—with so many people unable to pay their installments. There, the U.S. is really … [laughs] … leading as you know. We don't have this generation using seven or eight credit cards or debit cards, as in the U.S. People haven't become so artistic yet in that field.

Q: So credit standards have remained high?
Goldscheider: Absolutely. The banks are quite ridged, and still the economy is booming.

Q: What are some of the keys to investing across this relatively disparate region?
Goldscheider: That [diversity] is the big advantage for us, because we have people from all those countries. So it's easier for us [than] for Americans—they are used to having one language in the country. For us this is normality; we don't face any language barriers. Our company language is English, but we have native speakers in all those countries. We are a multi-domestic network of local companies. So we're really a network, a very decentralized network. Because to do business in Slovenia and the Ukraine is very different. You focus on very different activities even. You cannot operate the same in all those countries. You have to be very flexible. And because of our lean structure, we can be very flexible and very decentralized. We are seen, from a cultural point of view, as local players. We're seen as a Czech company in the Czech Republic, as a Hungarian company in Hungary, and so on, which give us earlier access to deal flow than most of the foreign banks.

Q: Yet you manage your portfolio coherently across this decentralized structure?
Goldscheider: I hope so … [laughs] … the returns are speaking for themselves. I think we're quite good managers, and we're quite competitive. And today our investments may be even more important than our consultancy business. We're more a merchant bank than a pure adviser or an investment bank.

Western-style leveraged financing is taking hold in Emerging Europe, adding liquidity to a maturing M&A landscape.

Levered Best

A decade ago, financial crisis erupted in the emerging markets of Asia, spreading rapidly to Russia and around the globe to Latin America. The causes of the 1997 Asian financial crisis are still debated today, but most experts agree that a major contributor was the lack of local currency financing in the emerging markets–principally Thailand and Indonesia –that added currency risk to already incendiary financial conditions. There is no such threat hanging over Emerging Europe today, even as signs of a potential leveraged finance bubble appear across the continent's burgeoning market for mergers, acquisitions and private equity investments.

Despite the spread of loose credit and more aggressive financing across Europe, bankers and financiers throughout Central and Eastern Europe (CEE) see no cause for alarm. Just the opposite; most say that financing–now dominated by the big European banks that in recent years have swallowed most of the locals–remains solid; much of it is available in domestic currencies or Euros, keeping risk profiles manageable.

"You have a real consolidation in banking," says Peter Goldscheider, co-founder and managing partner of the Vienna-based European Privatisation & Investment Corporation (EPIC). (Also see sidebar, page 5). "You have one Hungarian bank that is still independent, OTP [Bank plc]. But in most countries, all the big lenders have been taken over by European banks–Raiffeisen, HSBC, UniCredit, are examples."

The ratios of debt to equity for M&A deals in most of Emerging Europe are extremely consistent with those in the West, says Michal Dlouhý, a partner in the Prague office of law firm White & Case LLP, who specializes in private equity, M&A, privatization, securitization and restructuring transactions. "This may be the high-water mark, but certainly this year has been going very strong. And virtually every M&A deal is leveraged there, as it is [in the West]."

Dlouhý cites the increased availability of local currency financing, which offers lower rates and less foreign exchange risk on the investment, as a key factor in spurring M&A and private equity investments in the region. "For the local banks–they're not really local banks, they're the local branches of the European banks–they will offer either domestic currency financing or basically Euro financing for the acquisitions," he notes. "If the revenues are in local currency, you don't have the exchange risk."

"Eastern Europe has become almost boringly similar to the rest of the world," agrees Klaus Requat, co-head of UniCredit Group's EEMEA Investment Banking unit (formerly Creditanstalt Investment Bank, or CA IB.) "You can run the secondary and tertiary leveraged deals. You can run them at the classic loan structures. There's no more difference. The main difference originally was that such financing didn't take place at all."

Bubble Trouble?

Dealmakers throughout the region see Central and Eastern Europe as the best of both worlds: booming markets that are awash with available credit yet still offer emerging market opportunities for those with the patience and local connections to find them. Though the ascendance of the big European banks has made financing easier, the markets are not yet getting out of control as they seem to be in the West. The European leveraged finance market is an unsustainable bubble, according to nearly 60 percent of respondents in a new White & Case survey out of London, though nearly 70 percent said there is room for further increases in the debt multiples being employed in European buyouts.

"Like all bull runs, there will have to be a slowdown at some point," notes Mike Goetz, co-head of White & Case's London-based European leveraged finance team. "What is unclear is when this will happen, what will trigger it and how rapidly the brakes will be applied."

Ninety-seven percent of survey respondents, which polled senior figures at banks and private equity firms as well as turnaround specialists, believe the current bull run of acquisitions will continue for at least the next six months, with the same percentage thinking leveraged lending volumes will continue to either increase or remain steady during the same period. Yet most of the froth in the market remains in the West, where more than 12,900 publicly disclosed M&A transactions hit more than $1.5 trillion in value in 2006, compared to 1,760 deals valued at $95.3 billion in Eastern and Central Europe last year.

"For Bulgaria and the rest of the region as well, acquisition finance is a quite a new product," notes Ken Lefkowitz, managing partner of New Europe Corporate Advisory (NECA), a Sofia-based corporate finance and consulting boutique that is part of the EPIC network. "And there's a relative dearth of private equity deals here, simply because it's difficult to find local entrepreneurs who like that kind of structure and understand it and want to play that way."

Despite Bulgaria and Romania's ascension into the EU in January, Bulgaria's lending standards remain tight, and the market for acquisition finance is far from saturated. "Companies in general are not overleveraged here," Lefkowitz notes, describing a recent attempt by a Bulgarian manufacturing company he represents to buy a competitor in the U.K. "The Bulgarian bank didn't understand that deal at all. We went to London, and even there it was too much of a stretch for them," he says. "Our client wanted to reach too far, and we just couldn't put it together."

The emerging markets have yet to see the rampant growth of high yield, mezzanine and second-lien financings that are growing in popularity in the West, yet are untested in many European jurisdictions and could cause problems at the turn of the current credit cycle, experts warn.

Banking sectors in Emerging Europe "appear relatively sound, with adequate capitalization, solid profitability and good asset quality," notes the most recent Global Financial Stability (GFSR) report published by the International Monetary Fund in April. "Strong macroeconomic performance and the expansion of foreign financing continue to support buoyant lending to the private sector in most countries."

"When you do an acquisition, the local branches are there because they have a certain allowable credit exposure to the local market, which maybe the headquarters won't have," notes Lefkowitz, "but the real know-how you're going to find is in Vienna or Athens or London or wherever. There aren't many bankers locally who are doing leveraged finance."

Though its annual growth rate over the past five years has been close to 16 percent, total assets of banks operating in the entire CEE region amounted to only 846 billion Euro last year, notes Dr. Herbert Stepic, CEO of Raiffeisen International. Yet that region-wide total is only slightly more than half the total assets of a single bank–albeit the world's largest–London's Barclays Bank at 1.592 billion Euro. That leaves plenty of room for growth, he says, projecting total banking assets in CEE will grow by nearly 18 percent annually, reaching 3.717 billion Euro by 2014.

"The promotion of international integration is among the important functions international banks can contribute to the development of emerging economies . . . both with regards to foreign investments as well as promoting international trade," Stepic says. "Could be that I am not objective in this matter, but I consider CEE as the most important banking market in the world."

Tour(ism) de Force

Opportunities in the Region

To many investors, tourism in Emerging Europe evokes images of Bulgaria, where the influx of foreign investment has led to spiraling real estate prices among the Black Sea resorts and increasingly in the scenic mountains. Though Bulgaria may have a legitimate claim to the unofficial title of "The New Spain," a lot of smart money is looking west.

The Balkan states, particularly Croatia with its 6,000 kilometers/1,000 miles of unspoiled and underdeveloped coastline and its pending ascension into the EU, may offer among the best returns for investors in the region. Like much of Eastern Europe, which enjoyed a post-communist boom in tourism following decades of isolation from the West, Croatia has seen steady growth over the last decade in both the number of visitors, and more importantly, the money visitors are spending. Yet while other Eastern European destinations have seen growth slow down as the decades of pent-up demand burnt off, Croatia appears to have lots of room left to run.

"Croatia, the former Yugoslavia, was always a tourism destination, however it was a cheap, mass tourism destination, with a lot of two- and three-star, low-quality and cheap properties," notes Gustav Wurmboeck, a managing partner of the European Privatisation & Investment Corp. (EPIC), who also serves as chairman of the executive board of Valamar Hotels & Resorts, Croatia's largest hospitality management company. "Of course, with the change in politics and the privatization of all of the tourism companies, this is starting to change."

Indeed, Croatia has emerged in recent years as one of Europe's fastest growing vacation destinations, with increases in international tourist arrivals climbing to 7 percent in 2005. This is compared to the European average of 4 percent and 4.5 percent for Bulgaria, according to the most recent available data from the World Tourism Organization (UNWTO). The country, which claimed the lion's share of the coastline in the breakup of the former Yugoslavia, boasts a broad range of attractions, including the Istrian peninsula in the north, described by some as "the new Tuscany," with its impressive coastline and traditional stone houses. In the south is the picturesque medieval walled city of Dubrovnik, with its steep cobbled streets and splendid squares, churches and palaces. Yet Dubrovnik grows more expensive as its popularity grows. In between and less expensive is the Dalmatian coast, sporting more than 1,000 islands, islets and reefs.

"We have a lot of competitive advantages," boasts Wurmboeck. "In the northern part of Croatia, especially in Istria, you can drive there in your car from anywhere in central Europe." In addition to its overall economic boom in Croatia and political stability that has improved as it prepares for ascension into the EU, the ongoing privatization of assets and basic infrastructure improvements provides the foundation for growth in tourism. "The roads and highways have improved. So you'll be there from Italy and Austria in three hours and from Germany in six to seven hours," he notes. "The travel time is much shorter than it used to be and more comfortable. You don't have to deal with crowded airports and flights at night."

Untapped Potential

Aside from the natural beauty–the coastline, a Mediterranean climate, mountains, lakes, forests and abundant wildlife–what creates opportunity for investments is the yet-untapped potential. "The coast is still very beautiful and has crystal clear water," Wurmboeck says. "But it's not as overbuilt as Spain, where you have three, four, five rows of awful apartments. Or in some parts of Italy, where you have sand, but you don't have the nice blue sea."

Indeed, the demand for hotel accommodation currently outstrips supply, and the supply of Western-quality facilities lags even further, as the government's privatization of hotels remains on hold with 14 troubled properties still on the block. Although it's important for the government to find buyers for the 14 remaining state-owned companies, says Deputy Prime Minister Damir Polancec, the process is on hold due to the recent corruption scandal in the Croatian Privatization Fund. All of the properties have major problems and need loans to pay salaries, he says, and as such they are harder to sell. The only alternative to sale is bankruptcy, he adds, which the government obviously wants to avoid.

Other challenges–which pose both risks and opportunities for investors–include the lack of some leisure infrastructure that Westerners may take for granted, and lingering legal problems for outside investors gaining clear title to property.

"Of course, we would like to have more support on the political level for the tourism industry, so that even more and faster investments can be made," Wurmboeck laments. "More of the infrastructure needs to be improved; we still we have no golf courses." Difficulties gaining clear title to property have prevented some foreign investors from investing additional money into upgrading facilities, he adds.

EPIC invested in Valamar more than 10 years ago, in the early days of its government privatization. A pioneer in facilitating the divestiture of government-owned companies and assets when it was founded in 1989, EPIC bought out most of its local partners to take a controlling interest in the company two years ago. Valamar now operates a total of 40 tourist properties on the Adriatic coast, including more than 20 hotels, eight apartment villages and nine campsites.

Wurmboeck says he has his hands full trying to maximize the value of EPIC's assets in Croatia and isn't necessarily looking to expand its tourism footprint in other Eastern Europen countries within the next three to five years. "In other countries like Montenegro, we have missed the opportunity to buy cheap," he adds, and investors may have to look as far south as Albania for bargains.

Land-Locked

Yet another former Yugoslav republic, Macedonia, may also be a solid bet for investors. Also on track to join the EU and with many of the same attributes–and challenges–as its Eastern European neighbors, Macedonia is making a big push to grow its tourism industry, despite its land-locked status.

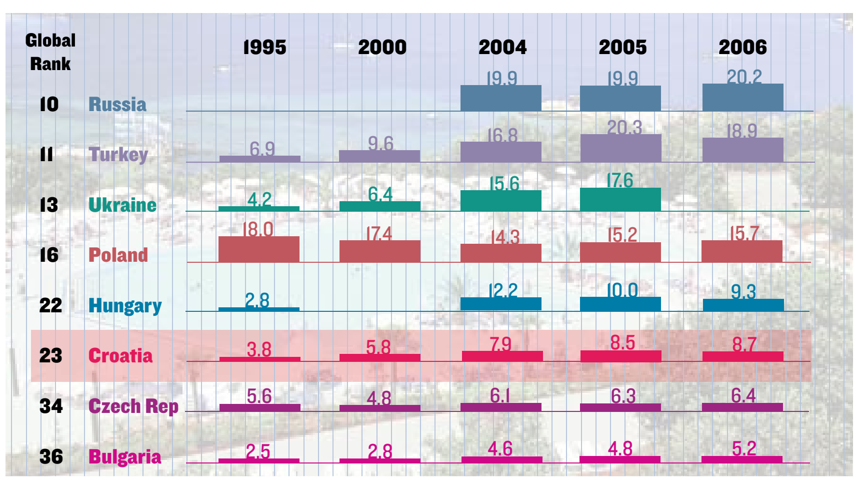
"We do not have sea access, but we do have lakes," notes CEO of Invest Macedonia, Viktor Mizo. "And as you know, lake tourism is the highest value-added tourism, whether it's the Finger Lakes in upstate New York or the lakes in Switzerland and northern Italy."

Macedonia last month awarded a contract to Austria's Soravia Group to build a Hilton hotel on the shores of Lake Ohrid, Europe's oldest lake and one of the oldest in the world. In addition to the beauty of its lakes, Macedonian tourism draws on the ancient history of the region, said to be the cradle of the Slavic civilization where the Cyrillic alphabet was invented.

"We're looking at our lakes and the history and culture in the country, from the time of Alexander the Great and the Byzantine Roman Empire," Mizo says, noting that many of the country's churches and monuments are between 2,500 and 3,000 years old. "We really have a lot to show and offer," he adds, "It's a type of cultural tourism, rather than just a regular vacation on the beach that the Caribbean would offer."

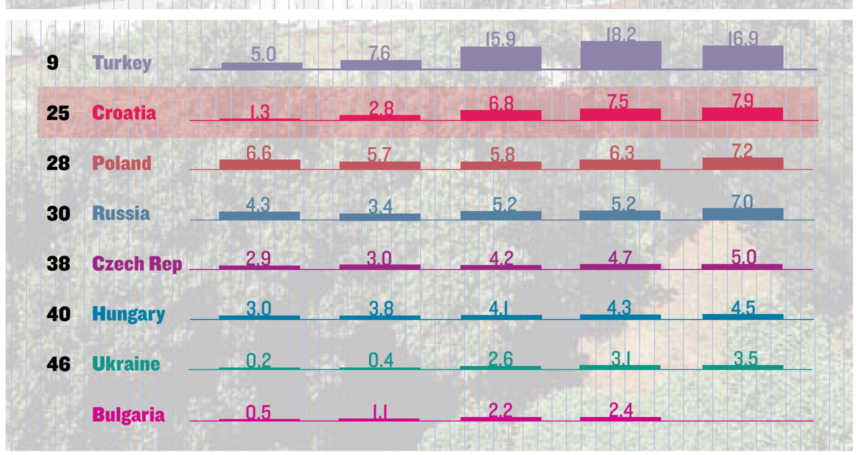
International Tourist Arrivals by Country of Destination

Though it remains in the bottom third among CEE countries in tourist arrivals, . . .



International Tourist Receipts by Country of Destination (US$, millions)

Croatia has passed all but Turkey in the value of its tourism receipts.



Source: World Tourism Organization (WNWTO), June 2007

Tax Assessment

Could a Tax Hike on Private Equity Threaten Europe's Financial Hub?

Last month the U.S. Senate Finance Committee fired a warning shot across private equity giants Blackstone and KKR as they prepared to sell shares to the public. A bi-partisan bill to end favorable tax treatment of carried interest–initially aimed only at firms that go public but soon joined by a broader House measure targeting most investment partnerships–wasn't exactly the shot heard 'round the world.

Unlike in the U.S., where politicians taking aim at buyout firms is a relatively recent phenomenon, the tax assault on private equity in Britain has been heating up for months. Since March, the U.K. government has been conducting a far-reaching review of the tax treatment of private equity, and recently even some industry heavyweights, along with both the outgoing and newly appointed prime ministers, have joined the chorus calling for higher taxes on private equity and fund executives.

And while the political heat has been drawn by the giant buyout firms and some of the mammoth transactions that have entered the pipeline in recent months, the fallout could be far-reaching across the entire industry, including the mid-market, hedge fund managers and virtually all investment partnerships.

"The worry is that a tax regime that's been … a tremendous success in driving enterprise and entrepreneurship doesn't just apply to private equity, it applies to 4 million enterprises across the whole U.K.," said Jeremy Hand, vice-chairman of the British Private Equity and Venture Capital Association, on a BBC Radio interview last month. "The risk is that ... the attention on a few very big deals and a few very wealthy people is so intense that the baby gets thrown out with the bathwater."

Among the key issues, of course, is the tax rate buyout firms and their top executives pay on carried interest, the typically 20 percent slice of profits they retain after paying investors. Taxed as capital gains rather than corporate or personal income, the rate in the U.K. dips–known as "taper relief"–to 10 percent for gains, held for at least two years. That compares to a top U.K. tax bracket of 40 percent. Though private equity is credited with helping stimulate Europe's most vibrant economy, its growth in recent years along with its acquisition of some of the U.K.'s largest companies has made it a tempting target. The current assault, led by the labor union GMB, has raised fears of job cuts and over-leverage as well as the specter of tax inequity.

None other than Sir Ronald Cohen, the founder of Britain's first venture capital firm, Apax, added his voice last month to the calls for tax-law changes when he told the *Financial Times* that partners in the largest funds should pay more tax. His comments echoed the widely quoted and eyebrow-raising statements by Nicholas Ferguson, chairman of SVG Capital and a founding partner of the firm that became Permira, Europe's largest private equity fund. Ferguson's comments, vilified by other private equity executives, decried the fairness of "highly paid private equity executive paying less tax than a cleaning lady."

Then-Prime Minister Tony Blair seemed to agree, noting that "real issues" had been raised in the subsequent hearings before the Parliament's Treasury Committee, in which a who's who of buyout titans refuted criticism of private equity. He promised a conclusion to the review of private equity tax treatment before the Treasury publishes its pre-budget report in the fall. Chancellor of the Exchequer Gordon Brown, who has since succeeded Blair as prime minister, also signaled that private equity could face increased taxes, in a speech before last month's GMB conference. "We will make sure there is justice and equity in the treatment of tax arrangements in that area," he said.

The criticism of U.K. buyout firms is nothing new, but it has become more politically charged in recent months as the global giants have shopped some of Britain's largest companies. The heat was turned up after a group of funds considered a bid for the country's third-largest supermarket chain, J Sainsbury. Though that overture was rejected by the controlling family, it raised anxieties, particularly among labor. And those jitters were reinforced in April when another household name, pharmacy group Alliance Boots, was taken private by KKR.

The apparent momentum behind higher taxes on private equity–with industry luminaries Cohen and Ferguson, along with Jon Moulton, founding partner of Alchemy Partners, all seemingly siding with critics–threatens to slow investment and topple London from its perch as the top global financial center, others fear.

"Any shift in the tax system, at a time when other European countries are coming into line with the British perspective, could put the U.K. at a disadvantage," the Carlyle Group submitted in a written statement to the Treasury committee.

"Private equity is a force for good," KKR partner, Dominic Murphy, told lawmakers. "My experience of private equity is increased employment, increased investment, increased growth and superior returns to pensioners up and down the country." On his company's investment in Alliance Boots, he noted, "KKR is a patient, involved, long-term investor. We anticipate owning Boots for at least five years. We've got a very strong growth vision for Boots."

Murphy was among a small cadre of private equity executives who defended the industry at the Treasury Committee hearings, including Robert Easton, managing director of Carlyle, Damon Buffini, managing partner of Permira Advisors and Peter Taylor of Duke Street Capital. Blackstone senior managing director, David Blitzer, declined to testify, citing SEC rules requiring a quiet period following its $4.75 billion IPO last month.

Over-leverage?

The firms also addressed fears of over-leverage in LBO and M&A transactions. Citing Standard & Poor's figures, venture capital firm 3i Group noted in its written statement, that average ratios of debt to earnings in Europe have risen less than one percentage point, from 4.9 times Ebitda in 1999 to 5.8 times adjusted earnings in the fourth quarter of 2006.

Separately, the Economic Secretary to the Treasury, Ed Balls, plans to review the tax treatment of debt in highly leveraged private equity deals. He suggests that such debt is, in fact, a form of equity and questions whether dealmakers should be allowed to treat it as debt for tax purposes.

Despite his suggestion that a tax increase might be in order, newly appointed Prime Minister Brown, in his prior post as Chancellor, has been supportive of the industry, which he sees as a central component of London's role as the leading in financial services hub. Not only the firms themselves, but British banks, lawyers and accountants have profited hansomely from the £489 billion that U.K. private equity firms have already generated in deals this year.

In fact, the Global Financial Centres Index (GFCI), developed by the City of London Corporation, gives London with a slim, 5-point lead over New York as the leading financial hub globally. However, New York leads in all five criteria: people, business environment, market access, infrastructure and general competitiveness. London and New York are well ahead of the two leading Asian hubs, Hong Kong and Singapore, followed by Zurich and Frankfurt in fifth and sixth place, respectively.

For his part, SVG Capital's Ferguson dismisses the notion that private equity firms and executives will flee London in wake of tax-law changes as "scaremongering." Any fund partner who wants to live in Guernsey, the island in the English Channel that is a well-known tax haven, already can, he observes. For those residents born overseas, or who have parents born overseas, British tax law allows them to be considered "non-domiciled" so that they may avoid taxes on foreign income. This is a loophole available to many private equity partners when their original investment is made through offshore accounts.

Unlike the U.S., where sweeping tax law changes are often debated for years and easily stalled in Congress, the U.K. government has a track record of private equity tax changes that have significant impact on business. Two years ago Parliament enacted limits on the amount of debt that can be introduced into a deal from "connected parties" and the interest rate charged, which has changed the way many deals are structured, observers say.

A Taxing Situation in Germany

Opponents of a tax increase on private equity in the U.K. need look no farther than neighboring Germany for evidence that taxing carried interest as ordinary income is bad for business. For years Germany and other European countries have seen the U.K. and U.S., with their preferential tax rate for such capital gains, grab the lion's share of European private deals. Britain raised 75 billion euro ($100.8 billion), or 67 percent of the total European equity funds last year, according to the European Private Equity and Venture Capital Association (EVCA), compared to only 3 percent raised in Germany.

Although it might seem that the Germans would welcome movements across the Atlantic and the Channel to close the tax gap, private equity executives are not necessarily cheering the current backlash. Rather, they continue to lobby the German government for more favorable and consistent tax treatment across all types of private equity, not just early-stage venture funds that are the beneficiaries of newly drafted tax law. While they do so, they are not eager to be cast in the same spotlight as their British and American counterparts.

"The timing of this controversy in the U.K. and the States is very bad," said Rolf Christoph Dienst, head of BVK, the chief lobbying association for German private equity firms. "It undermines the message of our industry in Germany that we need clear and consistent tax treatment across all asset classes."

"The private equity fund industry as a major and important investor in German companies and their financial position has to carry a far too high tax burden," notes Dr. Lutz Becker, managing partner at Angermann M&A International GmbH in Hamburg, the only German member of M&A International Inc., a consortium of boutique M&A firms. Though the government has attempted to create a more hospitable environment for private equity, "pending tax laws completely fail to improve the overall situation," he adds.

German officials last month drafted a new law for venture capital that would create a more beneficial corporate structure for VC firms and allow for tax breaks when investing in startups worth up to 20 million euro ($27 million). Yet buyout firms and M&A funds get no such treatment, and the comprehensive private equity law promised when the current coalition government took office three years ago has not materialized. Though Finance Minister Peer Steinbrück, a Social Democratic, is said to be sympathetic, Labor Minister Franz Müntefering, back when he was chairman of the Social Democratic Party, reportedly referred to private equity firms as "locusts" who devour once-productive companies.

Euro Deal Flow

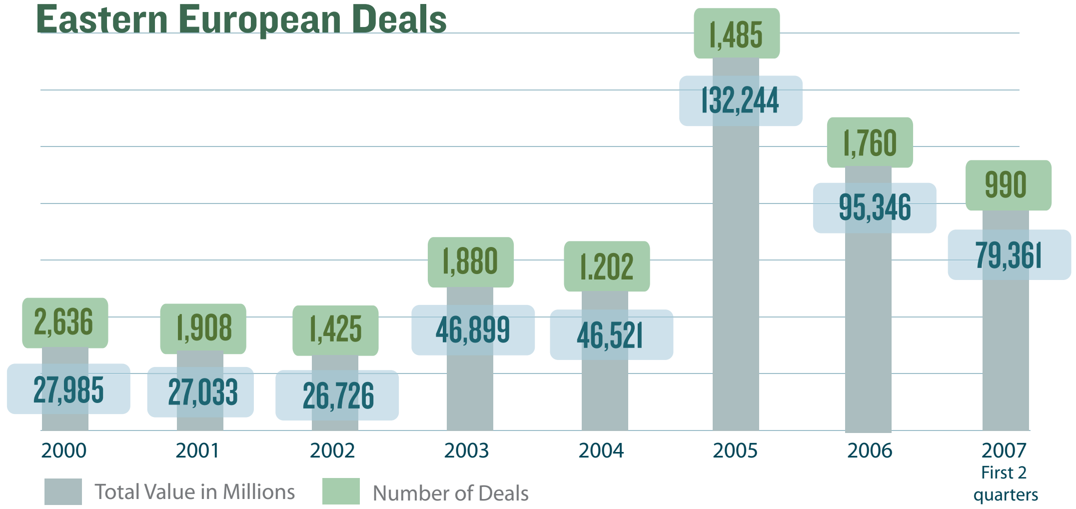
European M&A deal volume and dollar value continues on the rise. If the first two quarters of 2007 are any indication, this year could set an all-time record and provide the peak expected by some dealmakers and observers. The dollar value—if not the deal volume—of European transactions last year surpassed that of 2000 for the first time this millennium, while the value of Eastern Europe M&A deals took a breather after the tremendous spike in 2005. Yet the first two quarters of this year show Emerging Europe back on a record pace for total deal value, and the average value per deal of more than $80 million, closing the gap with the West on deal size.

Average Deal Value (in millions $US)

Year	Total Europe	Eastern Europe
2000	66.2	10.6
2001	46.1	14.2
2002	51.3	18.8
2003	54.2	24.9
2004	74.7	38.7
2005	97.9	89.1
2006	126.2	54.2
2007	160.2	80.2

Total European Deals

Eastern European Deals



Source: Data compiled by PricewaterhouseCoopers, July 2007

GOODWIN | PROCTER

The Deal

October 18, 2007

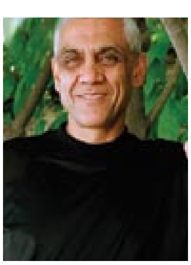
Investing in Change: Clean Energy Solutions Today and in the Future

QUADRUS Conference Center, Menlo Park, CA

2:00 pm	Registration
2:30 pm	**Vinod Khosla**
3:15 pm	Panel discussion
5:00 pm	**Jim Woolsey**
5:30 pm	Cocktail reception

Clean technology is becoming a worldwide economic opportunity.

Learn which technologies have generated substantial returns for entrepreneurs and investors and what industry experts foresee as the best investment strategies for the coming decade. Join private equity and venture capital investors as well as entrepreneurs and scientists in discussing the technology trends, government legislation and corporate successes that are affecting this rapidly growing market.



Keynote Speaker

Vinod Khosla

Khosla Ventures

Closing Speaker

Jim Woolsey

Former head of the CIA

Booz Allen Hamilton Inc.

To register go to www.goodwinprocter.com/cleanenergy.html