McDermott Will & Emery

APRIL 2015

The Use of Alternative Credit in Europe

Mark Davis and Calum Thom

As a result of the reduced availability of conventional credit from lending institutions in the wake of the financial crisis of 2008, Europe has been eager to develop an alternative credit market to unlock the demand for money from small and medium sized enterprises (SMEs). Private equity firms and corporate entities unable, or unwilling, to enter the public debt capital markets can tap into the growing private placement markets as an alternative credit source. A number of recent developments in the United Kingdom and Europe serve to illustrate an increased confidence and desire to develop strong private placement markets in these jurisdictions.

The Need for Alternative Credit

The European debt market has traditionally been dominated by corporate debt funded by banks. This is in contrast with the more flexible debt model in the United States, where alternative providers are more commonplace and the market more developed and liquid.

The European banking sector has undergone significant changes in the seven years since the financial crisis. Banks have sought to deleverage assets and boost their balance sheets to comply with capital requirements under Basel III and Solvency II. Further, the market has seen a desire by banks to reduce credit risk, with lending primarily focused on larger corporates and debt being provided on a shorter term basis, albeit the market has seen a significant shift towards covenant-lite terms.

The overall reduction of credit from the banks in Europe has stunted growth in SMEs and stifled the mid-market buyout sector. A much needed boost in the debt market has come in the form of alternative sources of credit, including by way of bonds, private placements and lending from mezzanine debt funds.

Private Placements

Private placements are medium to long-term debt instruments negotiated with, and issued to, a select number of institutional investors. Unlike publically traded debt, i.e., high yield bonds, there is no requirement to secure formal credit ratings for borrowers. To date, and in comparison with the United States, the private placement market in Europe is fairly fragmented, with activity largely centered in France and Germany. That said, a growing market is now evolving at pace in the United Kingdom, with bankers and lawyers starting to develop standard form documentation and distinct market practices being established.

Until recently, there had been no consistency in the approach to documentation from transaction to transaction, which has contributed to inefficiencies in the process and additional costs for the borrower. The welcome introduction of standardised documentation published by the Loan Market Association (LMA) in January 2015 and a proposal by the UK Government to introduce a new exemption from withholding tax on interest on private placements, together with continued interest from European investors, e.g., UK insurance companies) is set to help the alternative credit market flourish alongside the United States.

STANDARDISED DOCUMENTS

There are a number of common key features in a private placement transaction:

- There is no requirement for borrowers to be rated by credit agencies.
- Placements are offered to a select number of private investors.
- The debt is senior, unsecured and transferable.

Until the publication by the LMA of a standard form of facility agreement and subscription agreement, there was, however, no standard approach to private placements in the United Kingdom and Europe. The two standard forms produced by the LMA are intended to allow parties to choose the most appropriate format for the individual transaction and, despite being governed by English law, the LMA forms have been designed to be adaptable for use in other jurisdictions.

UK WITHHOLDING TAX EXEMPTION

The UK Treasury's announcement that an exemption from grossing up interest payments to non-UK investors on private placements would be introduced in the next finance bill will open up the market and encourage cross-border lending in the private placement market. The proposed changes in the tax regime have not come into effect (these reforms are expected in Spring 2015) so full details are yet to be made clear. There are, however, proposals by the government to set a number of conditions on the exemptions that could impact their application, e.g., the exemption will only be applicable to private placements of between £10 million to £300 million.

There have also been developments in the creation of a pan-European private placement market. The International Capital Market Association published a guide in February 2015 setting out what it hopes will be a best practice model that will enable cross-border placements.

Benefits for Both Investors and Borrowers

The availability of alternative credit to SMEs and private equity firms is set to become cheaper and more efficient. Although, for investors, the European market presents a difference risk profile to the United States, with the secondary transfer market still to develop, the advances made in the early part of 2015 are encouraging. A welcome consequence of the developments is that traditional lenders now have real competitors in the form of alternative credit providers who will be able to move faster and offer more flexibility than ever before, increasing liquidity options for borrowers.

Buying and Selling a Craft Brewery in the United States

Marc Sorini and Thomas Conaghan

The craft beer business has never been hotter, with market share now approaching 8 per cent by volume in the United States and margins that have attracted the attention of private equity and venture capital investors, and even large brewers.

The Current Climate

There is likely to be an increase in the number of M&A and other deals in the craft beer business over the next decade, for several reasons.

First, the age of the first generation of craft beer founders and owners will force them to consider succession planning. In some cases, one or more family members present the most attractive option, but not all owners will have interested or qualified family members ready to take over the business. For such businesses, a sale presents a compelling option.

Second, even if a founder wishes to "stay in the game" either by him/herself or through a family member, smaller and/or passive investors may want or need to monetize their investment after years of patience. Given the growing maturity of the industry, more and more breweries will find themselves in this situation. In some cases, a founding owner can easily buy out other investors, but this may prove impossible if the value of the other investors' equity exceeds what the founding owner can afford and borrow. Remember, too, that allocating all of the primary owner's capital in an internal buy out can leave the business undercapitalized and therefore vulnerable in an increasingly competitive market.

Third, increasing growth may require additional capital beyond the reach of the original owners. Today's excellent craft beer growth rates will likely not last forever, so making substantial investments now in production capacity and other competitive tools, such as more marketing, a bigger salesforce, etc., may ultimately drive an owner towards a sale or other partnership.

Regulatory Considerations

An important factor in planning and executing the purchase or sale of a craft brewery arises from the maze of alcohol beverage regulatory requirements imposed on the industry. These factors can substantially influence deal structuring and, in some cases, can put up an unsurmountable roadblock to a proposed transaction.

PERMITS AND LICENSES

The craft brewery business involves various permits, licenses, and other approvals from both the federal government (mostly the Alcohol & Tobacco Tax & Trade Bureau (TTB)) and from almost every state in which the brewer conducts business. Alcohol regulatory authorities will be reluctant to issue a license to any owner, officer or director with a criminal record or some other significant background “flaw”, e.g., an ongoing tax dispute with the Internal Revenue Service.

Every brewery will hold at least one TTB-issued Brewer’s Notice and a license in the state(s) in which it operates. Craft brewers that distribute in many states or have multiple locations, e.g., a brewpub chain, will hold many more licenses and permits. As these government approvals are necessary to legally operate the business, transaction planning must ensure that the proposed change does not result in a gap in licensing, at least not in materially important jurisdictions.

A host of factors influence the license transition process, and the licensing process itself may influence transaction structuring generally. For example, the license transition process for an ownership change by way of a stock/equity sale is much easier to accomplish in most jurisdictions than a change achieved through an asset sale. While only one consideration among many, alcohol licensing considerations standing alone generally favor stock sales over asset sales in the alcohol beverage market.

A buyer should conduct its own internal due diligence to identify any potential obstacles to licensing, prior to embarking on an acquisition.

TIED-HOUSE RULES

A more common problem arises from the “tied-house” rules separating (albeit unevenly) the various tiers of the industry. Most of these laws and regulations contain broad language prohibiting direct or indirect ownership interests between tiers, particularly between the retail tier and either of the “upper” two tiers of the industry: manufacturing and wholesale distribution. Moreover, few of the laws contain exceptions. Those that do exist are often very particular and require careful evaluation to determine if they might apply.

Tied-house rules present a formidable obstacle to many private equity investors with vast holdings across the country or the world that, quite often, will include hotels, restaurants, grocery stores or other businesses licensed to sell alcohol beverages at retail. Experienced alcohol counsel is essential for the early evaluation of almost any acquisition by a significant private equity investor in order to detect and, if necessary, evaluate and resolve any potential tied-house issues raised by the transaction.

Even if no tied-house issue exists at the time of the craft brewery investment, a private equity investor would be wise to recognize and understand how ownership of a brewery may impact future potential investments in the retail or wholesale sphere.

Tax

For craft brewers, another important consideration involves the availability of the small brewer tax rate and, perhaps, other special benefits that a potential buyer may not qualify to receive.

Virtually all craft brewers today qualify for the federal small brewer excise tax rate on a 60,000 barrel allowance. Acquisition by a private equity investor or a brewery that results in all brewers within the same “controlled group” producing more than two million barrels (regardless of where) would, however, make the acquired craft brewer ineligible to receive this benefit. Even a sale to, or merger with, another small brewer can have a significant excise tax consequence, as each “controlled group” is entitled to just one 60,000 barrels allowance at the lower excise tax rate.

Distribution Considerations

Distribution presents another area for unique due diligence in the alcohol beverage market. A private equity investor with no distribution network of its own will not likely do much to change existing distribution channels when acquiring an individual craft brewery. A private equity investor employing a buy and build strategy, however, or undertaking a transaction involving multiple packaging breweries, any distribution synergies, or the lack thereof, can present a real problem.

By conventional wisdom at least, consolidated distribution of multiple brands represents the best option in most jurisdictions, most of the time. In the typical transaction, an acquirer of a business wants to quickly consolidate distribution networks, achieving considerable synergies in the process. But the beer "franchise" laws enacted by many states do not permit easy consolidation, even where the new owner only purchases the assets of a craft brewery and specifically does not purchase or assume the contracts of the craft brewery changing hands.

Owing to the operations of these franchise laws, a potential buyer cannot expect the same quick synergies a buyer in another industry might enjoy. Instead, while consolidation may be relatively easy in some jurisdictions, in many others the process will require either negotiating a voluntary transfer of the brand or proceedings to determine the "fair market value" owed to the distributor losing the brand as a result of the change in brand ownership. The details will vary substantially from state to state, so conducting early due diligence on this aspect of a transaction will avoid surprises and maximize the ability to achieve at least some consolidation in the wake of closing.

Key Points

The business of craft brewing continues to grow and evolve. That growth has, and will, continue to attract investments both from inside and outside the brewing industry, and, as first-generation owners will seek to monetize their hard work. For the owners and employees involved, the sales decision can be emotional and stressful. With careful work by experienced counsel, however, at least the legal aspects of the transaction can move forward in an orderly fashion.

McDERMOTT PRIVATE EQUITY HIGHLIGHTS

New Partners in Paris

On April 2, three new partners, Henri Pieyre de Mandiargues, Carole Degonse and Grégoire Andrieux, joined our Paris office. Ranked in the top tier by *Chambers Europe*, the new group represents mid-market private equity fund sponsors in domestic and international transactions, management teams in management buy-outs and buy-ins, and French and foreign companies in domestic and cross-border transactional work and restructurings.

Boot Camp for Private Equity Investment Professionals, Thursday May 14, Chicago, IL

Now in its fourth year, McDermott Will & Emery's live Private Equity Boot Camp continues to utilize a fast-paced, interactive format to explore the many components of and considerations involved in buyout transactions.

EDITORS

For more information, please contact your regular McDermott lawyer, or:

Matthew R. Bielen
+1 305 347 6531
mbielen@mwe.com

Eleanor West
+44 20 7577 3461
ewest@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com

McDermott Will & Emery

Office Locations

BOSTON
28 State Street
Boston, MA 02109
USA
Tel: +1 617 535 4000
Fax: +1 617 535 3800

BRUSSELS
Avenue des Nerviens 9-31
1040 Brussels
Belgium
Tel: +32 2 230 50 59
Fax: +32 2 230 57 13

CHICAGO
227 West Monroe Street
Chicago, IL 60606
USA
Tel: +1 312 372 2000
Fax: +1 312 984 7700

DALLAS
3811 Turtle Creek
Boulevard, Suite 500
Dallas, TX 75219
USA
Tel: +1 972 232 3100
Fax: +1 972 232 3098

DÜSSELDORF
Stadttor 1
40219 Düsseldorf
Germany
Tel: +49 211 30211 0
Fax: +49 211 30211 555

FRANKFURT
Feldbergstraße 35
60323 Frankfurt a. M.
Germany
Tel: +49 69 951145 0
Fax: + 49 69 271599 633

HOUSTON
1000 Louisiana Street, Suite 3900
Houston, TX 77002
USA
Tel: +1 713 653 1700
Fax: +1 713 739 7592

LONDON
110 Bishopsgate
London EC2N 4AY
United Kingdom
Tel: +44 20 7577 6900
Fax: +44 20 7577 6950

LOS ANGELES
2049 Century Park East, 38th Floor
Los Angeles, CA 90067
USA
Tel: +1 310 277 4110
Fax: +1 310 277 4730

MIAMI
333 Avenue of the Americas, Suite 4500
Miami, FL 33131
USA
Tel: +1 305 358 3500
Fax: +1 305 347 6500

MILAN
Via dei Bossi, 4/6
20121 Milan
Italy
Tel: +39 02 78627300
Fax: +39 02 78627333

MUNICH
Nymphenburger Str. 3
80335 Munich
Germany
Tel: +49 89 12712 0
Fax: +49 89 12712 111

NEW YORK
340 Madison Avenue
New York, NY 10173
USA
Tel: +1 212 547 5400
Fax: +1 212 547 5444

ORANGE COUNTY
4 Park Plaza, Suite 1700
Irvine, CA 92614
USA
Tel: +1 949 851 0633
Fax: +1 949 851 9348

PARIS
23 rue de l'Université
75007 Paris
France
Tel: +33 1 81 69 15 00
Fax: +33 1 81 69 15 15

ROME
Via Luisa di Savoia, 18
00196 Rome
Italy
Tel: +39 06 462024 1
Fax: +39 06 489062 85

SEOUL
18F West Tower
Mirae Asset Center1
26, Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
Tel: +82 2 6030 3600
Fax: +82 2 6322 9886

SHANGHAI
MWE China Law Offices
Strategic alliance with
McDermott Will & Emery
28th Floor Jin Mao Building
88 Century Boulevard
Shanghai Pudong New Area
P.R.China 200121
Tel: +86 21 6105 0500
Fax: +86 21 6105 0501

SILICON VALLEY
275 Middlefield Road, Suite 100
Menlo Park, CA 94025
USA
Tel: +1 650 815 7400
Fax: +1 650 815 7401

WASHINGTON, D.C.
The McDermott Building
500 North Capitol Street, N.W.
Washington, D.C. 20001
USA
Tel: +1 202 756 8000
Fax: +1 202 756 8087