Q1 2016

UK Private Company Director

The newsletter for directors of owner-managed, family and private equity backed businesses

Corbett Keeling Corporate Finance

Hogan Lovells

Kleinwort Benson

Dear Reader

Welcome to the April 2016 issue of UK Private Company Director, the quarterly newsletter for directors of owner-managed, family and private equity backed businesses. UK Private Company Director covers financial, legal, tax, wealth management and similar issues that are crucial to both building and realising the value of your business.

As ever, this issue addresses some of the key developments currently facing directors of privately owned companies.

- While private company deal activity appears to have dipped in the first quarter, partly because of Brexit concerns, **private equity investors still have funds to deploy on businesses with compelling stories** to tell (pages 2 to 5).
- **The 2016 Budget introduced several new tax measures of importance** to owners and managers of privately held companies, some of which will be welcome, others less so (pages 6 to 7).
- The current uncertainty over the Brexit referendum is leading to considerable volatility in financial markets (pages 8 to 9), but **this may present some interesting opportunities for investors with a long time horizon.**

We were delighted to welcome so many of you to our annual drinks and discussion in March. For those of you who couldn't make it, we enjoyed a robust and fascinating debate on how long the current bull market is likely to continue and whether business owners should be selling now, in preparation for a potential downturn. Robert Darwin, partner of international law firm Hogan Lovells, said his team is seeing **"plenty of appetite amongst financial buyers for good quality, growing businesses,"** while Jim Keeling of corporate financiers Corbett Keeling noted **"extremely high levels of deal activity as business owners seek to capitalise on current market optimism to sell on the up."** Andrew Thompson, Head of Multi-Asset Investing at Kleinwort Benson Private Bank, said he remained **"cautiously optimistic on the outlook for the UK and global equities markets."**

Finally, as 23rd June draws near, all eyes have turned to the likely outcome of the Brexit referendum and the implications of a Leave vote. For once, the local is not parochial: the world is watching with unfeigned interest. While overseas observers naturally lean towards the maintenance of the status quo, we acknowledge the virtues of the case for greater autonomy and self-reliance, for the long-term demands of historical logic over short-term convenience. Whatever the outcome, I have no doubt that, come June 24th, managers and owners of private companies will show exactly the same commitment and resolve to grow their businesses as they always have. In the meantime, as one of our contributors shrewdly notes, long-term investors may be able to pick up some bargains in the stock market. It is indeed an ill wind which blows nobody any good!

Best wishes

Megan Peel

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A Brexit blip?

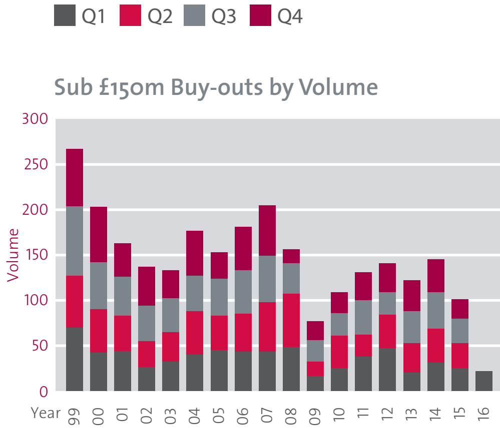
The world's financial markets had a turbulent first quarter of the year as concerns about a slowing of global economic growth waxed and waned. Here, Jim Keeling of corporate finance advisor Corbett Keeling looks at the data for private company deals over the quarter – and assesses whether any slowing of activity is likely to prove temporary.

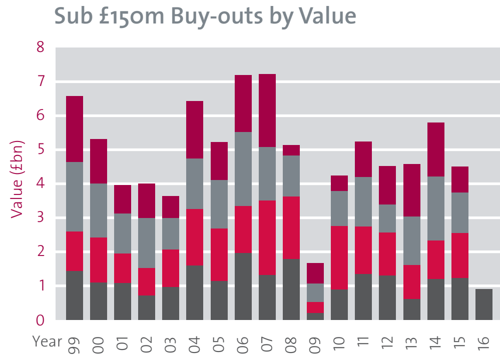
Private equity investors still have considerable sums at their disposal to invest, suggesting that competition will remain strong for companies which can identify the right bidders

Although 2015 was a very strong year for deal making activity in the private company sector, the fourth quarter showed signs of slowing momentum in all but the early stage and expansion capital segment. That deceleration certainly continued over the first three months of 2016, with clear signs of a slowdown at the higher-value end of the market. We see some indications that concerns about the possibility of a Brexit may be tempering enthusiasm in the near term. However, private equity investors still have considerable sums at their disposal to invest, suggesting that competition will remain strong for companies which can identify the right bidders – and then present a convincing case for their business's robustness and growth potential.

The smaller buy-outs sector showed some resilience. The number of deals increased slightly to 22, up from 21 in the last three months of 2015. The value of transactions also rose, to £902 million from £757 million in the previous quarter

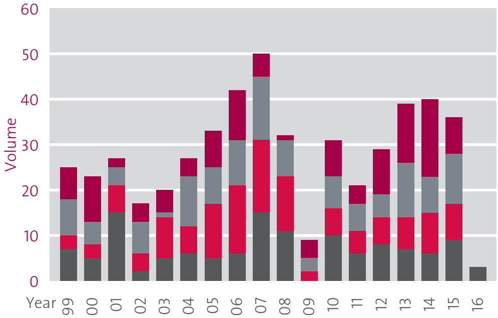
Let's delve in more detail into the first quarter's data.



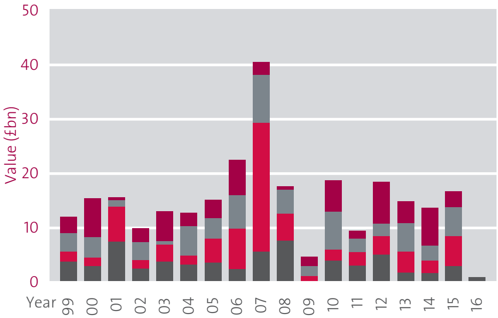


- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) showed some resilience. In fact, the number of deals increased slightly to 22, up from 21 in the last three months of 2015. The value of transactions also rose, to £902 million from £757 million in the previous quarter.
- The **larger buy-outs** sector (enterprise value of £150 million or above) had its most disappointing quarter since the dark days of the global financial crisis. The volume of transactions fell from eight to three, while the value of deals fell to £685 million, from £2.9 billion. Both figures were the worst since 2009.

£150m+ Buy-outs by Volume



£150m+ Buy-outs by Value



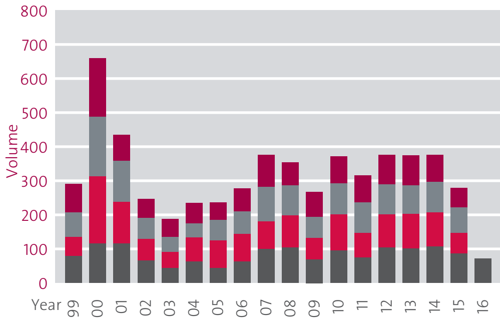
Early stage and expansion capital deals rose significantly, from 56 to a more than respectable 72, with a value of £940 million, well above the median level for the past four years

- Some slowing of momentum was only to be expected for **early stage and expansion capital deals**, after the value of transactions leapt in the fourth quarter to £3.25 billion, an all-time high for this data series. Nevertheless, the volume of deals rose significantly, from 56 to a more than respectable 72. And, while the value of transactions was down, it remained at £940 million, well above the median level for the past four years.

All equity buy-outs have been in a protracted slump ever since 2009, and they showed no signs of bucking that particular trend during the first three months of this year. After four all equity buy-outs in the previous quarter (the highest since the second quarter of 2012), only one all equity transaction was completed in the first three months of 2016. That comes as little surprise, given the continued availability of cheap debt funding.

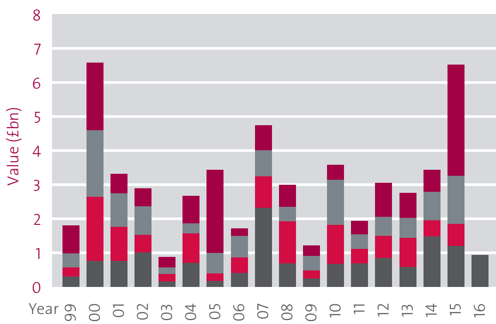
Brexit fears may be clouding the near-term outlook, but sentiment is holding up well and market participants are intensely busy

Early-Stage/Expansion Deals by Volume



If the backward-looking data from the first quarter was a bit disappointing in aggregate, what does our survey tell us about the prospects for the rest of the year? Broadly, it confirms anecdotal evidence that, while Brexit fears may be clouding the near-term outlook, sentiment is holding up well and market participants are intensely busy.

Early-Stage/Expansion Deals by Value

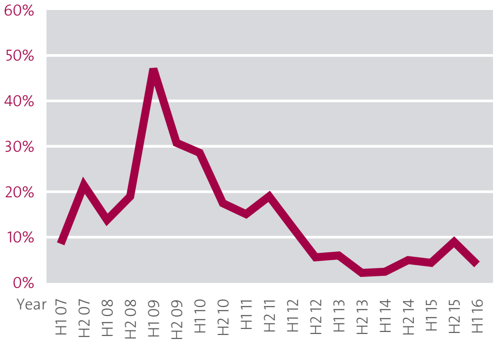


Respondents' optimism was virtually unchanged from the previous quarter. The percentage of survey participants expressing a positive view on deal making over the next 12 months fell only marginally to 65%

- Interestingly, the respondents' optimism was virtually unchanged from the previous quarter. The percentage of survey participants expressing a positive view on deal making over the next 12 months fell only marginally, from 70% to 65%, and the rest are in a neutral mood. None reported feeling cautious.

Just under half of our respondents said they were positive on the outlook for the availability of debt financing over the coming year. That was still over four times the proportion giving a negative response

All Equity Funded Buy-outs to All Buy-outs



- The outcome was a little less clear-cut when it came to the availability of debt financing over the coming year. Just under half of our respondents said they were positive on the outlook. That was still over four times the proportion giving a negative response. Over 40% were neutral.
- Perhaps not surprisingly, the Brexit referendum was seen as a genuine source of concern. Some 47% of respondents reported feeling negative on the referendum, while 29% were neutral. However, nearly a quarter said they were positive about it.

It is impossible to quantify with any accuracy the possible ramifications of a vote to leave the European Union. Nevertheless, we draw considerable comfort from the current mood of optimism and signs of brisk activity among market participants

Private equity transactions are not immune to negative developments in the global economy and markets, and we would not wish to underestimate the potential risks to the pace and value of deal making in the market place. In particular, we recognise that it is impossible to quantify with any accuracy the possible ramifications of a vote to leave the European Union. While it would undoubtedly cause some volatility in the near term, we think the concerns have been overstated in some quarters, and it is perfectly possible Brexit could have positive long-term implications. In any case, we draw considerable comfort from the current mood of optimism and signs of brisk activity among market participants.

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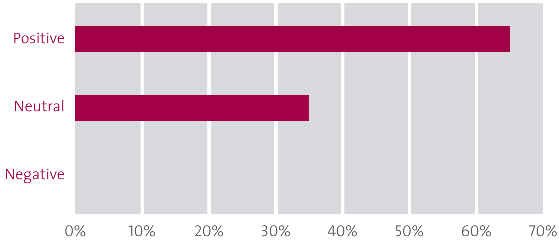
Survey of market expectations

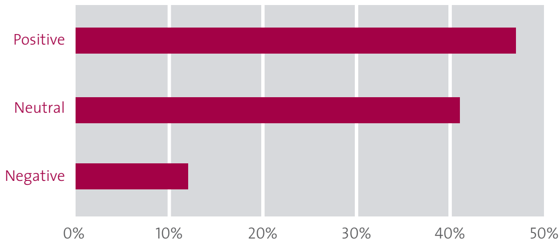
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q1 2016 predictions

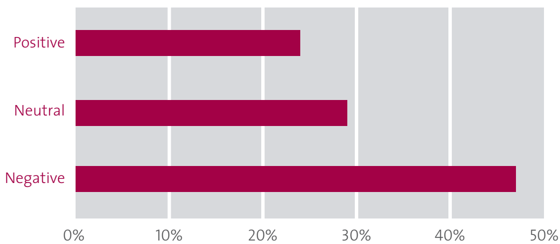
1 Do you feel positive, negative or neutral about deal making in the next 12 months?

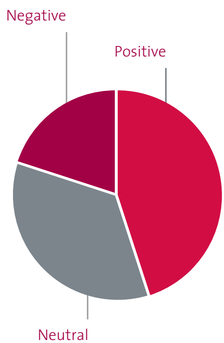


2 Do you feel positive, negative or neutral about the availability of debt in the next 12 months?



3 Do you feel the impact of the Brexit referendum on deal making is positive, negative or neutral?





Average of 1, 2 and 3 questions surveyed.

Budget 2016 – Key tax developments

One of the more action-packed Budgets of recent years reduced the rates of corporation tax and capital gains tax (CGT), announced restrictions on interest deductibility and corporate loss relief and introduced new rules on the taxation of carried interest and further anti-avoidance aimed at "income to capital conversion". Natalie Psaila of law firm Hogan Lovells International LLP outlines some key developments.

The 2016 Budget included several tax changes of importance to privately owned companies and their managers. The new carried interest rules and income tax anti-avoidance add further complexity to the critical issue of ensuring that returns (at a fund or shareholder level) are taxed as capital rather than income. The imposition of a lifetime cap on relief available to employee shareholders and retrospective tweaks to entrepreneurs' relief will also be of interest. Meanwhile, the changes announced on interest tax deductibility and carried forward loss relief will affect the amount of tax paid by businesses, making it harder to achieve the return sought by private equity investors.

All about you

CGT rates

From 6th April this year, CGT rates have fallen from 28% to 20% for higher and additional rate taxpayers and from 18% to 10% for basic rate taxpayers. Carried interest is carved out of these reduced rates.

Carried interest

The latest changes introduce an additional hurdle to be satisfied for private equity fund managers to obtain CGT treatment in respect of their carried interest. These new rules do not apply to carried interest arising in respect of employment related securities. So they do not currently apply to individuals who are directors or employees of a private equity fund's manager (or of the business managed). However, the Treasury has the power to repeal or restrict this exclusion, which creates uncertainty for managers.

In respect of carried interest arising from 6th April this year, the additional hurdle requires the fund to meet a new average investment holding period test. An average investment holding period of 40 months takes you over the hurdle, while a holding period of less than three years leaves you falling short (dramatic tapering applies in between). There are detailed rules identifying the investments to be included and providing for unwanted short term investments to be disregarded. There are also extensive provisions dealing with follow-on investments and sell-downs.

Even if the average investment holding period requirement is satisfied, carried interest will still only be taxed under the CGT rules if the funds received are actually capital in nature and the carry satisfies the statutory definition of carried interest introduced last year.

Income tax anti-avoidance

The government has added another targeted anti-avoidance rule (TAAR) to the growing body of complicated income tax anti-avoidance, while also widening the scope of the existing transactions in securities rules. Both rules treat receipts arising in respect of a transaction involving a close company as income rather than capital when certain conditions are satisfied and one of the main purposes of the transaction is obtaining a tax advantage.

The TAAR is aimed at distributions on a winding-up to individuals with a minimum 5% interest in the close company where the individual proceeds to carry on a similar business within two years. The transactions in securities rules apply to a broader range of transactions and could be relevant were an exit to be effected at a level below the top holding company, which is then liquidated, or if capital is returned to shareholders through a buy-back.

Employee shareholder status

Businesses taking advantage of employee shareholder status to incentivise employees should note the CGT exemption available on the disposal of employee shares will now be subject to a lifetime limit of £100,000 of gains. This limit applies to employee shares issued as consideration for entering into an employee shareholder agreement after 16th March 2016.

Entrepreneurs' relief

Some of the 2015 changes to entrepreneurs' relief have been partly reversed. A company which holds shares in a joint venture company (JVC), but has no trade of its own, will again be treated as carrying on a proportion of the JVC's activities which corresponds to the investing company's fractional shareholding. The person making the disposal on which relief is claimed will need a minimum 5% indirect interest in the shares of – and effective control of at least 5% of the voting rights in – the JVC. These changes, therefore, do not revive "Manco" structures, which relied on the requisite 5% tests being met by reference to the investing company, rather than the JVC.

Also of note is the new CGT investors' relief, which the Budget cryptically referred to as an extension to entrepreneurs' relief. This is a separate relief offering a reduced 10% rate of CGT up to a lifetime limit of £10 million on the disposal of shares subscribed in unlisted trading companies. In contrast to entrepreneurs' relief, there is a minimum three-year holding period but no minimum shareholding, and neither the investor nor anyone connected with the investor can be an officer or employee of the company.

All about the money

Corporation tax rate

As expected, corporation tax will fall from its current rate of 20% to 19% from 1st April 2017 and then to 17% from 1st April 2020.

Interest tax deductibility

The base erosion and profit shifting (BEPS) project initiated by the Organisation for Economic Co-operation and Development (OECD) in 2013 has identified key areas where multinational companies have a significant opportunity for BEPS. One is the use of corporate interest expenses to reduce the amount of tax payable.

Not surprisingly, George Osborne, who wants the UK to lead the way in implementing BEPS, has announced changes to the deductibility of interest payments. These changes are unwelcome to the private equity industry, which has long used debt funding in acquisition structures (and the corresponding interest tax deductions) to help generate the expected level of cash flows and returns.

A fixed ratio rule will restrict corporation tax deductions for net interest expense to 30% of a group's UK earnings before interest, taxes, depreciation and amortisation (EBITDA), subject to a de minimis group threshold of £2 million net UK interest expense. Companies whose activities justify higher borrowing will be protected with a group ratio rule based on the net interest to EBITDA ratio for the worldwide group, as recommended by the OECD.

Carry forward/back rules will deal with volatility in interest expense and EBITDA, and the existing worldwide debt cap will be integrated into the new rules.

These changes will impact the structuring of private equity investments as they will take effect from 1st April 2017. As yet, there has been no announcement on grandfathering provisions to allow an assessment of the impact of these changes on current portfolio companies and existing structures.

A detailed consultation is expected to be published by HMRC before the end of May: watch this space!

Corporate loss relief

Under existing rules, a company can surrender certain losses for the current accounting period to other members of its group. Carried forward losses may only be used by the company that incurred the loss. Restrictions apply to the type of profits against which carried forward losses can be used (for example, trading losses set against trading profits), but the amount of profit that can be offset is unrestricted.

The bad news first: from 1st April 2017, the reforms will restrict the amount of taxable profit that can be offset by carried forward losses to 50% for profits above £5 million. Banking companies will be subject to different restrictions.

On a more positive note, the reforms will seek to simplify and introduce greater flexibility into the existing system. Companies will be able to use carried forward losses (where the losses are incurred from 1st April 2017) against profits from other income streams or other group companies.

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Anyone for Broulette?

On 23rd June, the British electorate will decide whether to remain in the European Union or to opt for Brexit. As with the spin of a roulette wheel, the outcome is uncertain – but potentially life-changing. Fahad Kamal, Senior Market Strategist at Kleinwort Benson, outlines the shape, colours and numbers of the "Broulette" referendum wheel and assesses the potential investment implications for when the voting ball finally stops bouncing.

While the result of the Brexit referendum is still too close to call, one thing is clear: uncertainty often leads to volatility in financial markets and, if the UK votes to leave the EU, the period of uncertainty is likely to be prolonged.

The legal ramifications would certainly be extremely complicated. EU treaties have hundreds of pages of rules and procedures for a country joining the EU, but very few on an exit. Disentangling from the EU may take up to ten years and require new laws on countless issues ranging from European arrest warrants to trade with other countries.

The economic consequences are no easier to quantify. In 2014, the EU accounted for more than 44% of all UK exports of goods and services. Whether that percentage is maintained will depend on what trade deals can be negotiated with the EU and other countries. In particular, the UK is heavily dependent on its financial services industry. Even if access to EU markets is preserved, the UK would have to follow EU regulations for these markets, but it would no longer have a role in drafting them.

History suggests that the medium to long term impact of geopolitical events on equity markets is rarely significant

Market reactions: Red or black?

If the electorate votes to remain in the EU, the 2015 referendum on Scotland's independence can serve as a reasonable indicator of markets' likely reaction. Financial markets and sterling will undoubtedly encounter increased volatility before the referendum. After a remain vote, however, markets should quickly forget the issue even existed.

The implications of a leave vote are hard to judge, as there is no real precedent for the current situation. Both Switzerland and Norway have voted twice against joining the EU. In both Norwegian instances, in 1972 and 1994, equity markets rallied and the krone strengthened over the following 12 to 24 months. The Swiss equity market fell after their first vote not to join the EU (in 1992), but it rallied after the second (in 2001). Each time, the Swiss franc weakened. Of course, in all these instances, the status quo was extended, thus ending a period of uncertainty.

A vote for Brexit would mark the start of a period of upheaval, and so the market implications would probably be very different.

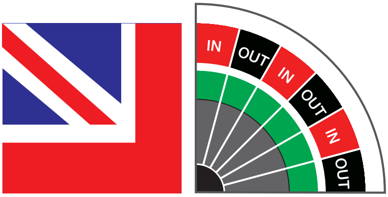
That said, history suggests that the medium to long term impact of geopolitical events on equity markets

Geopolitics and financial markets

Geopolitical shocks	S&P 500 TR Index (% change) Months after event 1	12
Korean War	-6.7	23.2
Soviets into Hungary	1.8	-8.3
Cuban Missile Crisis	7.2	34.2
Gulf of Tonkin Resolution (Congress 'authorises' Vietnam War)	2.0	8.6
Six-Day War	2.0	13.4
Soviets into Czechoslovakia	3.5	-1.0
Arab-Israel War	-6.9	-34.2
Soviets into Afghanistan	3.3	30.2
Martial Law in Poland	-4.8	19.2
Falklands War	0.6	42.9
US invades Granada	-1.1	2.8
US invades Kuwait	3.0	17.5
Serbians into Kosovo	5.3	23.5
September 11 attacks	3.2	-15.7
US invades Iraq	5.3	34.9
North Korea sinks a South Korean Naval vessel	4.1	15.4
Average	**1.4**	**12.9**

Source: Wikipedia, JP Morgan and Kleinwort Benson.

is rarely significant. In 16 serious geopolitical crises since 1950, there were only four cases of equity markets remaining down after one month and another four cases where markets were down after 12 months. Even if we could predict the political outcome in advance, the additional information would not necessarily help with making investment decisions. History tells us that the factors which really matter are not political but valuation, momentum and sentiment.



Place your bets

Like every year, 2016 will be defined by its unique set of global macro, geopolitical and market-related events, and the Brexit question looms large. No one knows where the Broulette ball will come to rest. But, as Warren Buffet's famous Noah rule puts it, predicting rain doesn't count; building arks does.

Investors and markets are no strangers to difficult circumstances or transformative geopolitics, and Europe is certainly no exception. In any case, as noted in the table, geopolitics often has little impact on asset price returns in the long run. We prefer to make a rigorous examination of valuation, momentum and sentiment signals, which have a proven efficacy in gauging expected long-term returns.

Ironically, the current Brexit crisis may lead to an excellent opportunity of harvesting long-term returns by investing in cheap and oversold assets, especially those that are in an uptrend.

At present, equity valuations are not stretched globally or in the UK. Furthermore, sentiment is becoming increasingly pessimistic, suggesting that equities have been oversold. We expect equity returns over the next five years to compensate for any volatility from holding them today. As a result, this remains the most significant allocation across asset classes for clients in our balanced portfolios. However, our optimism about the long-term outlook for equities is tempered by the asset class's negative momentum.

The value of holding government bonds in multi-asset portfolios as diversifiers is self-evident: they are much less volatile than equities, which is why we continue to invest in them

By contrast, although government bonds are unambiguously expensive, they have positive momentum. And the value of holding government bonds in multi-asset portfolios as diversifiers is self-evident: they are much less volatile than equities, which is why we continue to invest in them. Indeed, we may even increase our government bond allocations or duration positioning (that is, sensitivity to interest rates) if volatility makes equities less favourable long-term investments.

In recent years, we have increased our cash allocation in order to keep our powder dry for attractive investment opportunities. Even when interest rates on cash are low, it remains a core asset class as it should not lose value in nominal terms – a useful characteristic if volatility increases because of Brexit.

We would seek to deploy some of this dry powder if assets become more compelling, thanks to Brexit or any other factor. Bull runs typically begin when equities are cheap and sentiment is at oversold levels.

The year will undoubtedly present risks and opportunities that cannot be foreseen at present. However, we stand ready to be guided by our investment tenets of gathering the evidence, evaluating the impact on portfolios and acting according to our process.

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This article is intended to give an insight into the thought processes that lie behind our investment views and our investment strategy. They do not necessarily reflect the current investment policy of Kleinwort Benson. This article is intended for information purposes only and does not take into account the investment objective, the financial situation, or the individual needs of any particular person. Investors should obtain independent advice based on their own particular circumstances before making investment decisions.

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- **Management buy-outs**
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