Q4 2016

UK Private Company Director

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

Corbett Keeling
Corporate Finance

Hogan Lovells

Kleinwort Benson

Dear Reader

Welcome to the January 2017 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. It incorporates Corbett Keeling's report on deal activity in the private equity markets – a clear indicator of buyer and funder appetite for privately owned businesses.

What does 2017 hold in store for us? The last year has thrown many of our pre-conceived political notions into doubt, and many – not least the incumbents – will be looking forward with interest to the outcome of elections coming up in Germany, France and the Netherlands.

Yet, amidst all this uncertainty and upheaval, the wheels of finance have kept on turning. Indeed, stock markets have continued to set new record highs – though, in the UK's case, mainly because of the falling pound – and the figures for UK economic growth continue to confound the sceptics.

Is this a sign that markets are divorced from economic reality? Only time will tell for sure. However, we see good reasons for remaining at least cautiously optimistic for private businesses in the UK. Last quarter, we said that we would be watching political developments closely for signs of any anti-business legislation. So far, at a time of increasing anti-globalisation rhetoric in some quarters, Theresa May's government has shown itself to be broadly sympathetic to the needs of businesses and global trading. Long may that continue!

Here are the topics we address in this issue.

- While 2016 was not a vintage year for deal activity, **a strong December for the larger buy-out segment helped the market as a whole to demonstrate its resilience in the final quarter** (pages 2 to 5).
- The legal aspects of a transaction can be costly, complex and time-consuming, but burying your head in the sand won't help. **We highlight eight things to consider if you are to get full value from your lawyers** (pages 6 to 7).
- The political turmoil of 2016 appears to have been driven partly by increased inequality. Against this backdrop, **we advance the case for an investment strategy which is selective, disciplined and optimistic** (pages 8 to 9): there are still opportunities out there.

Our best wishes to you all for a happy and prosperous 2017!

Megan Peel

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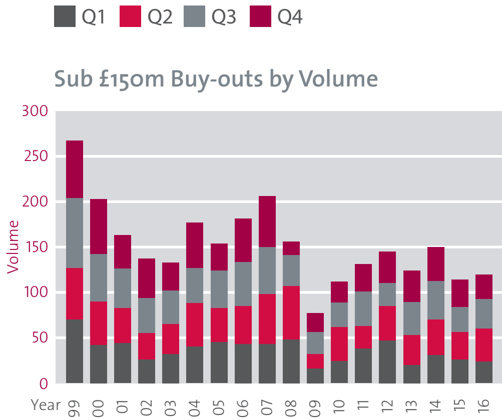
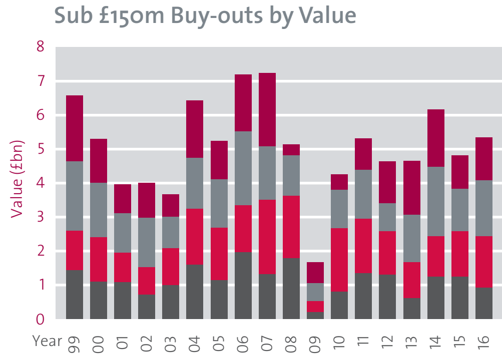
A mixed picture to end 2016

It was a year of momentous political developments, as the votes for Brexit and Donald Trump brought considerable uncertainty to the macro-economic environment. Here, Jim Keeling of corporate finance advisor Corbett Keeling evaluates the impact both on deal activity in the UK's private equity industry during 2016 and on the mood of market participants as they contemplate the year ahead.





The smaller buy-outs sector topped 2015's totals for both value and volume

A bumper December for the larger buy-outs sector of the market made it a strong final quarter of the year overall. However, that headline strength obscured a mixed three months for transaction activity, as the smaller buy-outs segment held fairly steady but early stage/expansion deals saw a decline in transaction values. Perhaps more to the point, the figures for the year are also mixed. Although the smaller buy-outs sector topped 2015's totals for both value and volume, larger buy-outs and early stage/expansion deals failed to match last year's strong numbers.

A clear majority of the respondents to our survey of market participants expect activity to pick up over the next six months

So how has this left market sentiment as we enter 2017? Certainly, we see no signs of pessimism. A clear majority of the respondents to our survey of market participants expect activity to pick up over the next six months. Nevertheless, doubts about the ultimate form and impact of Brexit are not surprisingly still weighing on the overall mood to some extent.

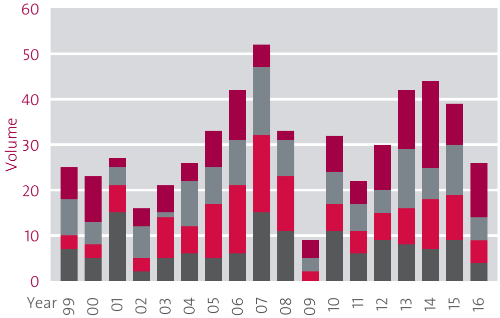
Before taking a closer look at the survey responses, here are the hard figures for the final quarter of 2016.

- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) was little changed from the third quarter of 2016, helping the sector to beat its 2015 totals for both volume and value. At 27, the total number of deals was slightly down (from 33), but the volume picked up later in the period, after a weak October. Similarly, while the value of deals declined from £1.6 billion in the third quarter, it came in at a fairly strong £1.3 billion.

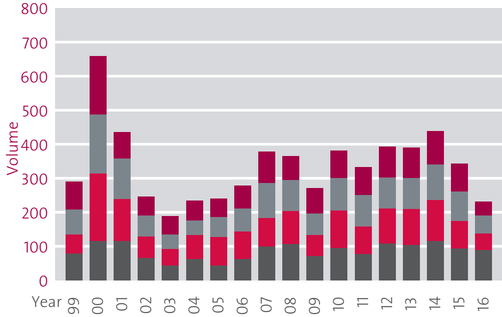
The number of deals in the larger buy-outs sector rose from 5 to 12, the best quarterly figure for two years. The value of deals was even stronger, up from £1.1 billion to £6.6 billion

- After a disappointing first three quarters of the year, the **larger buy-outs** sector (enterprise value of £150 million or above) rebounded strongly. The

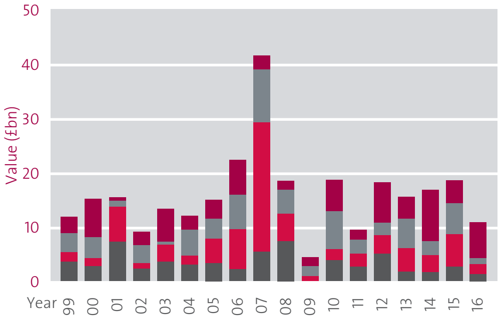
£150m+ Buy-outs by Volume



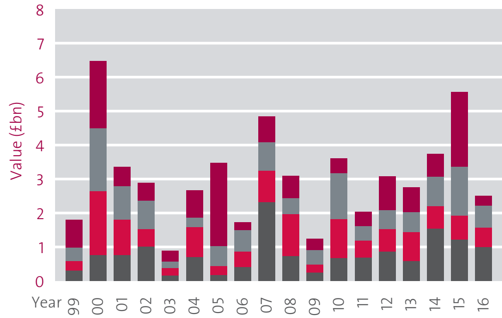
Early-Stage/Expansion Deals by Volume



£150m+ Buy-outs by Value



Early-Stage/Expansion Deals by Value



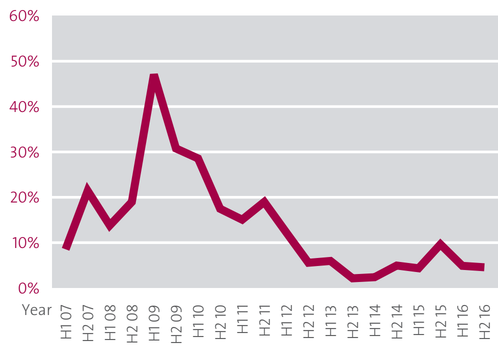
number of deals rose from 5 to 12, the best quarterly figure for two years. The value of deals was even stronger, up from £1.1 billion to £6.6 billion, helped by the fact that December was the strongest month for six and a half years.

Deal makers continue to shun equity funding, instead taking advantage of plentiful debt availability while interest rates remain low

- **Early stage and expansion capital deals** had a disappointing final quarter of 2016. The volume of transactions fell to 41, from 52, and their value also declined, from £635 million to £283 million. However, we continued to see plenty of activity in the market and we would not be surprised if these figures are revised up – as they generally are – in the weeks after quarter end.

Deal makers continue to shun equity funding, instead taking advantage of plentiful debt availability while interest rates remain low. The final quarter produced only three all equity buy-outs, around the average over the past ten quarters.

All Equity Funded Buy-outs to All Buy-outs



So, while the hard data for 2016 has been lacklustre in parts, we believe it has held up fairly well overall, given the abnormal level of political and economic uncertainty. But what does the future hold? Our survey of market participants offers some insights into the outlook for 2017.

Sentiment is still positive overall, with 60% of respondents forecasting a rise in activity over the next six months

- Although expectations for deal volumes are down marginally, sentiment is still positive overall, with 60% of respondents forecasting a rise in activity over the next six months. The remainder are split evenly between those predicting a decline in activity and those expecting no change.
- In short, sentiment is roughly in line with where it was in the first and third quarters – and significantly above where it was in the immediate aftermath of the Brexit vote.
- The survey reveals some concerns about the effects of Brexit, with 30% of respondents fearing an adverse impact over the next three months. The survey results were delivered before the Prime Minister's speech on 17th January setting out her plans for a "clean break", but it appears that many in the market had in any case been assuming a hard Brexit when planning ahead.
- Despite the fall in the pound and rising fuel costs, which are likely to lead to a rise in inflation, respondents are not yet worried about debt availability. Not one reported a negative view, although the neutral vote rose from 6% last quarter to 70% now.

We are encouraged by the generally resilient mood among market participants, and activity appears to be holding firm overall

As we look at the year ahead, political and macro-economic events continue to create significant uncertainty. However, we are encouraged by the generally resilient mood among market participants, and activity appears to be holding firm overall. In fact, our experience at present agrees with the comments of two of our respondents, who said that, though there is a "sense that some people are in wait and see mode", for most it is "business as usual".

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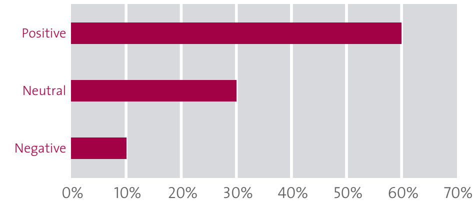
Source: Transaction statistics supplied by unquote"

Survey of market expectations

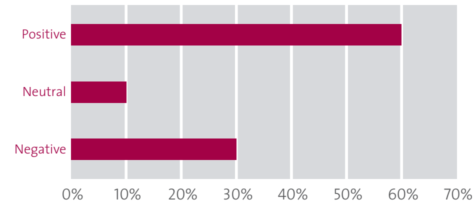
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q4 2016 predictions

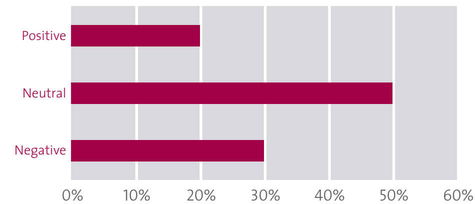
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next six months?



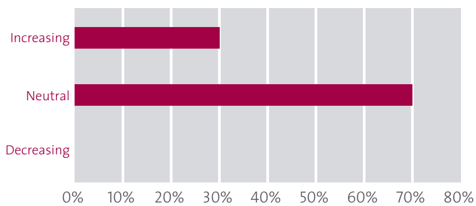
2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next six months?

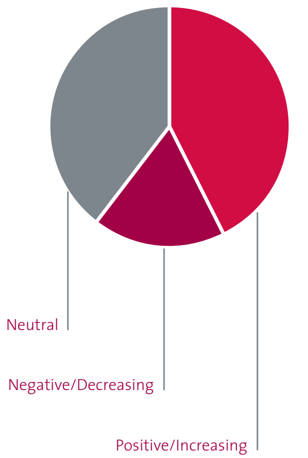


3 What do you think the ongoing impact of Brexit is now and for the next three months?



4 Is debt availability increasing, decreasing or neutral?





Average of 1, 2, 3 and 4 questions surveyed.

Getting the most from your lawyers

For management teams embarking on an acquisition or a disposal, the legal aspects of the case can seem a hassle – and a costly one at that. Yet appointing the right lawyers and engaging with them properly can have a major impact on the ease and even the outcome of the deal. Simon Grimshaw of law firm Hogan Lovells outlines eight key considerations to help you extract maximum value from your solicitors.

Mergers and acquisitions (M&A) lawyers generally play a crucial role in the purchase or sale of any company, whether public or private. So it is important to choose your solicitors wisely and then to establish a close and effective working relationship with them. As most businesses instruct lawyers only rarely, it can be difficult for their management teams to know where to start. Here we provide a few important pointers when engaging your lawyers.

Your financial advisers can often help with the appointment of lawyers. It is crucial they are subsequently able to work seamlessly together on the transaction

1 Engage early

You might be tempted to avoid instructing your lawyers until you have finished your initial negotiations and agreed a deal. However, if you instruct your lawyers earlier in the process, you will find that they should provide some useful guidance. Ideally, you will instruct them before signing any heads of terms – the agreed principles which set out the basis of the deal in broad terms – so that the lawyers can help ensure that all the key commercial elements of the transaction are captured, along with any important legal matters which may otherwise be overlooked. Front-loading detailed negotiations usually leads to a much more streamlined transaction.

In addition, your lawyers come into regular contact with other M&A professionals, such as bankers, accountants and tax advisors, and it may well be very helpful to have access to their address book from the start of the process.

2 Negotiate and understand the lawyers' engagement

Once you have chosen your lawyers, make sure you understand their engagement – and, where necessary, negotiate. You should be clear on exactly what you want and do not want your lawyers to do. If you know your lawyers will need to perform a specific task or deal with a particular issue, see that it is included in their scope of engagement. Conversely, the lawyers may have assumed that you will want them to do some work which you would prefer to complete yourselves internally. You should ensure any such work is removed from their scope. You may also find it helpful to request regular updates with a synopsis of work completed to date, so that you can keep abreast of legal developments.

Remember that the scope may change after you have signed your engagement letter. If a new issue arises during the course of your transaction, ask your lawyers to provide a further quote, including the additional work they will need to undertake.

3 Be candid

If you are upfront about known issues, your lawyers will be able to manage them in the context of the transaction – and ideally resolve them in advance, so that they are not issues for the other party. If a big problem crops up which you choose not to tell your lawyers about, time will be wasted bringing them up to speed and then resolving the issue. For your lawyers, forewarned is forearmed, and the transaction will proceed much more smoothly if they have had the chance to resolve matters before they become problems.

4 Agree communication protocols

When you get into the nitty gritty of your transaction, a lot of information will be exchanged with your lawyers which can be difficult to keep up with when you have a business to run at the same time. You may be happy to receive multiple emails from several lawyers directly, or you may wish to have updates and requests consolidated on a daily basis. Whatever your preference, instruct your lawyers accordingly.

To ensure you get what you want out of every important call, you may find it helpful and efficient to set agendas in advance.

5 Instruct and delegate clearly

As your transaction progresses, your lawyers will ask for instructions on numerous matters. Whilst good lawyers will provide guidance, these are ultimately your decisions. So make sure you have reviewed relevant documents and understood the points – and, if you haven't, get your lawyers to explain the issues clearly to you.

When you give instructions, try to give your lawyers authority to agree compromises on your behalf, perhaps within given ranges. Discretion to settle outstanding points can help your lawyers to agree points with the other party efficiently, rather than constantly having to take instructions. Equally, when you know your lawyers need instructions, having the relevant decision makers on the call or in the meeting, and having them appropriately briefed, can cut through unnecessary duplication.

6 Choose between quick, cheap and good

With lawyers, as with most service providers, you can usually have any two out of quick, cheap and good, but not all three. In terms of cost management, very tight deadlines or last minute issues will often result in more expensive work as senior lawyers will probably need to do the work themselves, rather than employing more junior resources, which are typically cheaper. Planning ahead and keeping your lawyers up to date with transaction developments should help to manage things effectively.

7 Have well-run data sites

It may seem like an additional overhead in an already expensive venture when selling a business, but it can avoid heated debates further down the line if you have a well-run data site that can automatically generate numbered indexes and provide reporting on who has looked at what. Although lawyers often end up running the data site, it is a broadly administrative task which you may wish to take on directly, with some guidance on structure from your lawyers.

English solicitors have professional duties to act in the best interests of their clients and to avoid any conflicts of interests. As a result, you should always be able to trust your lawyers to give you the right advice

8 Plan for your time

An M&A transaction requires substantial commitment in terms of time and resource from both the lawyers and the client. Management teams often find it challenging to keep doing their day jobs alongside the work required to keep the transaction progressing. It will help all concerned parties and free up managers' time if you organise contingency support, even just for administrative tasks such as collating and sending information to the lawyers and digging out key documents.

To end on a reassuring note, we should bear in mind that, unlike many other professionals who may be involved in your transaction, English solicitors have professional duties to act in the best interests of their clients and to avoid any conflicts of interests. As a result, you should always be able to trust your lawyers to give you the right advice. Remember that your lawyers are on your side – and only your side.

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Inequality bubble

A bubble can be defined as any system that is unsustainable and leads to catastrophic events that are largely unpredictable. It is a fragile state that presents risks and uncertainty. Here, Mouhammed Choukeir, Chief Investment Officer of Kleinwort Benson, investigates the presence of an inequality bubble. Does the current wealth distribution in the global economy present a risk to investors, and what are the potential implications for financial markets?

Bubble trouble?

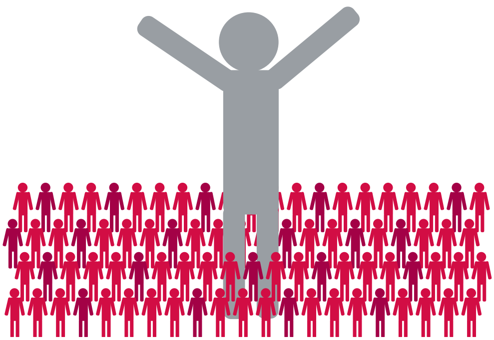
In the last 12 months, the politics of several countries have been transformed by populism. A new political order is taking root, with the meteoric rise of outsiders such as Bernie Sanders and President Donald Trump in the US and the Brexit vote in the UK. Anti-establishment movements are also coming to the fore across Europe. In Germany, the right-wing Alternative for Germany is now a potent political force, while Marine Le Pen of France's Front National is a near certainty for the second round of the 2017 elections. The Italian Five Star Movement has surged in popularity, particularly in light of December's referendum. And, in Spain, the two traditional parties garnered only 50% of the vote between them, while populist party Podemos won 25%.

This is no coincidence: the political upheaval reflects an emerging paradigm which separates humans less by country, culture or religion than by income, education and social mobility. In short, inequality appears to be driving the rise of political uncertainty around the world. In financial markets, it pays to be aware of such tectonic shifts and seek to evaluate their potential impact.

The penny drops

As recently as 1993 - 2005, real incomes rose for 98% of households in 25 advanced economies*. In the decade that followed, however, real incomes fell or were flat for two-thirds of households in those countries – a massive 540 million people. The UK is no exception. By our calculations, UK median disposable income was over twice as high in 2015 as in 1977. But, over this same period, mean household income increased at a much faster pace as high-income households took an increasingly large share of the pie. Indeed, since 1977, the top fifth of incomes have grown 25% faster than those in the bottom fifth, and the distance between the top and bottom income quintiles is now far greater than in the 1970s and 1980s.

In his book *The Moral Consequences of Economic Growth*, Benjamin Friedman of Harvard University said that, while most people do not read income statistics, they draw internal conclusions about the economic progress that they see in their lifetimes. Discussing Friedman's work, economist Robert Shiller said: "If people can't see themselves and others in their cohort as progressing over a lifetime, their social interactions often become angry, resentful and even conspiratorial." In a recent survey we conducted in collaboration with YouGov†, about half of the British population felt their wealth was "about the same" or "less" than ten years ago (48%). Of those who felt "less wealthy", nearly one-third thought themselves responsible (32%); 55% thought someone else responsible. And thus one begins to piece together the puzzle of public anger which is transforming global politics.



Innumerable factors drive something as complex and structural as global income inequality. They include: ageing; slowing global growth; declining productivity; higher household debt for those with lower incomes; globalisation; automation; education; capital gains; and taxation.

While each topic is worthy of an individual paper, we will here focus on three key trends.

Ageing and myriad effects: After World War II, industrialisation, rapid population growth and urbanisation led to a "golden age". When this effect began to fade in the 1970s, falling trade barriers and rapidly increasing demand from emerging markets prolonged the "golden age" for a few more decades. Today, advanced economies and many key emerging ones, such as China, have a reversing demographic dividend. Trends such as ageing, falling fertility rates and a rising ratio of dependants to working age adults is driving down households' total income, leading to reduced demand for goods and services. Perhaps more importantly, income in advanced societies is disproportionately accruing to those who are least likely to consume and most likely to save. Simply put, you are less likely to spend your millionth pound than your thousandth.

Capital gains: Nearly every major investable asset class – stocks, bonds, credit, real estate – has done phenomenally well in recent decades. Even cash, barring the last few years, has usually delivered positive real returns. So people who have owned assets have generally increased their wealth, while those who depend solely on wages for wealth creation have become relatively poor – and more insecure. In 2014, capital income in the UK amounted to 33% of disposable income for the richest quintile of households, compared with just 7% of disposable income for the lowest quintile.

Leverage: The Great Depression of the 1930s and the Great Recession of recent times were partly due to increases in borrowing by low and middle-income people, who used debt to maintain standards of living. Income earned is mostly spent on immediate consumption and debt servicing, leaving very little to invest in education. This is no trivial matter. Education is the biggest single indicator of higher future income. Richard Reeves, a senior fellow at the Brookings Institution, cites data showing that 56% of heads of US households in the top quintile have college or advanced degrees, compared with 34% in the third and fourth quintiles and 17% in the bottom two quintiles.

Investment implications

Brexit and the Trump victory reveal the structural forces reshaping the geopolitical landscape. Against that uncertain backdrop, populist outcomes should no longer come as a shock. Our advice to clients is threefold.

First, **be optimistic**. There are many causes for concern in the current macro environment, with a prevailing mood of pessimism and scepticism. However, those are often excellent conditions to invest; it is when everything looks rosy that one should be cautious. Over the past five years, for example, sentiment has been negative, reflecting the eurozone crisis, the US debt shutdown and downgrade, the slowdown in Chinese growth and, lately, Brexit and Trump. Yet the global equity market is up 71% over that period (11.4% a year).

Second, **be selective**. Not long ago, cash in a savings account yielded 5%; today, even equities may well struggle to achieve that. As the conditions for a "golden age" of growth are unlikely to recur in our lifetimes, we should accept a lower return for a given level of risk than we have historically. So we should make the most of the opportunities that do arise, and defensive assets, such as government bonds and cash, give us "dry powder" to invest opportunistically. Although equity market valuations look on the high side by some measures, certain sectors and regions still offer the potential for good long-term returns.

Finally, **be disciplined**. When markets react with staggering speed to unforeseen events, the urge to take action can be hard to resist. Often, that emotional impulse is wrong. A disciplined and robust investment process will seek to ignore the short-term movements accompanying periods of great change; instead, it will evaluate the fundamentals – such as valuation, momentum and sentiment – which drive long-term returns from assets. In our view, that is the key to prudently managing such periods of uncertainty.

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Sources for all data: FactSet, Kleinwort Benson.

* *McKinsey Global Institute,* Poorer Than Their Parents? Flat Or Falling Incomes In Advanced Economies *(July 2016).*

† *All figures, unless otherwise stated, are from YouGov Plc. Total sample size was 2,232 adults. Fieldwork was undertaken 25th - 28th November 2016. The survey was carried out online. The figures have been weighted and are representative of all GB adults (aged 18+).*

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