Q1 2017

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 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.

In our last issue, we looked forward to the year ahead and noted that 2016's political upheaval could extend into 2017, given the uncertainty over the forthcoming elections in France and Germany. What we hadn't expected – after the passing of the Fixed-Term Parliaments Act in 2011 – was a General Election in the UK this year.

The Conservatives start the race as heavily fancied favourites. However, to win the backing she seeks to reinforce her hand for the Brexit negotiations, the Prime Minister will need to set out a clearer vision of the post-Brexit Britain she is aiming for. In particular, we will continue to watch with interest to see just how pro-business that vision will be and how far she can stay true to the Tory party's free-trade roots while addressing concerns about excessive immigration.

For one example of effective cooperation continuing across Europe even after Brexit, we need look no further than Globalscope, the international M&A network of which Corbett Keeling is a UK member firm. In the Thomson Reuters small cap league tables for deals during the first quarter of 2017, Globalscope topped the league in Germany and Eastern Europe and came seventh in Europe overall, completing more lower mid-market transactions than Deloitte, Oaklins and EY.

As usual, this issue takes a look at some topics we trust will be of interest to private company directors.

- After the last quarter of 2016 which was heavily reliant on a few big deals, transaction activity gained momentum in the first three months of 2017, marking **the strongest start to a year since 2012** (pages 2 to 5).
- Private equity funds often seek co-investors to help diversify their investments. **We explain some features of co-investments which private company directors should know about** (pages 6 to 7).
- Commercial property has been in demand as an investment in recent years, given its typically strong yields. **We highlight some areas of the UK market which appear to offer good value after Brexit-related declines** (pages 8 to 9).

Best wishes

Megan Peel

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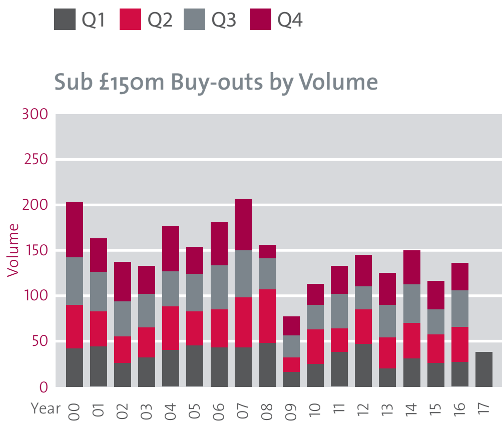
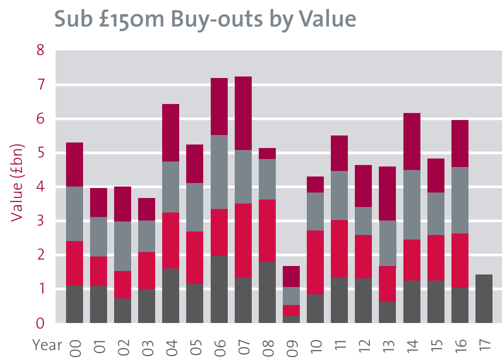
Can the strong start continue?

Though deal activity held up well last year despite the uncertainty caused by the vote for Brexit, doubts lingered over the outlook for 2017. However, Jim Keeling of corporate finance advisor Corbett Keeling finds that not only has the new year got off to a strong start but survey evidence points to a robust remainder of the year.





Overall, we were pleased with the resilience shown by private equity deal-makers in 2016. Though far from a vintage year, activity certainly didn't suffer the sort of collapse some of the Brexit doom-mongers were predicting. Nevertheless, towards the end of the year, we had slight concerns about the balance of activity. In the final quarter of 2016, weakness at the smaller value end of the market was masked by a bumper December for larger buy-outs.

2017 has got off to a strong start so far. In particular, we are encouraged that activity seems more evenly balanced across the sectors

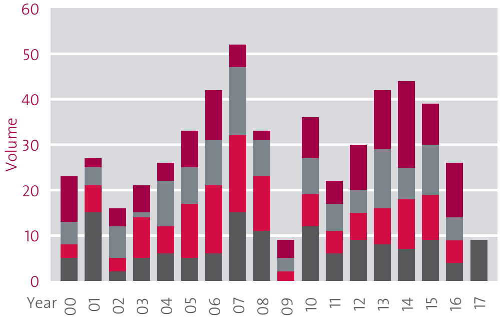
The good news is that 2017 has got off to a strong start so far. In particular, we are encouraged that activity seems more evenly balanced across the sectors. Furthermore, the results of our latest survey of market participants reveals that they are in a generally positive frame of mind for the year ahead. While this survey was conducted before the announcement of the General Election, we expect any disruption to be minimal, given the short campaigning period, and the result should bring greater clarity to the outlook.

The smaller buy-outs sector had its best start to a year since the global financial crisis, with a notably strong March suggesting that momentum is building

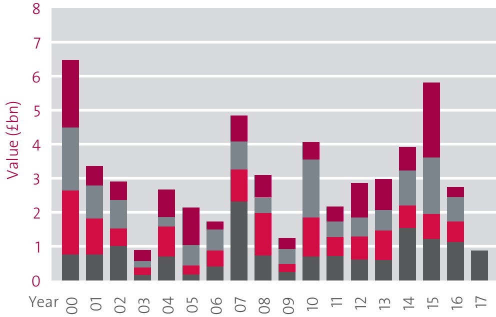
First, though, let's assess the data for the first quarter of 2017.

- In value terms, the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) had its best start to a year since the global financial crisis. The volume of deals was up from 30 to 38, while the value rose slightly to just above £1.4 billion, with a notably strong March suggesting that momentum is building.
- Not surprisingly, activity in the **larger buy-outs** sector (enterprise value of £150 million or above) was unable to match the exceptionally strong final quarter of 2016. Nevertheless, the number of transactions (nine, down from 12) was the equal highest first-quarter figure since 2010, and their total value (at just over £4 billion, down from £6.4 billion) represented the best start to a year since 2012.

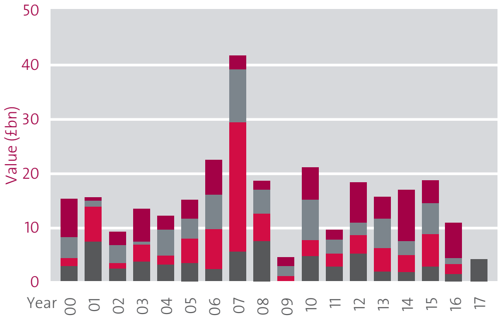
£150m+ Buy-outs by Volume



Early-Stage/Expansion Deals by Value

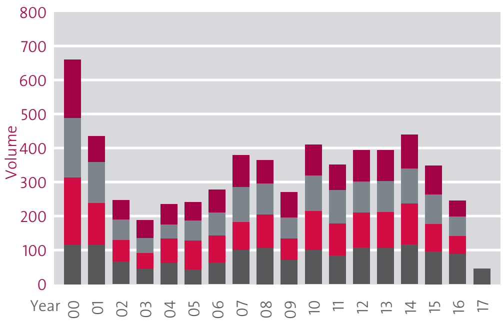


£150m+ Buy-outs by Value



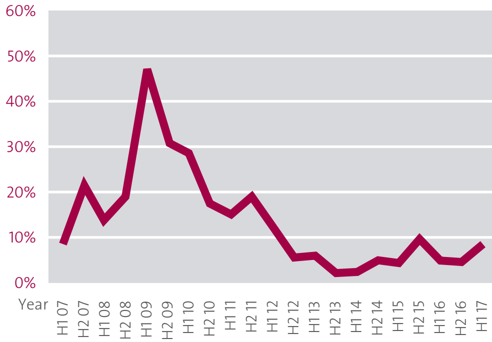
- **Early stage and expansion capital deals** was the only sector not to beat the figures for the same period last year. The volume of transactions remained subdued, only matching the previous quarter's 46. However, their value almost tripled, up from £293 million to a solid £869 million – the highest level for four quarters.

Early-Stage/Expansion Deals by Volume



Could we be in the early stages of a pick-up in equity funding? All equity buy-outs have been bumping along the bottom in recent years since reaching their nadir in July 2013 to June 2014, when only three deals were funded without any debt. Last quarter's total of four all equity buy-outs is the highest figure since the end of 2015. Still, with debt cheap and readily available, it remains a modest total.

All Equity Funded Buy-outs to All Buy-outs



Overall, more respondents expect the number of deals to increase over coming months than to decline

So we are encouraged by the data for the first quarter. But what does our latest survey reveal of the market's mood looking out over the rest of the year? In broad terms, sentiment appears fairly confident, in line with our experience in the market.

- Overall, more respondents expect the number of deals to increase over coming months than to decline. Perhaps not surprisingly, though, given the very strong recent activity in the larger buy-out segment of the market, expectations here are more evenly balanced, with 40% predicting higher volumes, 40% forecasting a decline and the remainder anticipating no change.
- Interestingly, market participants appear fairly sanguine about the impact of Brexit in the months ahead. The percentage of respondents expecting a positive impact has remained fairly constant at around 20%, whereas the number predicting a negative impact has fallen from 30% last quarter to 19% now.
- Respondents showed no concern about debt funding. The percentage seeing increased availability has risen from 30% to 80%, while none report a decrease.

GDP growth remains solid here and in most regions of the global economy. We remain confident that deal making activity can continue to build as we head into the summer months

As we noted at the start of the year, there is no shortage of political and macro-economic events which are creating significant uncertainty around the world. Quite apart from the UK General Election, the eurozone faces a series of testing elections and a possible resurgence of worries about debt in the peripheral countries. Meanwhile, US President Donald Trump faces some testing challenges in foreign policy, particularly in his dealings with Russia and China over Syria and North Korea.

However, we hope that the election result in the UK will at least bring greater clarity to the political background and the path forward for the Brexit process. Meanwhile, GDP growth remains solid here and in most regions of the global economy, and financial markets have enjoyed a strong run. In these circumstances, with sentiment showing no signs of worsening, we remain confident that deal making activity in the private equity sector can continue to build momentum as we head into the summer months.

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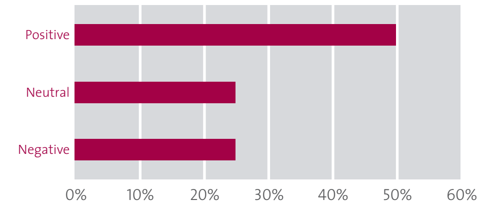
Source: Transaction statistics supplied by unquote

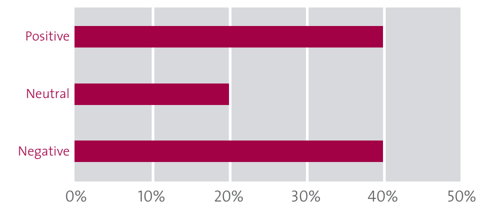
Survey of market expectations

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

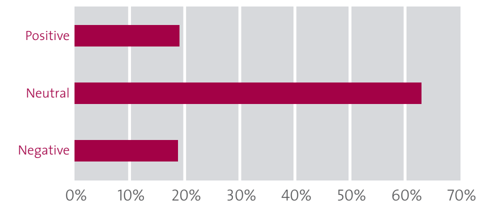
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next six months?



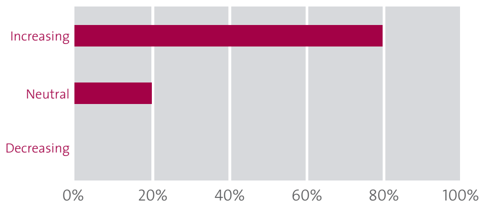
2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next six months?

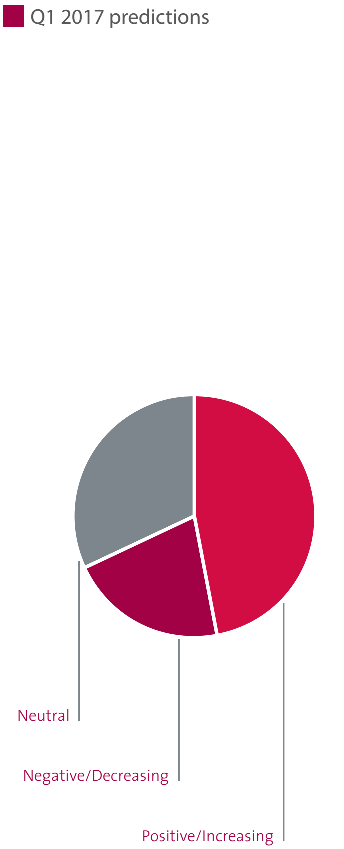


3 What do you think the ongoing impact of Brexit is now and for the next three months?



4 Is debt availability increasing, decreasing or neutral?





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

The rising popularity of co-investments

Private equity funds often seek co-investors to help them manage condensed investment exposure or respect diversification requirements in their governing documents, while an investor or debt provider may seek co-investment rights as a part of its investment in funds, so that they can access more private equity investments at the same time as leveraging the costs they are already paying to the fund. Hannah Wilson of Hogan Lovells International LLP examines typical co-investment structures and features which directors of private equity invested companies should be aware of.

What is a co-investment?

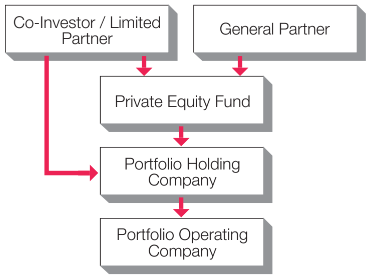
An equity co-investment is typically a minority investment (made directly or indirectly) into a portfolio company alongside the main private equity sponsor. Usually, a co-investor will invest at the same time as the private equity fund, but sometimes syndications can happen after the main investment is concluded. Co-investments are used in a range of transactions, from leveraged buy-outs and recapitalisations to growth capital deals.

Who are co-investors?

A co-investor is typically, though not always, an existing limited partner in the private equity fund that is making the main equity investment. In a standard fund structure, such investors are passive and pool their resources with other investors, which are managed by the fund's general partner. However, a co-investment is made outside of the standard fund structure and gives the investor the opportunity to participate directly in the equity of the portfolio company *(see diagram)*.

While the investment agreement between the investor and the fund may contain a right to participate in a co-investment, the opportunity to participate in any particular co-investment can also be offered to investors or debt providers on an ad hoc basis.

As mentioned, co-investment partners are not restricted to the private equity fund's existing limited partners. A private equity fund may seek co-investment from other sources, including PE sponsors or family offices. This may be seen as an attractive option where the investor is able to provide specialist skills (such as industry knowledge) or to help develop a strategic relationship with the other firm.



Why are co-investments used?

A private equity fund may choose to bring in a co-investor because:

- the additional capital provided by the co-investor enables the private equity fund to make a larger investment than it otherwise could alone, with the added benefit of not having to go outside its existing investor group for the capital;
- it helps to overcome restrictions in the fund's governing documents which limit the size, diversity or illiquidity of assets of an investment – bringing in a co-investor allows the private equity fund to reduce the amount it is required to dedicate to the investment, thereby reducing the fund's exposure; or
- having a co-investor from the outset makes it easier for the private equity fund to achieve a subsequent syndication.

An investor may choose to make a co-investment because:

- the co-investment may out-perform their other private equity fund investments, increasing the investor's overall return;

- it is a way to take an additional stake in a preferred portfolio company; or
- co-investors rarely pay management fees or carried interest on a co-investment, with fees often being included in the investors' existing fees arrangement.

What is a typical co-investment structure?

In a private equity investment structure, the private equity fund invests in the holding company, which is the ultimate owner of the operating portfolio company. The co-investor also invests at the holding company level. However, the co-investor's interest in the holding company may be either direct, where the investor is a shareholder of the holding company, or indirect, through an intermediary special purpose vehicle (SPV) in which the investor acquires an interest.

Direct Investment

The co-investor directly owns shares in the operating portfolio company's holding company. While shareholder voting arrangements between the co-investor and the fund may be addressed in a shareholders' agreement, this structure allows the co-investor some independence from the fund as the co-investor will be able to exercise its voting rights in the company independently of the fund. Direct investment also gives the co-investor greater visibility: as a shareholder in the company, the co-investor is likely to be in direct contact with the portfolio company; and the co-investor will be entitled to certain minimum statutory rights as a member of the company.

Indirect Investment

The co-investor takes a stake in an intermediate SPV, usually either a limited liability company or a limited partnership. The choice of SPV will largely be driven by tax considerations and the structure of both the fund and the co-investor – indirect holding structures can become quite complex. An indirect structure may also be chosen where the private equity fund intends to bring in additional co-investors at a later stage, as it will not then have to re-open investment agreements or shareholder arrangements at the portfolio company level. However, as the co-investor is one level removed from the operating portfolio company (or at least its holding company), it will not have the same direct contact with the portfolio company as in a direct investment.

What rights could a typical co-investor expect?

Co-investment rights are often negotiated when the investor is making its initial capital commitment to the fund and are provided for in the fund documents when the fund is launched. The fund should therefore consider at the outset the strategy it will adopt for co-investments, including what rights a co-investor may have and which investors will be granted co-investment rights. The general partner generally seeks to achieve as much uniformity of co-investment rights across all its limited partners as possible, but it may also want to grant special co-investment rights to certain strategic or large investors.

Of course, it may not be possible to conclude detailed co-investment negotiations at the time of the initial fund raise, and fund partnership agreements will often allow for flexibility to conclude co-investments at the time of the specific investment.

Co-investments are typically passive, non-controlling investments, as the private equity firm will want to control the investment and perform management functions. The co-investment is usually made when the private equity fund invests in the portfolio company, so time to negotiate specific co-investment rights may be limited and deal documents – on the same terms and conditions as the fund – are often presented to co-investors on a take-it-or-leave-it basis. The ability to negotiate any specific rights may be even further restricted where the fund has already made its investment in the portfolio company, as it may not be possible to re-negotiate investment documents.

The choice of investment structure may also affect what control rights the investor is able to obtain. Direct co-investors may look for customary minority shareholder rights, such as pre-emptive, tag-along and information rights. A board seat or observation rights are less common but may be available depending on the size of the co-investment. Where a co-investor is another private equity firm, the co-investor will also need to ensure that the terms of its own investment documents are satisfied when making its investment and may want to maintain control over its own investment.

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Seeking value in UK commercial property

In the wake of the Brexit vote, commercial property suffered as investors digested the possible impact on demand within the sector. But Delyth Richards, Head of Investment Solutions at Kleinwort Benson, sees certain areas of the market where valuations are now low and there may be interesting opportunities for investment.

In the years since the global financial crisis, the steep fall in yields from government bonds has led investors to seek elsewhere for assets which provide reliable streams of income. Among the beneficiaries of this search for yield has been commercial property. The result has been a long period of strong performance for this asset class.

However, after three consecutive years of double-digit returns, the UK commercial property market hit the wall in 2016. The result of the Brexit referendum cast doubt on future growth in the UK economy and, in particular, demand for commercial property. Headlines warning of a possible mass exodus of overseas firms from the City and a decline in foreign companies' investment in the UK took their toll, and valuations tumbled.

So where are we now?

More recently, valuations have recovered from their post-referendum falls as the apocalypse has so far failed to materialise. For most sectors, supply and demand look fairly well balanced. We see few signs of too much supply as construction has been muted in all areas except for the City of London, where we have some concerns.

Crucially, vacancy rates are generally low. Even in the high-street retail sector, where vacancy levels still appear higher than we would like, vacancy rates have been declining over the past three years, coming down from 14% to 12% over that period.

Commercial property yields remain stable and continue to provide an attractive level of income for investors, particularly relative to low rates of interest on bank deposits and government bonds. However, the difference in yields between primary and secondary UK property have become compressed in recent years. As a result, more UK investors have started to consider opportunities in commercial property markets overseas. And certain sub-asset classes, such as infrastructure, remain compelling thanks to their cash flows, which are guaranteed under long-term contracts.

UK commercial real estate remains attractive to overseas buyers. Sterling's depreciation since the Brexit vote has created better value opportunities

The outlook for commercial property

Bond yields and interest rates are expected to rise from current historically low levels. That would provide two significant headwinds for commercial property. But UK commercial real estate remains attractive to overseas buyers. Sterling's depreciation since the Brexit vote has created better value opportunities, and we have seen increased interest from US dollar-based investors.

We forecast that UK real estate will remain subdued in 2017. Uncertainties persist about the implementation of Brexit and the possibility of a second referendum on Scottish independence, which may result in some occupiers delaying new letting decisions. Indeed, anecdotal feedback from market participants confirms that some businesses are putting off decisions to develop, invest in or take leases on commercial property.

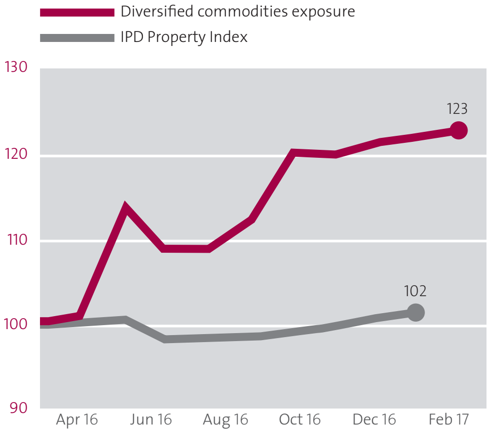
Investment opportunities

At the end of April 2016, we sold out of all direct UK property exposure within clients' portfolios as capital values started to decline. In its place, we added exposure to broad commodities, which appeared to offer good value after several years of underperformance and looked set to benefit from more solid growth in the global economy.

Since then, the diversified position in commodities has enjoyed a strong return *(see chart)*, whereas returns from direct property (as measured by the IPD Property Index) have been muted.

Property vs Commodities

Monthly returns, March 2016 = 100



Sources: FactSet and Kleinwort Benson.

Commercial property can provide significant diversification benefits when held within a broader multi-asset portfolio, leading to potentially stronger returns for a given level of risk

However, we are always looking for attractive opportunities to re-invest in property. In our view, this asset class can provide significant diversification benefits when held within a broader multi-asset portfolio, leading to potentially stronger returns for a given level of risk. So is now a good time to invest?

Quoted real estate investment trusts (REITs) – both in the UK and globally – sold off in the aftermath of the Brexit vote and have fallen to levels where they now appear to offer investors compelling valuations.

Indeed, some names have now met our strict selection criteria for both valuation and quality. As a result, we have recently moved to include them within the equity segments of clients' portfolios. These decisions have been driven by our bottom-up assessment of specific REITs' fundamental merits, rather than by a positive view on the sector as a whole.

We have also been analysing opportunities with very long leases – typically of more than 20 years – that offer inflation-linked rents

We are also reviewing opportunities in direct property investments, looking at some healthcare assets, such as GPs' surgeries, medical centres and pharmacies. We have also been analysing opportunities with very long leases – typically of more than 20 years – that offer inflation-linked rents. Examples include supermarkets, budget hotels and strategic assets. The era of very low inflation may be coming to an end if quantitative easing and emergency low official interest rates start to be reversed, a process which has already begun in the US. If that, coupled with the post-Brexit decline in the pound, feeds through into higher inflation, the attractions of such inflation-linked rents may become more apparent to investors.

At this stage, we continue to evaluate these ideas. In particular, we look for opportunities with attractive downside protection, which we believe offer the best balance of risk and return characteristics for investors.

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