Q2 2016

UK Private Company Director

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

Corbett Keeling
Corporate Finance

Hogan Lovells

Dear Reader

Welcome to the July 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. It incorporates UK M&A Watch, Corbett Keeling's report on deal activity in the private equity markets.

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

- In the run-up to the referendum, private company deal activity appears to have remained subdued, although the smaller buy-outs sector actually re-accelerated. However, many **private equity investors remain eager to deploy funds** and are hopeful that the dust will soon settle (pages 2 to 5).
- **We examine some of the many potential legal implications of Brexit on UK M&A activity** and highlight certain areas where the UK has an opportunity to ease the burden on business and some risks that need to be addressed (pages 6 to 7).
- Even with the Bank of England set to cut rates again and bank deposit rates unlikely to return to more attractive levels (pages 8 to 9), **cash should not be neglected as an asset class, particularly as government bonds are likely to produce low returns or even outright losses.**

For once, it is no exaggeration to say that we are living through historic times. The post-Brexit political landscape is undergoing seismic shifts, and it is likely to be some time before it assumes a definite, settled topography. Will the result be a narrower, more insular Britain or a re-energised country looking away from a self-obsessed Continent towards the rest of the world? Until that question starts to be resolved, the uncertainty is likely to weigh on markets and certain segments of the economy.

However, the potential benefits of disruptive change are one of the mantras of modern business life, and we are optimistic that, whichever way we voted individually, we can now collectively seize the chance to transform the UK for the better. Brussels has sometimes been blamed for our own politicians' and civil servants' eagerness to wrap businesses in red tape. But is it too much to hope that the government can take advantage of this once-in-a-lifetime opportunity to unwind unnecessary regulation and create a more competitive, productive and dynamic country?

Best wishes

Megan Peel, Editor
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Back to business – businesses to back!

After a solid first quarter, it was little surprise that the pace of deal making activity slackened amid the uncertainty in the run-up to the Brexit referendum. Here, Jim Keeling of corporate finance advisor Corbett Keeling looks at the data from the second quarter and assesses the state of the market as participants digest the implications of the referendum result.

Deal making has certainly not fallen off the cliff, and two out of three segments actually saw a pick-up in activity

In our last issue, we noted signs of a pre-referendum slowing in the pace of transactions. The preliminary figures for the second quarter reveal that activity remained subdued over the period. However, deal making has certainly not fallen off the cliff, and two out of three segments actually saw a pick-up in activity.

We see no signs of anyone walking away from transactions which were started before the Brexit vote, and some deals which had been put on hold are likely to be resumed in the near future

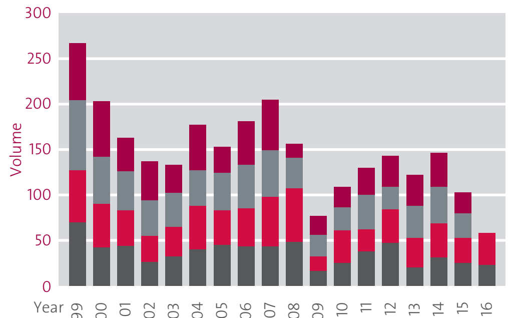
While the Brexit uncertainty may continue to weigh on activity in the near term as the market collects its breath over the summer holiday season, many of the private equity investors we've spoken with are hopeful that the dust will soon settle and investing will return to normal. We see no signs of anyone walking away from transactions which were started before the Brexit vote, and some deals which had been put on hold are likely to be resumed in the near future.

Before looking ahead, though, we should first examine the extent of the slowdown in deal making.

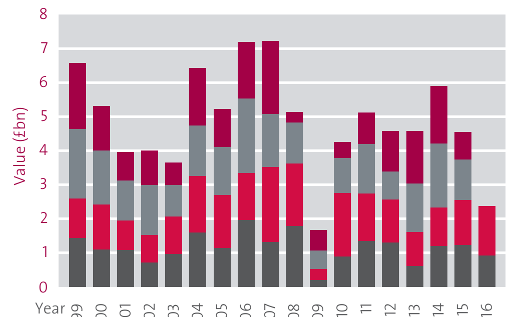
- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) had a solid second quarter, accelerating slightly from the first three months of the year. The total number of deals rose from a solid 23 in the first quarter to 35, the most since the last quarter of 2014. The value of deals came in at just shy of £1.5 billion, again the highest for six quarters.

Q1 Q2 Q3 Q4

Sub £150m Buy-outs by Volume

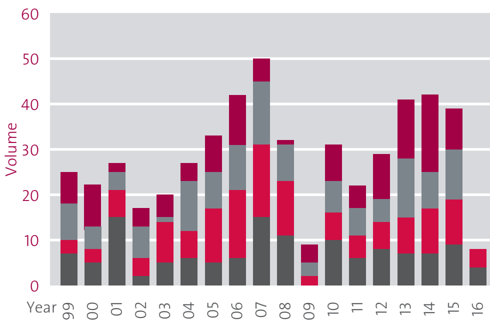


Sub £150m Buy-outs by Value

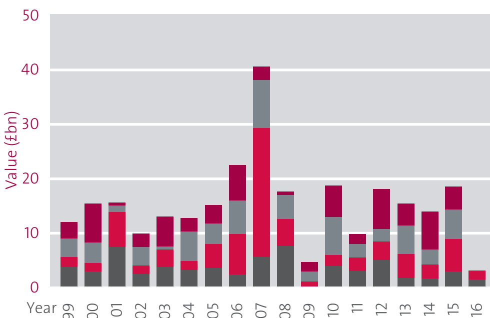


Deals in the smaller buy-outs sector rose from a solid 23 in the first quarter to 35, the most since the last quarter of 2014. The value of deals came in at just shy of £1.5 billion, again the highest for six quarters

£150m+ Buy-outs by Volume

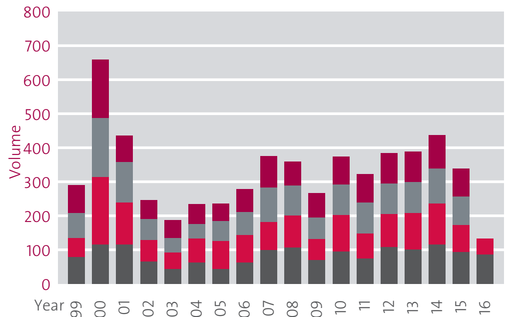


£150m+ Buy-outs by Value

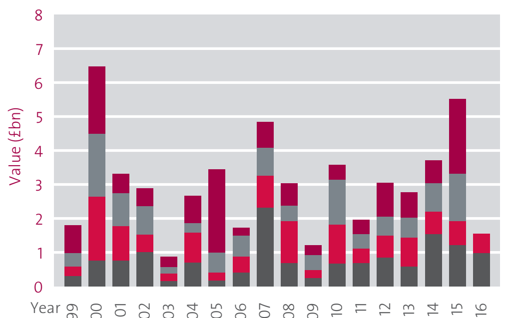


- The **larger buy-outs** sector (enterprise value of £150 million or above) was in muddle-through mode. The number of deals remained the same as in the first quarter, at a lowly four. However, the value of transactions increased, if only to a relatively modest £1.6 billion.
- The only real decline from the first quarter was in **early stage and expansion capital deals**, where the volume of deals fell from 86 to 46, the lowest level since 2005. The value of transactions, at £564 million, was well down on the first quarter's £989 million. For the first half of the year, however, the total value is not far off previous years' levels and is well above the depths plumbed in the global financial crisis.

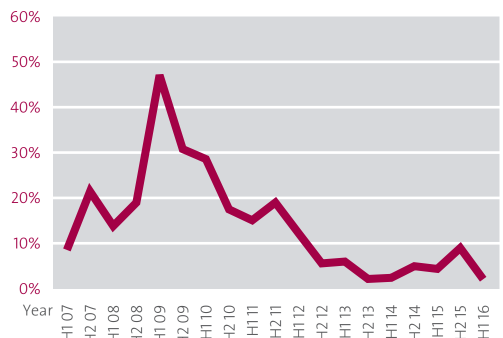
Early-Stage/Expansion Deals by Volume



Early-Stage/Expansion Deals by Value



All Equity Funded Buy-outs to All Buy-outs



With debt still available, the all equity buy-outs remain an endangered species. Only one such transaction was completed in the second quarter, down from an already paltry three in the first three months of the year.

Our latest survey shows little sign of the pessimism prevalent in certain sections of the national media. As ever, market participants are keen to get on with their jobs

The question now is how long this period of lacklustre activity is likely to persist. Our latest survey shows little sign of the pessimism prevalent in certain sections of the national media. As ever, market participants are keen to get on with their jobs.

Given the persisting uncertainty about the form Brexit may take, respondents remained on balance optimistic on the opportunities for deal making

- Perhaps surprisingly, given the persisting uncertainty about the form Brexit may take and concerns over the potential repercussions for trade with the EU, the respondents remained on balance optimistic on the opportunities for deal making. While half foresaw no change in the volume of transactions over the next 12 months, 30% expected an increase and only 20% a fall.
- None of our respondents predicted any change in the availability of debt. However, it was clear that cyclical businesses in particular may find it harder to obtain favourable terms.

60% of respondents either saw no impact or were unsure whether the Brexit referendum had resulted in more deals than usual being put on hold, while 20% reported being busier than normal

- Asked whether the Brexit referendum had resulted in more deals than usual being put on hold, 60% of respondents either saw no impact or were unsure, while 20% reported being busier than normal. The remaining 20% said deals had been delayed, though one respondent thought that was unrelated to the referendum.

We expect deal volumes to stay healthy. Private equity houses are eager to step in where trade buyers may be hesitant, and banks remain willing to lend. The news is not all bad – and certainly not as bad as the media like to portray it

We would not be surprised if the effects of the Brexit vote linger for some time yet. However, with a new prime minister swiftly in place, some of the uncertainty may soon be resolved, and the process of negotiating will be able to begin. Much will depend on the precise route the new prime minister and Cabinet agree to take, and some senior politicians have hinted at new business-friendly measures to offset any adverse macro-economic impacts of Brexit. In any case, the weakening of sterling will have made exports cheaper and increased the attraction of UK companies for overseas buyers, one step along the path towards correcting the long-standing imbalances in the UK economy. In the meantime, we expect deal volumes to stay healthy, as some of the transactions which were delayed pending the result of the referendum are resumed once more. Private equity houses are eager to step in where trade buyers may be hesitant, and banks remain willing to lend. The news is not all bad – and certainly not as bad as the media like to portray it.

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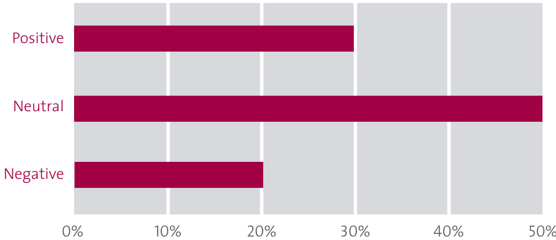
Survey of market expectations

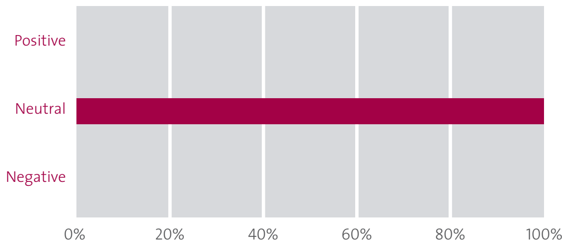
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q2 2016 predictions

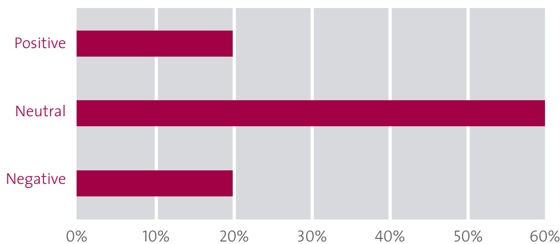
1 Do you expect deal volumes to be up, flat or down in the next 12 months?

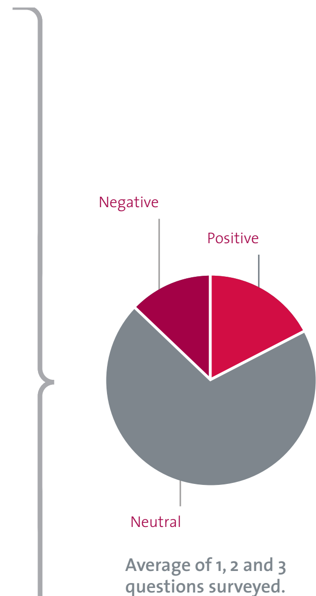


2 Do you expect debt availability to be up, flat or down in the next 12 months?



3 In your view was the number of deal processes put on hold during Brexit referendum more, the same or less than normal?





Average of 1, 2 and 3 questions surveyed.

How might Brexit affect UK-related M&A?

The outcome of the UK's referendum on its membership of the European Union creates a host of uncertainties. In this article, Robert Darwin (Partner), Jonathan Russell and Umar Azmeh of law firm Hogan Lovells International LLP discuss some of the immediate legal issues and questions related to M&A deals involving the UK.

The current state of play

Whilst the referendum result provides a political mandate for Brexit, its legal status is only advisory. The formal process for Brexit will not start unless and until the UK delivers a notice under Article 50 of the Treaty on European Union. That would trigger a two-year transitional period for the UK's withdrawal arrangements to be negotiated, at the end of which (barring an agreed extension) the UK would automatically leave the EU.

The UK's future relationship with the EU could take a range of forms, from full membership of the European Economic Area (EEA) to the UK failing to negotiate a trade agreement with the EU and falling back on World Trade Organisation (WTO) rules. Clearly, the model chosen will influence the outcome and related issues

Impacts on UK-related M&A

Commercial

The uncertainty flowing from the referendum result is likely to create both risks and opportunities for buyers and sellers of UK and European assets. For example, concerns about changes in UK companies' future ability to sell goods or services to the EU and the rest of the world may have a negative effect; conversely, opportunities may arise in terms of pricing, not least as a result of currency movements.

Legal

No laws have changed because of the referendum, and there is no certainty that any will change. However, we think it is possible, even at this early stage, to identify certain immediate issues.

1 Signed deals that have not yet completed: has a MAC occurred?

Parties to deals which signed before the referendum result but have not yet completed may wish, if the terms of the deal include a termination right in the event of a Material Adverse Change (MAC), to consider whether there has been a MAC. This will depend entirely on the drafting of particular clauses, but, where a company's business model is subject to particular negative effects caused by the referendum result, there may be grounds for asserting that a MAC has occurred.

2 Future deals: Brexit conditionality

It is likely that acquirers will wish in future to negotiate bespoke MAC and conditionality clauses in acquisition agreements to provide themselves with increased flexibility, given the various possible outcomes of Britain's exit negotiations (for example, conditions relating to financial passporting rights, specific changes in law, or tariffs).

3 Merger control: a potential for greater political interference in UK-related deals?

Currently, the EU merger control framework acts as a constraint upon political interference in mergers. The European Commission (EC) reviews transactions solely on a competition-based test (whether or not the transaction will "significantly impede effective competition" in the EU), and there are limited exceptions where EU member states can intervene to protect specified "legitimate interests". With the loss of this system following Brexit, UK merger control might possibly become more politicised or locally focused. This could impact on deal clearance certainty and necessitate the use of political avenues to secure clearances.

At a practical level, certain transactions will also no longer benefit from a "one-stop shop" merger control review by the EC. Instead, they will require review by both the EC and the UK's Competition and Markets Authority. This may increase

execution risk and extend deal timetables and costs.

4 Public M&A: the Code will continue

While it is technically correct that the UK Takeover Code implements the EU Takeovers Directive, the Code existed in substantially its present form before the implementation of the Directive and has governed UK public takeovers for over 40 years. So, while small amendments may be made after Brexit, the Code will probably remain largely unaltered.

5 Private M&A: could cross-border mergers involving companies incorporated in the UK cease?

Private M&A is significantly less regulated in the UK than M&A relating to public companies. Accordingly, Brexit is less likely to affect legal aspects of UK private M&A activity. One potential impact of Brexit, however, would be on UK-incorporated companies' ability to make use of the EU cross-border merger regulations, which enable companies to merge with or into companies incorporated in other EEA states. Although the UK may be happy to continue to apply the relevant legislation after Brexit, it remains to be seen whether EEA states would agree to reciprocate.

6 Due diligence and warranty packages

The range of potential outcomes from Britain's exit negotiations will also need to be considered by buyers during due diligence and in the context of the warranty and indemnity protections, and undertakings. The scope of Brexit-specific due diligence will develop as more information is known about how the referendum result might be implemented, but we expect that increasingly a target's readiness for Brexit in key business areas (such as geographic structure, staffing, contractual structure, IP arrangements and payment flows), together with its internal Brexit-planning, will be an area of interest. In particular, Brexit could affect a target's key contracts, especially in relation to change of control provisions, territorial scope and the potential effects of regulatory change.

7 Intellectual property rights

After Brexit, all pan-EU intellectual property (IP) rights may cease to apply in the UK. The UK government may choose to deal with this either by allowing all such EU IP rights granted up to the date of Brexit to continue to apply in the UK, or by instituting a way to convert them into national rights. Alternatively, businesses might have to re-apply for protection for their key IP as national rights.

8 Business sales and employees: might TUPE requirements be relaxed?

At present, after an asset sale (as opposed to a share sale), acquirers have to employ existing staff of the transferor on their current terms and conditions under the Transfer of Undertakings (Protection of Employment), or TUPE, regulations. Even if the UK decides to retain the "automatic transfer" principle after Brexit, it is likely to become easier to change the terms and conditions of employment after a transfer. TUPE was reformed in 2006 and 2014, and it was recognised on both occasions in the UK that it would be helpful to allow more flexibility around post-transfer harmonisation of terms and conditions, but that this was very difficult to achieve in light of existing European case law.

9 Dispute provisions: will UK jurisdiction clauses and judgments be recognised and enforced?

We see little risk that Brexit might lead to jurisdiction clauses in favour of the UK not being respected by courts in EU member states, or that English judgments will not be easily enforced across the EU. This is because the UK is subject to the global jurisdiction and enforcement set out in the 2005 Hague Convention on Choice of Court Agreements, currently as a result of its membership of the EU. However, if the UK leaves the EU, it will very likely accede to the 2005 Convention as an independent contracting state, which it can do even without the cooperation of the EU. The 2005 Convention would guarantee that exclusive jurisdiction clauses in favour of, for example, English courts will continue to be respected in the EU in most civil or commercial disputes of an international nature, and that English judgments can be enforced there with relative ease.

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The return of the king

With bank deposits offering record low rates of interest, cash has fallen increasingly out of favour as an asset class since the global financial crisis. However, as Mouhammed Choukeir, Chief Investment Officer of Kleinwort Benson, points out, cash still has a vital role to play within investment portfolios – and that role is not just confined to safety.

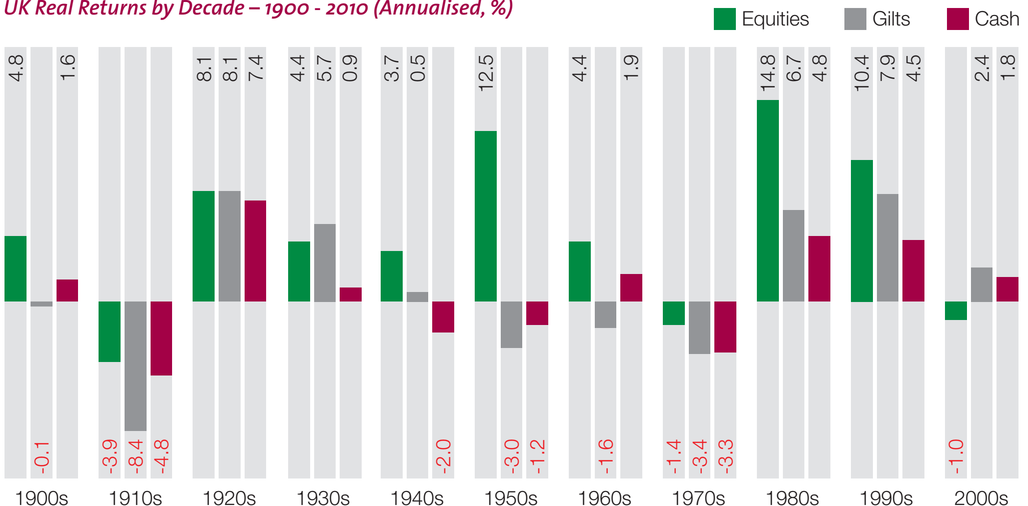
To many investors, cash represents “an opportunity cost, an opportunity lost”. They regard cash as a temporary holding place between investments in risk assets, which is held unwillingly, often for a lack of better ideas. We believe that is a myopic, limiting view. Cash is a core asset class, not just a blank canvas from which to create an investment at opportune moments. Sometimes, even over long periods, *cash proves to be a better investment than one or both of the other two core asset classes*, government bonds and equities. In most instances, even if cash underperforms equities or bonds, it still delivers positive returns in real terms (after the effect of inflation), with a very low risk of nominal losses. Although this unique, compelling trait is all too frequently overlooked, it is of tremendous value for investors.

History rhymes

While history doesn’t repeat itself – no two decades are exactly alike – it does rhyme. And, for investors, the long-term performance data for cash paints a compelling and consistent picture which should be enough to overcome any inherent recency bias, particularly any anchoring to the “anti-cash” mentality developed over the last few years of ultra-low interest rates (or financial repression, as it is known to economists).

In the only full decade of the current century, cash outperformed equities in real terms. It didn’t suffer a single moment of negative nominal or real returns

In fact, in the only full decade of the current century, cash outperformed equities in real terms. And, all that time, it didn’t suffer a single moment of negative nominal or real returns – a feature which you might have thought would have proved the asset class’s worth to investors during the helter-skelter days of the 2008 meltdown. By contrast, the 1980s and 1990s were a roaring period for risk assets,



Source: Kleinwort Benson and Barclays.

producing strong returns for both equities and bonds. Yet, even then, cash returned 5% above inflation annually in the 1980s and 4% above inflation in the 1990s, all with no fear of losses.

Perhaps of greatest relevance to the current environment is the 1950s, the last decade when interest rates were as low as they are today. It is no coincidence that then, as now, the low rates were the result of policy-driven financial repression in response to the staggering build-up in government debt – in that case, a hangover from funding the Second World War. In the 1950s, cash outperformed bonds and, indeed, it went on to do so over the following two decades (the 1960s and 1970s).

Investors today are well aware that equities are risky. But some may have forgotten – and would be wise to remember – that bonds, too, are a volatile asset class. During the three-decades-long bear market for bonds which began in the 1950s, the paltry real income from bond coupons was not enough to compensate for the fall in bonds' capital values, leading to negative returns. Furthermore, bonds with fixed coupon yields have "locked-in" rates of interest if you hold them to maturity; if you do not hold them to maturity and rates rise, you get punished with a capital loss. At the moment, the breakeven rate on index-linked gilts implies that the UK inflation rate over the next ten years will be 2.3%, while the 10-year gilt has a yield of 1.3%. So anyone holding the 10-year gilt is guaranteed to make a loss in real terms – even if rates do not increase. In contrast, cash tends to be much more flexible, and the returns on anything from simple bank accounts to sophisticated money markets funds rise along with base interest rates.

Admittedly, there are a number of demographic reasons (ageing populations and declining labour force participation rates) and structural reasons (such as the savings glut) to believe that rates – and therefore cash returns – may not rise again to pre-crisis levels in the foreseeable future. However, in that case, any inflationary headwinds to the real return on cash would also be diminished, which would be a fair compensation. Regardless, if policy-makers are to be taken at face value, we can reasonably assume that interest rates will be "normalised" at some level, safely above the inflation rate. The path to normalisation is likely to be more punishing for government bonds than for cash.

Investment implications

At present, government bonds are unambiguously expensive both in absolute terms and relative to other asset classes, and we have a negative view on them. Equity valuations are neither too expensive nor too cheap; of the core asset classes, they offer the highest relative expected returns. As a result, they form our most concentrated allocation in multi-asset portfolios. However, our optimism for equities is tempered by a number of economic risks and earnings headwinds, which leave us guarded. In addition, as of May 2016, the current equity bull run officially has become the second-longest in history. At some point, it will end. This partly explains our allocations to government bonds – which have positive momentum and performance that is inversely correlated to equities – even though they have an unpalatable expected return profile.

Holding tactical foreign exchange allocations can add value to cash beyond just plain vanilla interest – as our pre-Brexit allocation to US dollars amply demonstrates

This brings us to cash. We have increased our cash allocation in recent years. Firstly, it keeps our powder dry for attractive investment opportunities and reduces volatility from potential risks of all kinds, including the geopolitical (such as fallout from the Brexit referendum). Second, it is a core asset class. Although it may not always generate much in the way of returns, it does not lose nominal value – the most effective form of protection when the volatility of risk assets increases. Finally, the current environment of low inflation and low interest rates does not penalise us significantly for holding cash. Indeed, holding tactical foreign exchange allocations can add value to cash beyond just plain vanilla interest – as our pre-Brexit allocation to US dollars amply demonstrates.

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

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- **Management buy-outs**
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