Q2 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 July 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 also incorporates Corbett Keeling's report on deal activity in the private equity markets – a clear indicator of financial investor appetite for privately owned businesses.

As we hear all the time, businesses and the markets hate uncertainty. And what could be more uncertain than the current environment? Last quarter, we wrote that the General Election was expected to bring greater clarity to politics, with a stronger mandate for the government and a clearer vision of what Brexit might mean.

So much for our crystal ball. And yet we are far from downhearted. When we look around us at the market place, we see no signs of despair. Broader economic activity has held up well, and the latest inflation figures were lower than expected, easing the pressure on real incomes and suggesting that the Bank of England will keep interest rates low. Above all, we see plenty of deals in the pipeline for privately owned companies – and an increasing number of buyers in the market.

So perhaps others, like us, have found the antidote to uncertainty. As a successful entrepreneur noted at a recent conference we attended, privately owned companies should ignore the issues we are powerless to influence and get on with what we know how to do best: making the most of what opportunities there are. The Brexit vote may have brought increased uncertainty, but nothing is ever certain, and the obverse is that it has reduced the value of the pound. That not only makes life easier for British manufacturers looking to export but also makes many UK-based businesses look better value for overseas buyers.

As usual, this issue addresses some issues we think will be of importance to private company directors, especially those looking to sell their businesses.

- While the political uncertainty engendered by the General Election cast something of a shadow over the market's mood towards the end of the quarter, **deal making activity remained robust**, building on the strongest first quarter since 2012 (pages 2 to 5).
- Transatlantic transactions are often expected to be straightforward, but legal and language differences can cause confusion and additional costs. **We outline some important things to watch for when dealing with US counterparties** (pages 6 to 7).
- With stock market volatility at unusually low levels, investors could be excused for worrying that trouble lurks around the corner. But the **historical evidence suggests that low volatility doesn't necessarily presage either market turmoil or even poor returns from equities** (pages 8 to 9).

Best wishes

Megan Peel

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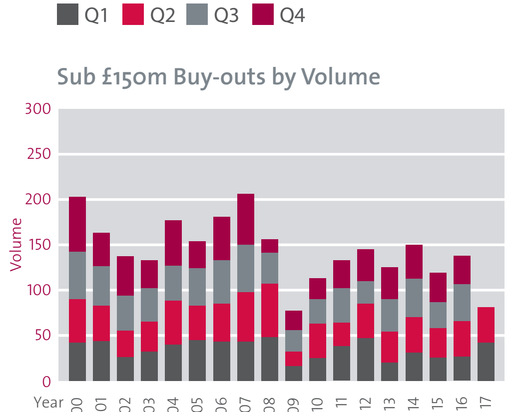
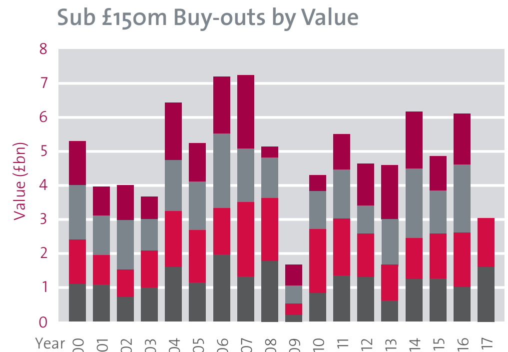
Was deal making momentum maintained?

After a strong first quarter, Jim Keeling of corporate finance advisor Corbett Keeling finds that deal activity remained robust in the second quarter as the European market enjoyed a clear pick-up in the first half compared with the same period of 2016. He also draws on the evidence of our latest survey in taking the pulse of the market.





Deal making remained consistently strong both across market segments and over each of the three months in the second quarter

Deal making activity in the second quarter of 2017 broadly matched the levels of the first quarter. Despite all the negative press about the start of Brexit negotiations, the concrete facts in the market place were the strengthening economic backdrop in Europe and a 74% increase in the value of deals done in the UK market relative to the first half of 2016. Encouragingly, deal making remained consistently strong both across market segments and over each of the three months in the second quarter.

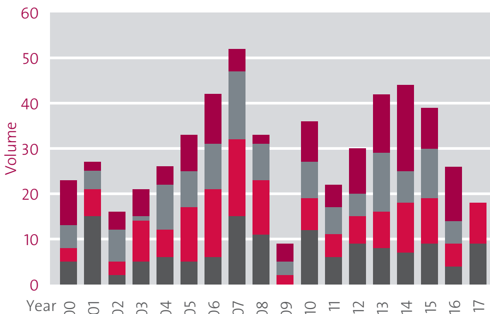
On the ground, we see plenty of market participants looking to put money to work, including overseas buyers seeking to take advantage of the weaker pound

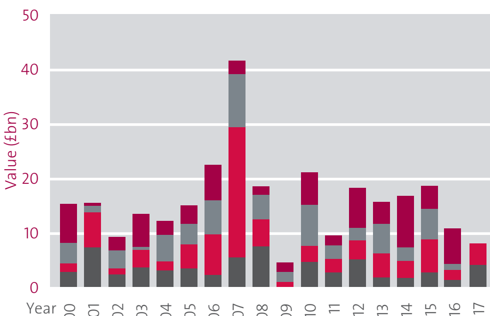
Of course, the result of the General Election cast something of a shadow over the market towards the end of the period. At the very least, it appears to weaken the government's hand for the Brexit negotiations. And Jeremy Corbyn's rebound in popularity, while it lasts, has also made more realistic the prospect of a less business-friendly government further down the line. However, on the ground, we see plenty of market participants looking to put money to work, including overseas buyers seeking to take advantage of the weaker pound. That has to be good news for company directors planning to sell their businesses.

The smaller buy-outs sector continued its strong start to the year; it marks the strongest first half of any year since before the global financial crisis

So what were the actual figures for deal making in the second quarter of the year?

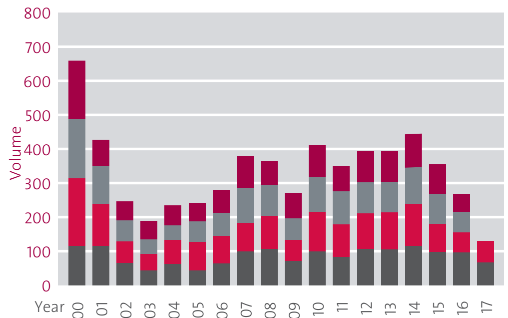
- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) continued its strong start to the year, with both the volume and the value of deals remaining very close to the figures for the first quarter. The volume was 39, fractionally down from 42, and the value was £1.4 billion, compared with £1.6 billion in the first three months of the year. That marks the strongest first half of any year since before the global financial crisis.

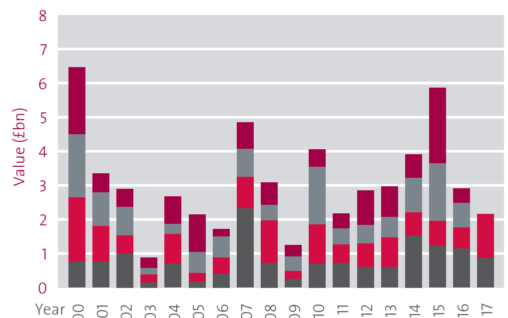




The larger buy-outs sector also broadly matched its strong showing from the first quarter

- The **larger buy-outs** sector (enterprise value of £150 million or above) also broadly matched its strong showing from the first quarter. The number of transactions held steady at nine, while their total value declined only marginally, from just over £4 billion to £3.9 billion.

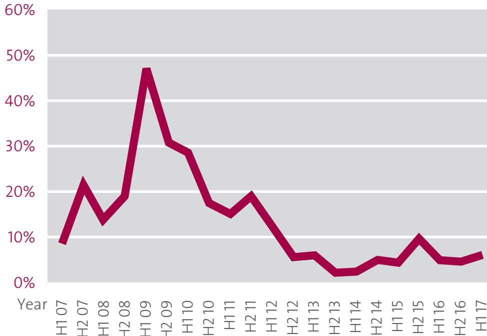




Early stage and expansion capital deals maintained their momentum as they continued to recover from the weakness at the end of 2016. Their value rose strongly, up from £873 million to £1.3 billion

- **Early stage and expansion capital deals** maintained their momentum as they continued to recover from the weakness at the end of 2016. While the number of deals was down slightly (from 67 in the first quarter to 62), their value rose strongly, up from £873 million to £1.3 billion.

All equity buy-outs remain in the doldrums. There were only two all equity buy-outs in the second quarter, down from four in the first three months of the year. This was the second-highest six-month total for five years, reflecting the continued availability and attractive pricing of debt.



So, in summary, we are encouraged by the hard data for the second quarter, which reveals a very healthy level of deal making activity. But what do the survey responses tell us of the current mood in the market? Our latest survey was conducted in the aftermath of the General Election and not surprisingly reflected the resulting uncertainty over the policy outlook.

Deal activity in the first half of this year has been far stronger than in the same period of 2016

- The proportion of respondents expecting deals to increase fell to 27% for the lower value segment of the market and to 18% for the higher value segment, their lowest levels since this time last year, when market participants were struggling to digest the implications of the Brexit vote. Of course, the bar for any increase in deals is set higher, given that activity in the first half of this year has been far stronger than in the same period of 2016.
- A majority of replies indicated that the General Election would have a negative impact on M&A activity in the next six months. Only 9% expected a positive impact.
- Respondents continued to show no concern about debt funding. While the percentage seeing increased availability has fallen back from 80% to 27% (roughly back where it was at the end of 2016), none see it decreasing.

Deal making activity has been robust, with no sign of slowing momentum. A growing number of buyers are creating competition for businesses which are up for sale

Sentiment has clearly declined in recent months, and that appears largely related to political developments. However, we note that the responses to our survey were more negative after the Brexit vote and yet they rebounded strongly in the following quarter, so the current softness may likewise prove temporary. Moreover, deal making activity has been robust, with no sign of slowing momentum. And, as we noted earlier, a growing number of buyers are creating competition for businesses which are up for sale.

We remain confident that sentiment will recover and activity will maintain its momentum over the remainder of the year

Above all, market participants are pragmatic and constantly adapt to changing circumstances, whatever direction they happen to take. Currently, that means – among other things – being alert to the growing number of corporate venture capital buyers and to overseas firms who may be seeking to take advantage of sterling's weakness to find relative bargains within the UK. Overall, we remain confident that sentiment will recover and activity will maintain its momentum over the remainder of the year.

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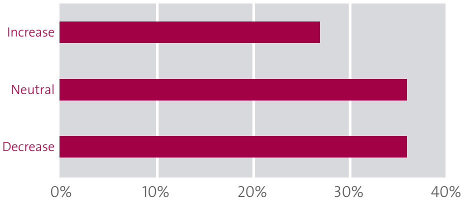
Source: Transaction statistics supplied by unquote

Survey of market expectations

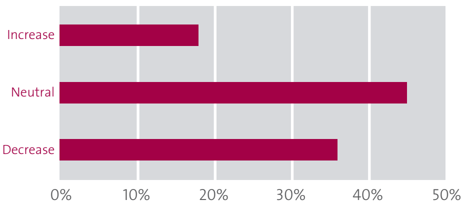
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q2 2017 predictions

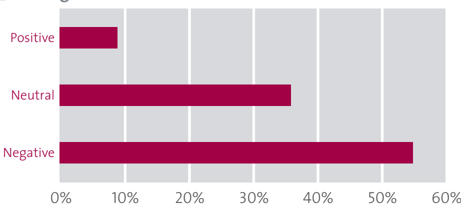
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next six months?



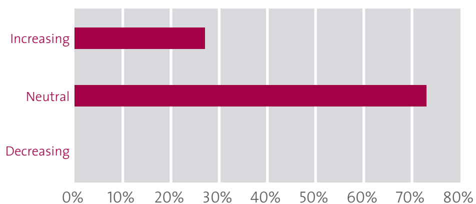
2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next six months?

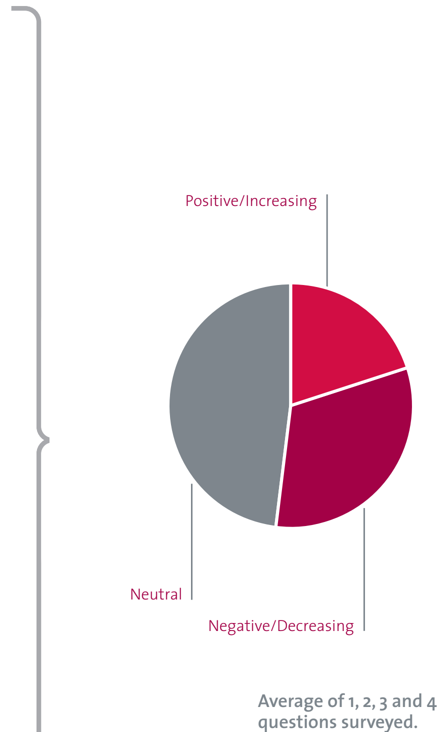


3 Is the impact of the June election going to be positive or negative for M&A in the next six months?



4 Is debt availability increasing, decreasing or neutral?





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

M&A with a US counterparty – two nations divided by a common language

Given our two countries' shared language and the common roots of our legal systems, embarking on mergers and acquisitions (M&A) with a US counterparty should be plain sailing. In reality, a number of important differences can frustrate parties on either side of the Atlantic. Here, Simon Grimshaw of law firm Hogan Lovells highlights some key points to consider if you are involved in a transaction with a US counterparty.

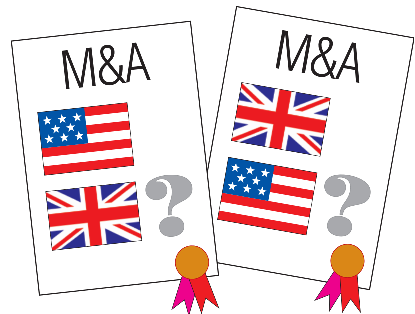
Differences in approach and even language between the US and the UK can lead to confusion and delay in M&A deals, which may prove costly. But many of these differences can easily be resolved by engaging lawyers who are familiar with each other's practises. Just because one party says "tomayto" and another says "tomahto", that's no reason to call the whole thing off.

We should start with two caveats. First, "in the UK" refers to deals governed by English law in general, not as opposed to Scots, Northern Irish or any other UK law. Secondly, laws in the US differ from state to state, so "in the US" illustrates typical differences from UK law and is not a guide to the laws of any individual state or US federal law. Further, we draw generalisations to illustrate these differences in approach, but every deal is subject to negotiation on the specifics.

1 Exchange and completion (called "signing and closing" in the US)

A key characteristic of transactions governed by English law is certainty as to when risk in the acquisition target transfers from the seller to the buyer. In the UK, transactions are normally structured so that exchange and completion happen simultaneously. Where a gap between exchange and completion is agreed between the parties (typically if the transaction requires the consent of a third party, for example for a regulatory or key contract consent), the buyer usually requires covenants from the seller and the target as to how the business is conducted in the interim.

Split exchange and completion is more common in the US, and completion is normally subject to more conditions (such as the buyer being given an agreed period to source financing for the acquisition). This greater conditionality usually means that the seller provides fewer pre-completion covenants. It is also common in the US to include a material adverse change (MAC) condition, allowing the buyer to refuse to complete if the economic position of the target has materially deteriorated between signing and closing. MAC conditions are much more closely negotiated by UK sellers, who may argue that only specific conditions required by law or agreed between the parties should be included.



2 Locked box or completion accounts

An increasingly common mechanism for calculating the purchase price of a target under an English law governed share purchase agreement (SPA) is the so-called locked box. The parties determine a price based on a defined set of accounts (locked box accounts) as at a specific date (locked box date). These are often a set of reference accounts drawn up specially for the purpose or the target's last statutory accounts. In

such deals, the buyer assumes the economic risk (and reward) for the target from the locked box date. The sellers also typically give a "leakage undertaking", where they promise to pay the buyer on a pound for pound basis any value which has leaked from the target group to the sellers.

In the US, a completion accounts structure is typically used. Accounts are drawn up as at completion, and the purchase price is adjusted against estimates or targets set at completion on the basis of a negotiated mechanism. Whereas both completion accounts and locked box mechanisms are well understood in the UK market, the locked box is much less prevalent in the US.

3 Warranties ("reps and warranties")

Under English law, there is a real difference between representations and warranties. The basis for calculating damages under each is different, and misrepresentation can potentially be remedied by rescission, whereby the transaction is unwound so that the parties revert to the position they would have been in had the contract never been entered into. So, under English law, the seller typically expressly states in the SPA that no representations have been given, so that misrepresentation can't be claimed.

Conversely, in the US, the terms representation and warranty are typically used interchangeably without distinction and often appear together as "reps and warranties".

4 Warranties or indemnities

In the UK, there is a further distinction between warranties and indemnities. Entire legal textbooks are written about this, but the main difference – in the context of the SPA governing an M&A transaction – concerns the measure of damages. For an indemnity claim, recoverable damages are (subject to drafting) on a pound for pound basis. For a warranty claim, usual contractual principles apply, so the buyer needs to prove a loss and has a general duty to mitigate any losses. In addition, the buyer typically has to prove that the breach of warranty caused a diminution in the value of its shares.

In the US, recovery for breach of any representation or warranty is normally on an indemnity basis. However, a US SPA typically includes several limitations on the buyer's ability to seek indemnification, such as a de minimis threshold for individual claims, a cap on aggregate liability and a shorter survival period than is expected in the UK. Such limitations are also usual in an English law SPA, but typically only apply to warranty, not indemnity, claims.

5 Disclosure letters ("schedules")

Disclosure is when a seller informs a buyer of any matters which qualify the warranties (or "reps and warranties") they are giving. If the disclosure is done properly, a buyer should not be able to sue a seller for breach of a warranty in respect of the disclosure.

In a US deal, the seller's disclosures (both statements of fact and the underlying documents relating to such statements) against the reps and warranties are usually contained in a schedule to the SPA. Such disclosures tend to be cross-referenced against specific warranties, with no or few general disclosures.

In the UK, disclosures are normally contained in a separate letter, given against all warranties they relate to, and include general disclosures, such as of matters discoverable on public registers and the information available in the transaction data room.

6 Investments in newcos or targets

In the UK, for various reasons (many driven by tax), in scenarios where a buyer will share ownership of the target group with some or all of the sellers after completion it is typical to incorporate a new company as the buying entity. This approach is not typical in the US, where such buyers would expect to simply buy or (particularly with private equity transactions) subscribe for shares in the target.

7 Presentation

The way lawyers draft documents in the two countries varies significantly. US drafting tends to be more verbose and less structured. Paragraphs lasting several pages and with little or no punctuation are not unheard of! A layman reading an English law SPA for the first time may be surprised to hear it, but English law drafting tends to be briefer and more structured and to include more punctuation to help the reader.

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The only thing to fear is fear itself

When, as today, markets are calm, some investors tend to assume that turmoil must be around the corner. Here, Mouhammed Choukeir, Chief Investment Officer of Kleinwort Benson, looks at the historical evidence and finds little reason to forecast an imminent jump in volatility – or to make significant adjustments to asset allocation based solely on current volatility levels.

Imagine you have just climbed on to a rollercoaster, the bar has lowered overhead and locked you in. Now the carriage is clicking as it inches up towards its apex. You brace for a steep fall . . . and whooooooosh! That is what it can feel like for investors when volatility levels are high.

At present, it is more like one of those 1950s westerns. There is a lull after a skirmish with the Cheyenne and one of the US cavalry troopers, with a glance towards the rocks above the encampment, nervously adjusts his yellow neckerchief and drawls, "It's quiet out there – too darned quiet." Volatility is currently very low; surely, it can only go in one direction – up. But is there in fact any reason to worry?

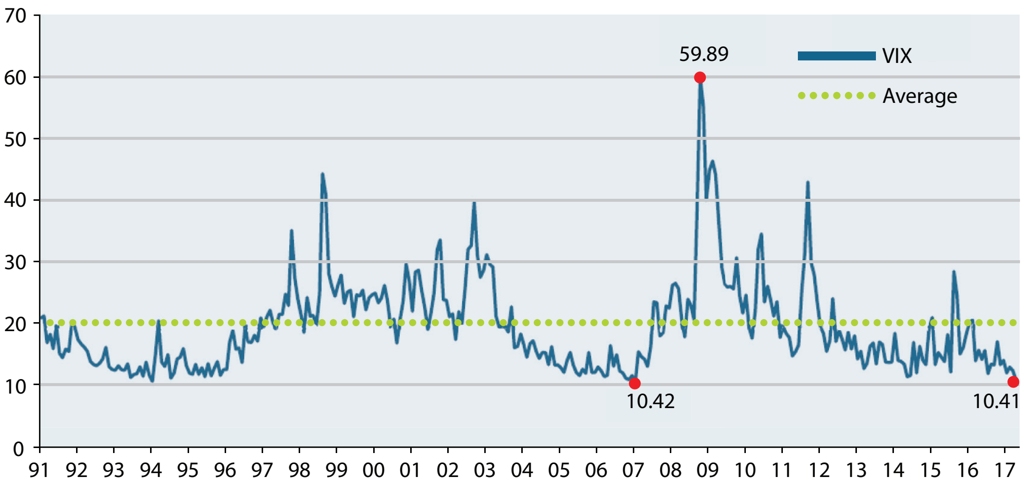
What does history tell us?

The most commonly used measure of volatility is the CBOE's Volatility Index, known as the VIX. It measures activity in the derivatives market around the bellwether S&P 500 stock index. Put simply, it shows how far investors are betting the S&P 500 will be from its current level in one month. If more activity than usual is taking place in the options market, with investors betting on large gains, steep falls or both, the VIX goes up. If investors are in a mellow mood, with little conviction on changes from the present level, then the VIX stays low. At current levels, investors are in deep-tissue massage territory.

Can history help to cast any light on the future? Unfortunately, the VIX doesn't have a lot; the index was only created in 1990. However, using historic 60-day volatility – which is highly correlated with the VIX – we can extend our analysis to 1953. That allows us to draw several important conclusions.

First, just because volatility is low, there is no reason to expect a spike upwards or even a rising trend any

Volatility Index (S&P 500) – 1991 - May 2017



time soon. Over a 12-month timeframe, volatility is more likely to remain in the same quintile than not. This is evidence of volatility "clustering": volatility tends to stay at the same level until something unpredictable causes a new volatility regime. This is like a striker in football being more likely to score a goal in a match after already scoring one. When you're hot, you're hot. By the same token, when the striker is in a lean patch, the chances of scoring in the next game are lower.

Second, what equity investors are really interested in is if any inference about future returns can be drawn from volatility levels today. It would be intuitive to suggest returns from low volatility regimes like the current one would be lower than those from higher volatility starting points; after all, things can only get "worse" from these historical lows. While we find some evidence to suggest forward equity returns are slightly constrained from lower volatility starting points, we can draw another important conclusion: on average, lower volatility starting points do not indicate future losses for equity markets. The long-term upward bias of the equity market is strong, and low volatility alone is not a good market-timing tool for reducing equity exposure.

Third, some trigger event will at some point kick off a shift in volatility from current low levels to higher levels. This is inevitable and should not cause alarm. When volatility is high, equity markets tend to have slightly more attractive subsequent return characteristics than on average. Warren Buffet's adage comes to mind: "Be greedy when others are fearful."

Investment implications

Currently, investors are somewhat crowded in equities, because they have little conviction on asset classes elsewhere. There are no great expectations for high returns or for a sharp drop, so the future volatility implied by options market prices is low. But even if volatility were high, we would take it with a pinch of salt, for all the above reasons; simply, put, there is no empirical case to adjust asset allocation based on volatility alone. In Franklin Roosevelt's words, we will not fear "fear itself".

At present, while we recognise that global markets are currently expected to produce relatively low returns, we remain sanguine on balance. **Equities** are not overvalued when assessed on a number of measures (such as price-to-book ratio). Moreover, they are still supported by strong momentum. Although volatility is low, few would describe the mood amongst investors as complacent. If anything, this long-running bull-market has been characterised by caution and some key sentiment indicators are displaying "oversold" characteristics. Therefore, equities are still our most significant allocation across balanced portfolios, though our stance is best described as neutral. Within equities, we prefer regions where we see better value, such as the eurozone.

We also recognise that markets can move rapidly, so we continue to have significant allocations to **government and investment grade bonds**, despite record low yields and high valuations. They are held primarily to diversify away from equity risk. But that is not the only reason. Fixed income securities also have positive momentum and are surrounded by negative sentiment, both aspects we like. Interestingly, they have surprised many people by delivering excellent returns over the last three and five years, through conditions similar to today. It is more than possible that they will continue to surprise on the upside, as they have done so far in 2017.

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