Q3 2016

UK Private Company Director

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

Corbett Keeling Corporate Finance

Hogan Lovells

Dear Reader

Welcome to the October 2016 issue of UK Private Company Director, the quarterly newsletter for directors of owner-managed 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.

At the time of our last issue, everyone was struggling to digest the news of the Brexit vote. It's been an interesting three months since then. In many ways, it has been full of incident, with initial volatility in stock markets followed by a pronounced rebound to new highs, further intervention from the Bank of England to support the economy, a steep fall in the pound and immense political upheaval.

Yet, in other ways, it has been surprisingly quiet. Markets have broadly stabilised, nothing much has yet been decided about the form Brexit will eventually take, and private companies have, of course, largely gone about their business much as they did before the referendum. While all eyes have been on the economic data for any signs of a downturn, we have seen no conclusive evidence yet one way or the other. Many remainers have been keen to cry "I told you so" whenever they have spotted any weaker data, while Brexiters have latched on to any positive economic numbers to say "See – it's not as bad as you thought!"

While we are broadly supportive of reclaiming sovereignty from Brussels and easing the regulatory burden on companies, we will be watching political developments closely for signs of any anti-business legislation (rather than just the rhetoric we have occasionally heard thus far). In the meantime, we trust to the usual determination and ingenuity of the individual business people who make up our industry and the wider economy.

Not surprisingly, Brexit matters continue to dominate our thoughts in this issue.

- Despite all the doom-mongering in the press, both **the volume and the value of private equity transactions have held up well**, and market sentiment remains reassuringly robust (pages 2 to 5).
- Amid all the post-referendum uncertainty (pages 6 to 7), **we look at some of the legal issues facing the industry** – such as passporting, tariffs and employment arrangements – **and how they might affect private equity activity in practice.**
- The Bank of England's intervention was just the latest example of the extremely loose monetary policy which has driven government bonds to historically high valuations. **While we still see valid reasons for owning bonds, equities appear to offer much better value** (pages 8 to 9).

Best wishes

Megan Peel, Editor
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No sign of Brexit blues!

After a robust 2015, activity in the UK private equity industry slowed overall in the first half of the year during the run-up to the Brexit referendum. But what actually happened in the first full quarter after the Brexit vote? Here, Jim Keeling of corporate finance advisor Corbett Keeling looks at the hard data and assesses the current mood of market participants.

The numbers are in, and while they reveal some reduction in activity from the second quarter – particularly at the larger value end of the market – the slowdown has been modest and does not suggest an imminent sharp downturn. Brexit may have clouded the macro-economic outlook somewhat, but it does not appear to be having much impact on mid-market private equity deals – so far, at least.

Brexit may have clouded the macro-economic outlook somewhat, but it does not appear to be having much impact on mid-market private equity deals

Perhaps this should come as little surprise. Brexit won't actually occur for at least two years, and conditions on the ground have not changed significantly as far as most current deals are concerned. Encouragingly, market sentiment remains sanguine and has, if anything, picked up from the previous quarter, according to our survey of market participants.

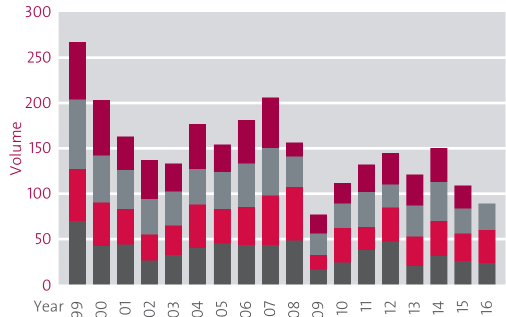
The smaller buy-outs sector of less than £150 million held steady

But let's examine the data for the third quarter in more detail.

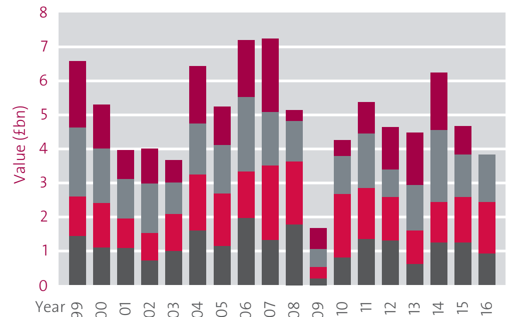
- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) held steady. The total number of deals (29) was down from the second quarter but was still above the average for the past two years. The value of deals fell to £1.4 billion from £1.5 billion. Yet there is no sign of Brexit blues: values for the first three quarters of the year almost exactly match the same period of 2015.

Q1 Q2 Q3 Q4

Sub £150m Buy-outs by Volume

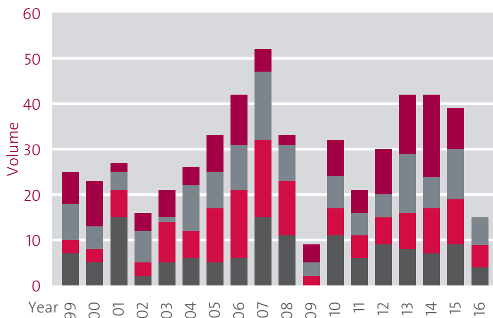


Sub £150m Buy-outs by Value

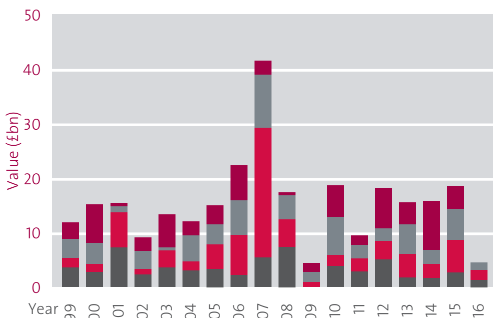


- The **larger buy-outs** sector (enterprise value of £150 million or above) shows some signs of being affected by the prevailing uncertainty. The number of deals rose slightly to six, while their value fell from £1.9 billion to £1.4 billion. Both volumes and values are well down on the same period of 2015. However, they are higher than in the first quarter of this year.

£150m+ Buy-outs by Volume

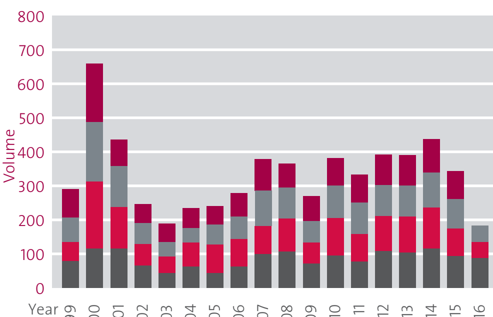


£150m+ Buy-outs by Value

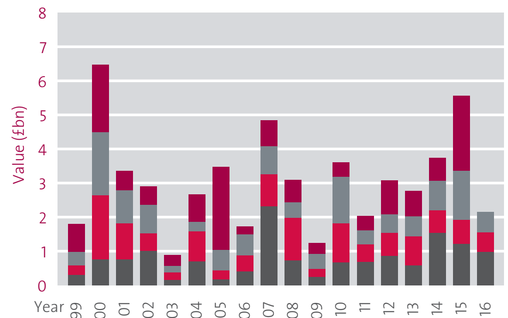


- **Early stage and expansion capital deals** almost exactly matched the second quarter. The volume of transactions edged up to 48 (from 47), while their value rose to £600 million (from £569 million). For the first three quarters of the year, the value of deals is lower than the past two years, but it is up fractionally on 2012 and 2013.

Early-Stage/Expansion Deals by Volume



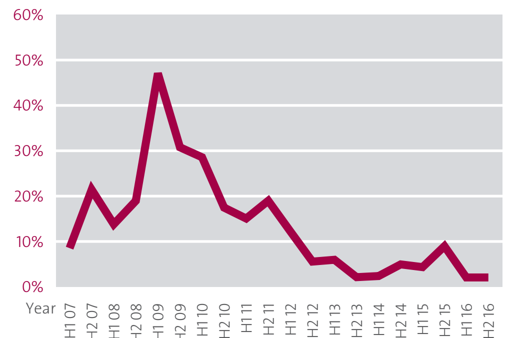
Early-Stage/Expansion Deals by Value



Debt remains a popular source of deal funding

With the Bank of England cutting interest rates further and extending quantitative easing, it's perhaps little surprise that debt remains a popular source of deal funding. As in the second quarter, only one buy-out was funded entirely by equity.

All Equity Funded Buy-outs to All Buy-outs



The overwhelming majority of respondents expect deal volumes to increase over the next 12 months. This figure is significantly more bullish than the overall figure for the second quarter and even beats the first quarter's level

As usual, we have conducted a survey of market participants to get their views of the outlook for deal activity and some of the pressing issues facing the industry.

- The overwhelming majority of respondents expect deal volumes to increase over the next 12 months. Indeed, the figure is significantly more bullish than the overall figure for the second quarter and even beats the first quarter's level.
- The optimism is more pronounced in the lower value segment of the market, where fully three quarters of those surveyed predict higher volumes and only 5% think they will fall. In the higher value segment, 60% expect volumes to rise (admittedly from a lower base), while the remainder expect no change.
- Almost all of our respondents report that debt availability is plentiful and indeed increasing, both for smaller and larger deals.

Participants remain broadly sanguine about the effects of the Brexit vote, with 90% saying they believe its impact will be neutral while the rest view it as a positive impact

- Intriguingly, participants remain broadly sanguine about the effects of the Brexit vote, with 90% saying they believe its impact will be neutral while the rest view it as a positive impact.

As we noted last quarter, it is early days yet in the Brexit era, and it is possible that the economy will experience some near-term pain as we all adjust to the new circumstances, particularly if EU politicians seek to punish the UK.

As one of the respondents to our survey has noted, this has been in many respects a "traditional summer", with plenty of activity in the market. We also share some other correspondents' view that a new sense of optimism is emerging about the long term future

So far, market conditions remain little altered. Anecdotal evidence suggests that some retail banks have turned more cautious on deals, and foreign investors may show greater reluctance to invest until the impact of Brexit becomes clearer. However, others have been looking to snap up some British bargains after the fall in the value of the pound. Yet the net effect has been barely noticeable on the industry's daily business. In fact, as one of the respondents to our survey has noted, this has been in many respects a "traditional summer", with plenty of activity in the market. That, I'm glad to say, certainly chimes with our own experience, and we also share some other correspondents' view that a new sense of optimism is emerging about the long term future.

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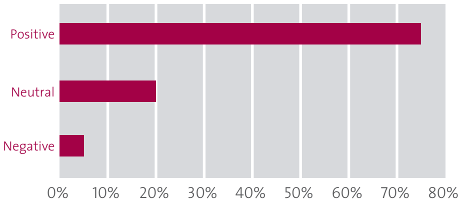
Survey of market expectations

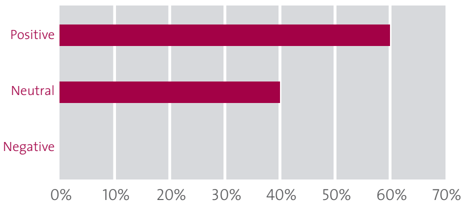
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q3 2016 predictions

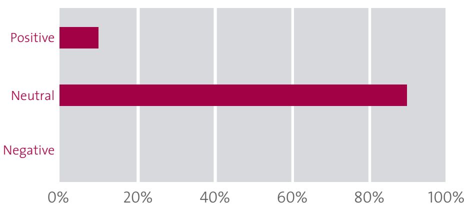
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next twelve months?



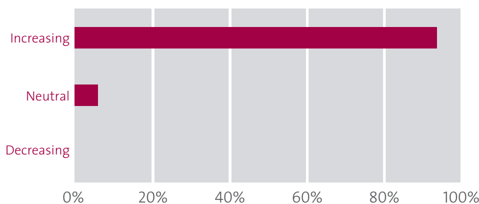
2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next twelve months?

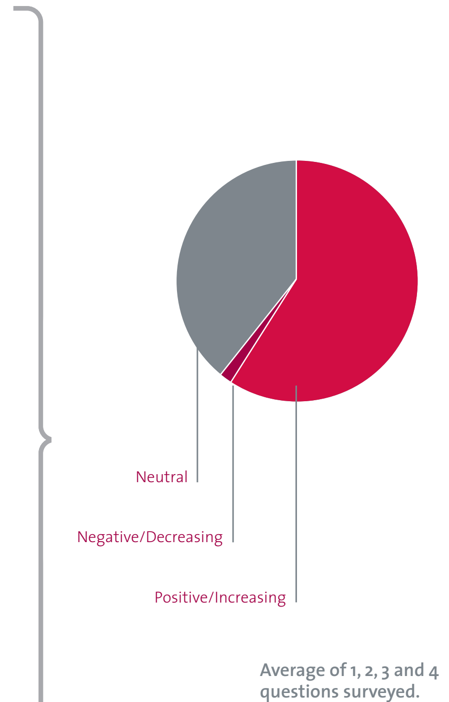


3 What do you think the impact of Brexit is now and for the next three months?



4 Is debt availability increasing, decreasing or neutral?





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

How will Brexit affect private equity activity?

Just four months after the EU referendum result, the outlook for UK business remains uncertain. Following on from our exploration of Brexit's likely effect on UK M&A in the last issue of this newsletter, Robert Darwin (partner) and Daniel Grant-Smith of law firm Hogan Lovells International LLP assess, more specifically, the potential impacts of Brexit on private equity activity in the UK.

As yet, we have received few clear answers to the pressing political, macro-economic and legal questions posed by the Brexit vote. The government has announced its intention to trigger Article 50 of the Treaty on European Union by March 2017, starting the two year negotiation period which will culminate in the UK's exit from the EU. Until that process begins, however, the referendum result will have no immediate legal effect. Equally, despite widespread media speculation about the nature of the deal that the government will pursue, the final form of Brexit remains unclear. The economic and market impacts thus far add to the lack of clarity. The 0.5% increase in UK GDP over the three months since the referendum result was stronger than expected, but sterling remains under severe pressure.

Uncertainty can have a significant impact on people's appetite for risk and willingness to make decisions. Current commentary is hugely varied, with studies predicting very different hypothetical outcomes for the UK. In this uncertain environment, perhaps a better approach would be to identify the potential practical realities of leaving the EU as they might apply to the private equity market.

Passporting

Exiting the EU could mean that the UK falls outside the 'passporting' regime. In that case, financial institutions based in the UK would lose their current ability to sell financial services to the rest of the EU and so might need to establish appropriately authorised entities in an EU market in order to provide the same services there or in other EU markets. This could lead private equity houses based in London and fundraising across Europe to reassess their location. Perhaps more significantly, it might lead US banks to relocate from the UK to an EU market, to facilitate selling their services within the EU. In the worst case scenario, where passporting rights are lost and government fails to provide a suitable alternative, PE houses and international banks could leave London en masse, critically affecting its status as a financial centre.

Would a European city such as Paris, Madrid or Frankfurt represent a more logical centre of business than London? The UK has held a strong position as a global financial centre since before the single market, thanks to the advantages of its language, time zone and legal system. The English legal framework for M&A represents a globally respected and stable foundation for private equity transactions around the world. None of these factors have been altered by the Brexit outcome.

It also seems unlikely that the government would deliberately minimise the influence of the UK in financial services. Indeed, recent remarks suggest that it would aim to prevent any exodus by replacing passporting with a suitable equivalent arrangement, if possible.

Trade tariffs

For some PE houses, Brexit could provide greater freedom to operate outside the confines of EU regulation, giving greater flexibility within a global, rather than local, market. Nevertheless, for PE assets operating and trading within the EU or with

operational supply chains reliant on EU members, consideration may need to be given to the potential impact from new trading tariffs, depending on the form Brexit takes. Portfolio companies will also need to consider any potential external impact, once the UK is outside the shelter of Europe. Neither the Comprehensive Economic and Trade Agreement between the EU and Canada nor the Transatlantic Trade and Investment Partnership between the EU and the US would apply to the UK, and similar trade agreements (if necessary) could be unpredictable and lengthy to negotiate. However, the key objectives are market access, regulation and cooperation, and it's difficult to see how being part of Europe, rather than an independent nation, would make the UK better placed to achieve those aims.

The Alternative Investment Fund Managers Directive (AIFMD)

Once out of the EU, UK based private equity fund managers would no longer be subject to the AIFMD. As a result, the reporting and anti-asset stripping obligations imposed by the directive will no longer apply to portfolio companies owned by UK fund managers. However, the AIFMD has been passed into domestic UK law on substantially the same terms as the directive. The law is unlikely to change, at least in the short term, and any eventual amendment would probably relax rather than toughen the current regulations.

Although the private equity industry in the UK was underwhelmed by the introduction of the AIFMD, principally because of the additional financial and administrative cost, fund managers who have received the pan-EU AIFMD passport would lose their passporting rights after Brexit. However, the UK would probably apply for a non-European Economic Area jurisdiction distribution passport, and it would be hard for the EU authorities to refuse, as the UK has adopted the AIFMD into domestic law.

Human resources

Brexit will probably also alter employment arrangements, impacting private equity at both fund and portfolio level. Any restriction on freedom of movement is likely to affect recruitment of workers from outside the UK. This should have a limited impact on EU citizens already working in the UK, as the government is expected to guarantee their legal status or enter into appropriate reciprocal arrangements with the EU. However, it could increase the cost and administrative burden of future recruitment from the EU, depending on the arrangements agreed.

Brexit will also allow the government to make changes to UK employment regulations founded in EU regulation. As a result, UK workers in the EU (and EU workers in the UK) could find their rights eroded and PE employers could face additional bureaucracy. However, it could also mean the end to regulation that is unpopular with business, such as that derived from the Working Time Directive and the Agency Workers directive. Other regulations, such as that governing collective consultation on redundancy and the transfer of undertakings, will probably get tweaked, rather than removed, while protections that seek to protect UK citizens and business are unlikely to change significantly.

Deal volume

The uncertainty and increased risk to UK businesses caused by a lack of clarity on the form of Brexit and by prolonged periods of currency volatility may cause delays to transactions and may slow deal volume. Indeed, some market figures appear to suggest that this is currently happening, with the number of private equity acquisitions of UK companies falling relative to the same period in 2015.

However, Brexit will also provide opportunities for PE buyers. The value of the pound has fallen significantly against the dollar and euro since the referendum. This will make UK businesses cheaper for non-sterling denominated funds and for overseas companies in general and thus potentially more attractive to buy.

Equally, Brexit could have particularly adverse implications for certain UK companies. They may include businesses with large exposures to the falling pound, such as those which rely heavily on the importing of foreign supplies but mainly operate domestically in the UK, as well as companies which depend heavily on EU labour. These companies may struggle to weather the volatility, providing further opportunities for foreign buyers looking to acquire cheap, distressed assets.

Notwithstanding the potential for delays or a temporary abatement of volume, the US continues to scour Europe for funding and assets. Cross border activity into and out of Europe looks set to continue.

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It was the best of times, it was the worst of times

August tends to be a sleepy month in markets, as financial professionals head off on their holidays. Indeed, the S&P 500 Index did not have a daily move of 1% in any direction, and the FTSE 100 had only one. Given this moment of calm, Mouhammed Choukeir, Chief Investment Officer of Kleinwort Benson, reflects on the year so far and assesses the outlook for various asset classes.

After encountering some severe turbulence earlier in the year, financial markets have regained their poise in the third quarter. Equities continue to rally, with the S&P 500 near its all-time high, the FTSE 100 up 9% on the year and emerging market equities back in vogue, up 10% in local currency terms (at the time of writing). These returns represent a staggering comeback from the first quarter, when each index was down at least 10%.

However, this most recent upturn in the multi-year equity bull market has not been accompanied by much of a feel-good factor. German and Japanese bonds maturing a decade from now offer negative yields, and UK government bond yields are at record lows across the yield curve: 30-year gilts yield just 1.23%, while those with maturities of five years and below yield next to nothing. Furthermore, assets that are popular hedges at times of crisis have also rallied this year, with gold up 23% and the yen 17% in US dollar terms (to the end of August).

Markets vs economic reality

Nearly a decade on from the financial crisis, global economic growth remains insipid despite the colossal efforts of central banks around the world. These efforts, though largely fruitless in their primary aim of stoking growth, continue to underpin equity and bond markets. The Bank of England, the European Central Bank and the Bank of Japan are directly intervening in financial markets, buying government and corporate bonds, bidding prices up and yields down. Even the US Federal Reserve, while not actively buying assets at present, continues to flip-flop on the trajectory of its interest rate increases; US bond yields also remain at record lows.

Financial institutions keep finding themselves with excess cash in return for the bonds they are selling to the central banks. This cash, in turn, is ploughed into assets such as equities, as it has been since the onset of the financial crisis.

The lower the yields are on government bonds, the more attractive equities appear in comparison. Many investors are holding increased equity risk in portfolios to get "pre-crisis" levels of return. At the end of 2007, a portfolio comprising 50% global equities and 50% government bonds had an expected return of 5.5% (expected returns are based on the average five-year historical return from the starting valuation). Today, it can be expected to generate about 3.5%. To achieve 5.5% currently, the portfolio would have to hold 80% in equities, making it far riskier. The alternative is to settle for lower returns for the same level of risk, an unattractive option for many investors.

The monetary easing around the world, while supportive of risk assets, carries serious risks. First, pushing most investors to take more risk increases the overall systemic risk in markets, as has been outlined at recent G20 summits. Second, low rates and bond-buying cannot continue indefinitely. When they come to an end, equities and bonds could be severely re-rated. Third, and perhaps most importantly, there is no substitute for economic growth. While growth is not correlated with asset class returns in the short run, it influences long-term returns. Markets would prefer risk assets to be underpinned by healthy long-term economic fundamentals, rather than short-term monetary policy.

Some potential pitfalls

Several other economic and geopolitical risks further muddy the waters. In February 2016, equity and commodity markets were in freefall because of fears of a slowdown in the Chinese economy. In June and July, markets experienced ructions again after the UK's vote to leave the EU. Both these issues remain unresolved.

In China, the state-controlled depreciation of the renminbi continues. The implication that the Chinese

authorities have faltering faith in their own growth prospects has caused concern. In addition, a Chinese real estate bubble, built on debt and speculation, continues to get larger.

In the UK, while the sentiment gauges may have overshot on pessimism in the early days after Brexit, the actual data seems to have held up well. Nevertheless, most economic forecasters still believe Brexit will lead to at least a short-term loss in GDP, with a longer-term recession possible. Also, while Theresa May swiftly took the reins as prime minister, negotiations with the EU and the actual invocation of Article 50 remain to be done. The task at hand is enormous – Whitehall and Westminster have to decouple the UK from more than 40 years of EU law – and fraught with potential missteps.

Also looming large is the US election. Investors are scrambling to separate Donald Trump's bombast from his policy. We have heard plenty of rhetoric ("ban trade", "build a wall"), but few details on how these policies will be funded. Conservative estimates are that they will cost trillions, and even doubling the historical GDP growth rate (an impossible task) would not make up the shortfall. A Clinton presidency may be more palatable to investors (the first time a Democrat has been favoured over a Republican candidate in decades). Certainly, markets are likely to remain volatile up to the election. And the winner will govern a country more polarised than it has been for many years, which does not bode well for a country that represents one-fifth of global GDP.

Investment implications

While acknowledging these challenges to global markets, we remain sanguine: equities are still our most significant allocation. Why? They look attractive not only relative to bonds, but also in absolute terms. Equities offer some value across a number of measures (such as price to book ratio). Moreover, equities are supported by strong momentum and bearish sentiment, which we believe are more important drivers of returns than monetary dynamics or geopolitics.

However, markets can move with staggering speed, and we still have significant allocations to government bonds, despite their record low yields and high valuations. They are held primarily to diversify away from equity risk. But government bonds also have positive momentum and negative sentiment, both aspects we like. They have delivered surprisingly strong returns over the last one, three and five year periods through conditions similar to today. They may well continue to surprise, particularly given current monetary policy conditions.

As another form of defence, we have increased our cash allocation in recent years, for two key reasons. First, it gives us a flexible position to capitalise on attractive investment opportunities (such as commodities), while reducing volatility from potential risks of all kinds, including geopolitical. Second, it is a core asset class. It may not generate much in the way of return, but it does not lose nominal value – the most effective form of protection if riskier assets become more volatile.

In commodities, we see an attractive nexus of cheap value, positive momentum and bearish sentiment. After precipitous falls in the prices of a diversified commodity basket during their five-year bear market, a floor in oil prices proved a catalyst for the asset class to regain positive momentum based on compelling valuations. In April, we re-entered the asset class after a three-year hiatus, and we may well add to that position.

Lastly, we took profits on all of our long-standing UK commercial real estate positions a few months ago, thus avoiding the Brexit-triggered carnage. Until recently, commercial real estate was the darling of many investment portfolios, providing a decent yield and strong capital appreciation in a low-return world. Yet, even before Brexit, valuations were becoming stretched, momentum was faltering and complacency had set in.

In conclusion, the summer appears to have provided a period of calm for markets and an opportunity for most to step back and reflect on the big picture. No doubt the months ahead will bring further uncertainty and volatility to markets. We stand by our investment process to navigate the uncertainty and capture the opportunities.

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Sources for all data: FactSet, Kleinwort Benson.

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

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