Q1 2018

UK Private Company Director

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

Corbett Keeling Corporate Finance

Hogan Lovells

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Dear Reader

Welcome to the Spring 2018 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.

Last quarter, we noted that we are in something of a sweet spot for private company acquisitions. Just how much of a sweet spot was made clear by some recent data from Private Equity Investment, which revealed that private equity funds alone raised $411 billion globally in 2017. That is on top of the large amounts of dry powder corporate buyers and debt funds have at their disposal to make purchases. In fact, some commentators estimate that up to $1 trillion of cash may be looking for work. Small wonder, then, that valuations have been rising across all sectors – and look set to continue doing so in the months ahead.

This positive backdrop could, of course, last for many months yet, and we hope that it does. However, the sales process can be long and complicated, and, maybe unsurprisingly, you will see that, on reviewing market sentiment, Corbett Keeling concludes that anyone contemplating the eventual disposal of a privately held company would do well to get on and explore their options, as they are unlikely to find conditions that are much more favourable than at present.

In this issue, we delve into some of the topics we believe should be of interest to directors of privately held companies.

- Though down slightly from its heady pace in the second half of 2017, **deal making in the first quarter remained at a robust level and our latest survey indicates no concerns of an imminent slowdown** (pages 2 to 5).
- A recent High Court decision underlines **the need to comply with the strict terms of notice provisions in a sale and purchase agreement.** We assess some practical implications for private equity practitioners and directors looking towards a sale (pages 6 to 7).
- With the prospect of a Labour government in the offing, we evaluate the historical record and find that, **while economic growth has been a little lower under Labour, stock market performance has been broadly similar under both main parties** (pages 8 to 9).

Best wishes

Megan Peel

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Make hay while the sun shines

After a bumper year for transaction volumes and values across the private company market in 2017, Jim Keeling of corporate finance advisor Corbett Keeling looks at the data from the first quarter of 2018. He finds that activity, though down slightly overall from the second half of last year, remains robust. However, he warns that conditions for potential sellers will not always be this favourable.

Once the uncertainty of last June's general election was over, the market forged ahead. Taking advantage of a still business-friendly political environment and the continuing availability and low cost of debt, it posted the strongest six months of transaction values since before the global financial crisis.

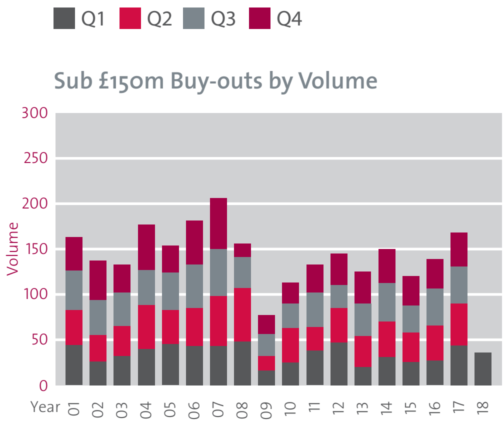
We find that, after a quiet January, activity in the first quarter of 2018 has stayed at a brisk rate across all segments of the market

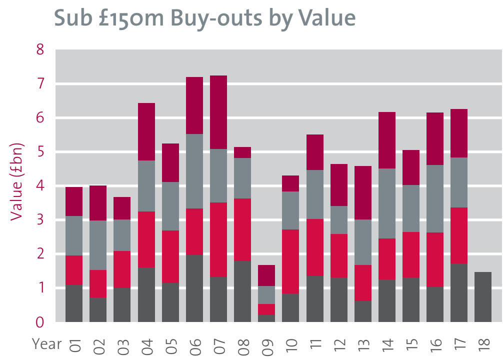
It was always going to be a big ask to maintain that momentum. However, we find that, after a quiet January, activity in the first quarter of 2018 has stayed at a brisk rate across all segments of the market. In fact, we would normally argue that the current level of activity should prove to be more sustainable than the heady pace of last year's final six months. Certainly, barring any unforeseen shocks, we see no immediate threat of a significant slowdown.

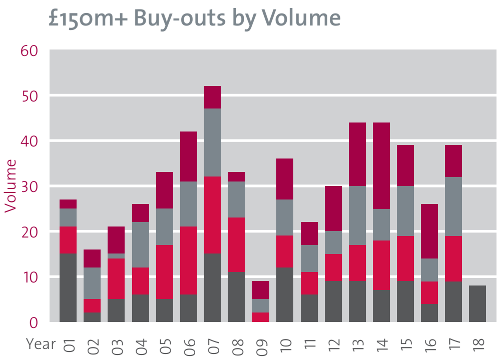
As regular readers will know, we are generally optimistic and by no means given to doom-mongering. However, we are conscious that current conditions are unusually favourable for owners looking to sell their privately held business and this cannot last indefinitely. While central bankers are keenly aware of the need to tighten policy only gradually, we can expect interest rates to rise from current historically low levels. Moreover, the Brexit negotiations have further to run, and they are likely to bring political and economic uncertainty at some point over the next few years. In particular, we are cognizant that a change in government might create a less favourable market backdrop for private businesses. At the industry level, buyers will not always be this flush with cash – or debt always this available – to fund acquisitions.

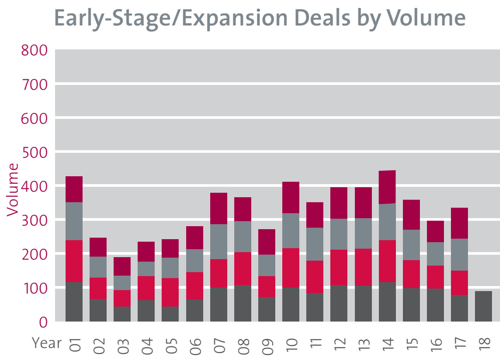
But that is a concern for the longer term. We will shortly turn to the near-term outlook. First, though, let's assess the data for the first three months of 2018.

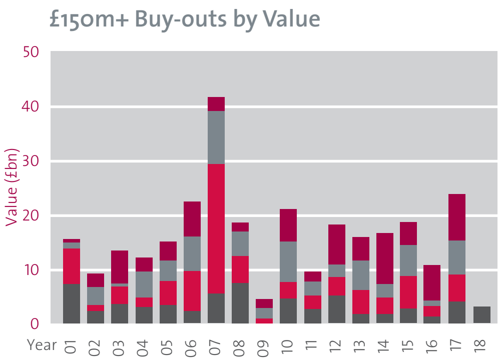
- ***The smaller buy-outs sector was the one segment which maintained the same pace of activity as in the final quarter of last year. The volume of deals was broadly flat (with 36 deals recorded as complete at the time of writing, versus 37 in the previous quarter), and the value actually edged up from £1.4 billion to £1.5 billion.***

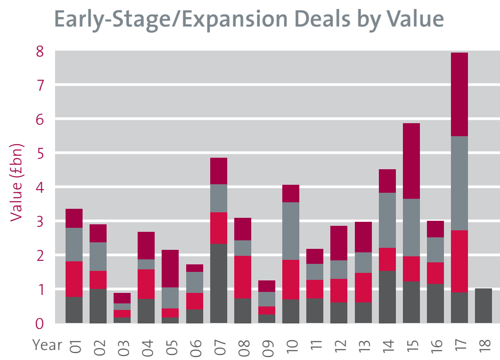










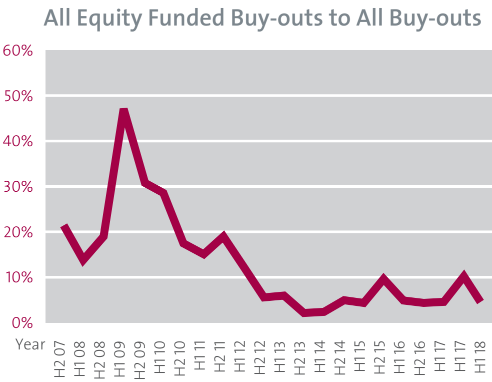


- While the value of deals in the **larger buy-outs** sector (enterprise value of £150 million or above) was down sharply from £8.5 billion to £3.0 billion, the number of transactions actually increased from seven to eight.
- Volumes also held up well for **early stage and expansion capital deals**, with 89 deals recorded, compared with 90 in the last three months of 2017. However, the value of deals – at a still perfectly respectable £1.0 billion – was markedly lower than the previous period's £2.4 billion.

All equity buy-outs show no sign of regaining their former glory. Only two such transactions were reported in the first quarter of 2018, down from three in the final three months of 2017. That is little surprise, given the continuing availability and low cost of debt funding.

So what does market sentiment tell us about the prospects for the months ahead? Anecdotally, some of our contacts in the market suggest that activity has eased slightly from the hectic pace in the second half of last year. And our survey of market participants is perhaps a fraction less optimistic than in January.

All but two buy-outs involved debt, which is little surprise given the continued availability and low cost of debt funding



- Half of respondents still expect deal volumes to increase from current levels, and only 14% thought that activity was likely to decline. The rest predicted little change.
- None of our respondents expressed any concerns about the availability of debt funding for transactions. That said, the proportion expecting increased availability came down from 50% to 29% (the remainder thought it would stay broadly at current levels).
- The market does not appear to believe that overall conditions for sellers are likely to improve from here. Asked if our current position in the economic cycle, the possibility of a change in government, less easy access to capital and the risks from Brexit all suggest that now is the time to consider selling a business, the unanimous result was a resounding yes.

The evidence from the transaction data confirms that participants are making hay while the sun shines

The current backdrop for deal making remains exceptionally benign, and the evidence from the transaction data confirms that participants are making hay while the sun shines. Furthermore, our survey suggests that they look set to continue doing so.

Given the length of the sales process, owners of privately held companies may wish to initiate proceedings sooner rather than later

However, we are becoming more concerned that this environment may not remain equally favourable in the next few years. So, given the length of the sales process, any owners of privately held companies who are contemplating an exit at some point may wish to initiate proceedings sooner rather than later.

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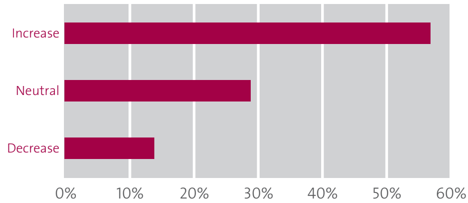
Source: Transaction statistics supplied by unquote

Survey of market expectations

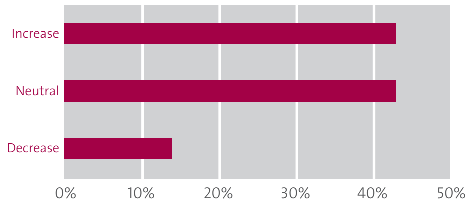
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q1 2018 predictions

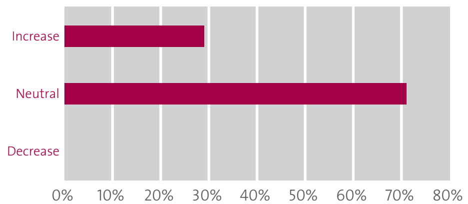
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next six months?

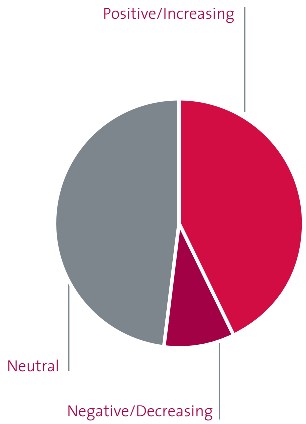


2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next six months?



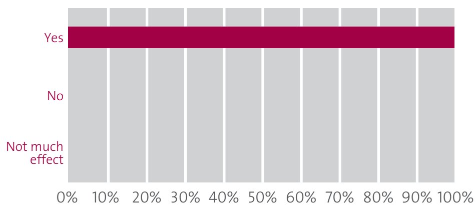
3 Is debt availability increasing, decreasing or neutral over the next six months?





Average of 1, 2 and 3 questions surveyed.

4 Does the combination of: position in the economic cycle, risk of change in tax policy, Brexit risk and ease of access to capital, suggest this is the optimal moment to consider a sale of your business?



Complying with SPA notice provisions

When it comes to a sale and purchase agreement (SPA), it is important to comply with all the legal minutiae of the provisions, as a recent decision in the High Court has made clear. While this may sound arcane, Ivan Shiu and Karla Dudek of law firm Hogan Lovells argue that this decision will be of great practical relevance to private equity practitioners and directors looking to sell their company.

The High Court decision in the 2017 case of Zayo Group International Ltd v Ainger and others (*Zayo*) delivers a pertinent reminder of the need to comply with the strict terms of notice provisions in an SPA, both in terms of the contents of those notices and how they are served. In addition, all parties should consider the effects of limitations of liability *(see box)*.

Anyone considering the sale of a company should take note of this decision. One of the key issues the court considered was the interpretation of a so-called musketeer clause in the SPA, which said that no management seller would be liable for a warranty claim unless a notice of the warranty claim was given to all of the management sellers.

The dispute

A dispute arose between Zayo Group International Limited and a group of management sellers after the 2014 sale of Ego Holdings Limited and its subsidiaries. The subsidiaries included Geo Networks Limited, which provides a fibre optic network in the UK. Zayo claimed the management sellers had breached their warranties on the accuracy of the target companies' accounts, resulting in significant losses.

The SPA provided that the management sellers would not be liable for a warranty claim unless all of them had been given notice of the claim, and that Zayo would have 18 months from the date of a claim to give this notice. Zayo did not give notice of its claims until the last day permitted under the SPA. Unfortunately for Zayo, the courier did not deliver one of the notices to the address specified in the contract as he was told that the addressee no longer lived there. So only six of the seven management sellers received notice of the claim.

The management sellers denied all claims and issued an application for them to be struck out or for summary judgment, or both.

High Court decision

The court held that the notice had not been validly served, and it granted the management sellers' application to strike out all of Zayo's claims. The court said that, even if the notice had been served on time, it failed to comply with the SPA requirement to state a reasonable estimate of the amount claimed.

The notice merely stated the target companies' liability in relation to the alleged breach of warranties and did not provide any information on Zayo's loss, which would have been the resulting reduction in the value of the shares it had acquired. The court also found that, even if the claims had been advanced as claims for diminution in value, they would still have been lacking important information. Therefore, Zayo would have had no real prospect of succeeding on these claims.

SPA notice provisions

Although practitioners often regard notice provisions as boilerplate, *Zayo* confirms that generally these notice provisions must be complied with and, if they are not complied with, then it is not necessary for the court to go on to consider the seller's liability. So, if a notice is not served correctly or its contents are deficient, the courts will have grounds to dismiss the warranty claim without even having to consider the merits of the claim.

Below we outline some of the key lessons from *Zayo*:

Information in the notice – during SPA negotiations, practitioners should consider carefully what information needs to be included in a warranty claim notice, whether a notice will be invalidated if this information is not included and, when there are several sellers, whether a notice must be served on each seller in order to be valid against any seller. The buyer may instead require all the sellers to appoint a representative and insert a provision in the SPA that service of a notice on this representative will be deemed to be service of notice on each of the sellers.

Correct measure of loss – most SPAs require a notice of warranty claim to give a reasonable estimate of the amount claimed. Unless the SPA provides that warranties are given on an indemnity basis, this should be based on the estimated reduction in the value of the shares resulting from the warranty breach. It should not be based on the amounts paid by the seller or the target company as a result of an alleged breach, as Zayo did in this case.

Where an incorrect measure of damages is included in the notice, a court will probably determine that the notice did not include a reasonable estimate and the claim may be dismissed. The court in *Zayo* noted that this is not a technical point. Rather, it goes to the commercial purpose of the notice clause: the failure to provide an estimate of the loss based on the correct measure of damages would affect the defendants' ability to put monies aside or pay the claim, or reach a settlement on the claim.

Claim details – warranty claim notices should provide a reasonable level of detail about the claims being made. In *Zayo*, the court held that Zayo had failed to provide sufficient detail in several ways including by: not specifying what the level of accounting provision should have been, nor what its impact was on maintainable earnings or the value of the shares; not separating out the value of different claims; and significantly changing the amounts claimed for in its particulars of claim.

Instructions to couriers – practitioners should give couriers clear instructions on what to do if they are told the intended recipient no longer lives at the address stated in the SPA or is not at home. In *Zayo*, if the courier had left the notice at the address stated in the SPA, the notice would have been deemed to have been delivered.

Timing of the claim – don't leave it until the last minute. If the warranty claim notice is not served within the periods stipulated in the seller limitations of liability provisions in the SPA, the claim will be dismissed by the courts.

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Accounting provisions

The High Court in *Zayo* also considered the interpretation of a common limitation of liability provision. This provides that a seller won't be liable for a warranty claim to the extent that a provision in respect of the liability giving rise to the claim has been made in the accounts of the target company. The court noted that the management sellers had made provisions in the accounts for several of Zayo's claims and said that these provisions amounted to "buyer beware" flags that transferred the risk to the buyer.

For buyers, *Zayo* reinforces the importance of:

- giving full consideration to accounting provisions;
- deciding whether to investigate the relevant matters further;
- and considering the impact of the liability on the valuation of the business, including whether to seek a price reduction or a specific indemnity, which could be negotiated to fall outside this limitation of liability provision.

The court in *Zayo* also said that, if the buyer knows a provision has been made in the accounts, the seller will have no liability at all for a breach of warranty in respect of the matters giving rise to that claim, whether or not the provision is sufficient. The decision did not address whether the situation would be different where the limitation refers to a provision that may subsequently be made in the completion accounts.

Hard Labour?

The forthcoming local elections have focused media attention on the potential for a Labour government led by Jeremy Corbyn. Mouhammed Choukheir, Chief Investment Officer of Kleinwort Hambros, analyses the historical record to see what such a government might mean for both economic growth and the performance of equity markets. Some of his findings may be surprising.

Local elections in the UK – coming in May – will be the clearest litmus test of the country's mood since last year's snap election. Conclusions will be drawn about the state of the parties nationally, notably the potential for a Labour government at the next parliamentary elections. If the headlines are to be believed, the Conservative party is heading for a rout; and this has raised what for some is the spectre of a Jeremy Corbyn-led Labour government raising tax rates sharply, and perhaps even placing controls on capital.

When it comes to elections, we have learnt to be sceptical about headlines. Before the 2015 general election, no party was expected to win outright. In fact, David Cameron led the Tories to a clear majority. In the subsequent Brexit referendum, his advisers and most pundits predicted a remain vote. When Cameron's successor, Theresa May, bowed to favourable opinion polls and opted to call a snap general election to bolster her party's lead and win a mandate in her own name, the Conservatives lost their majority and she lost face.

Such miscalculations occur often and everywhere. Like financial markets, politics is dependent on human behaviour, which is complex and unpredictable, and near certainties can turn out to be anything but.

With that in mind, we explore the question of a change in government in the UK in the same way we attempt to unravel the uncertainty of financial markets – by looking at historical data.

Breathe again

While this election carries new and unexplored questions for the UK, we have looked back at 118 years to see what history can teach us. In that time, Conservative governments have delivered average annual GDP growth of 2.6%, appreciably better than their Labour counterparts (2.1%). However, Labour governments' record has been far from disastrous. In fact, the economy expanded during the tenure of every single Labour prime minister barring Gordon Brown. Removing the three Brown years – which spanned the pre-financial-crisis peak to the post-crisis trough – there is even less difference between the two parties.

Moreover, whether the government is Conservative or Labour has made little difference to equity market performance. In the 37 years since 1900 that began with Labour running the government, UK equities were up 7.7% per year on average in real terms (adjusting for inflation). For the 65 years when the Conservative party held sway, UK equities were up 7.9% annually on average. Indeed, Labour arguably has the better record: only one of its six prime ministers, Clement Attlee, presided over negative equity returns. By contrast, no fewer than four of the 14 Tory PMs – Sir Alec Douglas Home, Anthony Eden, Edward Heath and Neville Chamberlain – saw total returns from equities fall in their tenure.

Interestingly, when the now defunct Liberal party – a very different entity from today's Liberal Democrats – was in charge for 16 years in the early 20th century, GDP growth and equity returns were abysmal, with annual averages of 0.1% and –0.7%, respectively. If anything, one should hope for a continuation of the two-party system of successive Conservative and Labour governments – the only other party that has run the show had terrible results.

Another observation was teased out from the underlying data: political change appears to have an impact on equity performance. In years when there is no change in Prime Minister, equity performance averages about 4.8%. However, in years when the Prime Minister changes, equity performance is 13.0% in real terms. One likely explanation is that, before an election or in periods of political turmoil, investors are obsessed with all the things that might go wrong. We may be in such a period now. Inevitably, when that election or choppy period has passed, investors realise that the UK's powerful national institutions remain strong, and a sense of relief may well cause markets to rally.

We can draw an important inference about the value and depth of the UK's institutions. No matter who is in power, or what the pre-election rhetoric has been, a strong system of checks and balances exists. This helps temper any leftward or rightward lurch of policy, nudging it back towards the moderate centre.

Moreover, no government should take too much credit for growth or investors' returns: economies and markets are affected by far more than just prevailing domestic politics and policies. In the end, both major parties recognise the foundational role of global market forces in the UK's prosperity, and both uphold that the provision of a welfare state is a basic principle of government. When it comes to continuing growth and conditions conducive to favourable investment returns, although each period is always different, the detail tends to matter little over the long arc of history.

1 Total return calculated by taking the cumulative return/loss from capital appreciation and income (dividends, coupons, etc.) using Barclays Equity Gilt Study Data.

2 PM at beginning of year given credit for entire year.

3 Real GDP data taken from a Bank of England continuous time series that runs from 1700: 1870-1913 Solomou and Weale (1991) balanced measure of GDP at constant 1900 factor cost; 1913-20 Feinstein's Compromise index of GDP at factor cost available in Mitchell; 1920-48 Sefton and Weale (1995) balanced measure of GDP; 1948-2009 ONS GDP at factor cost, chained-volume measure, 2006 reference year prices.

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UK Prime Ministers since 1900	Years in Office	Total Real Return on UK Equities (%)	Average GDP Growth
Conservative	**65**	**7.9**	**2.6**
Alec Douglas Home (1964)	1	–9.3	5.6
Andrew Bonnar Law (1922 - 1923)	2	20.6	4.2
Anthony Eden (1956 - 1957)	2	–8.0	1.8
Arthur James Balfour (1903 - 1905)	3	5.8	1.2
David Cameron (2011 - 2016)	6	5.1	2.1
Edward Heath (1971 - 1974)	4	–11.3	2.9
Harold Macmillan (1958 - 1963)	6	18.2	3.4
John Major (1991 - 1997)	7	13.9	1.9
Margaret Thatcher (1980 - 1990)	11	12.3	2.5
Marquess of Salisbury (1900 - 1902)	3	3.7	1.3
Neville Chamberlain (1938 - 1940)	3	–9.9	5.1
Stanley Baldwin (1925 - 1929; 1936 - 1937)	7	5.7	2.9
Theresa May (2017)	1	9.1	1.8
Winston Churchill (1941 - 1945; 1952 - 1955)	9	14.0	2.1
Labour	**37**	**7.7**	**2.1**
Clement Attlee (1946 - 1951)	6	–0.2	1.7
Gordon Brown (2008 - 2010)	3	1.6	–0.9
Harold Wilson (1965 - 1970; 1975 - 1976)	8	15.7	2.3
James Callaghan (1977 - 1979)	3	8.5	3.4
Ramsay MacDonald (1924; 1930 - 1935)	7	13.0	1.8
Tony Blair (1998 - 2007)	10	4.2	2.9
Liberal	**16**	**–0.7**	**0.1**
David Lloyd George (1917 - 1921)	5	0.7	–4.4
Henry Campbell-Bannerman (1906 - 1908)	3	3.9	0.4
HH Asquith (1909 - 1916)	8	–3.3	2.9
Grand Total	**118**	**6.7**	**2.1**

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