

Dear Reader

Welcome to the January 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.

We currently seem to be in something of a sweet spot for private company deal making. The economic background is supportive, Capital Gains Tax is low (for the time being at least), buyers have plenty of funding at their disposal, and sellers have been obtaining good valuations for their businesses. This favourable environment translated into a bumper year for transactions. But can the good times continue to roll?

While it is always possible that some unknown unknowns could derail this benign backdrop, we see no immediate threats to any of the four factors listed above. Nevertheless, the current deal cycle has already lasted several years and is probably nearer its end than its beginning. The current government has been comparatively stable, despite its parliamentary minority, but any major political shock could see it replaced with a less business-friendly regime. In addition, the Brexit negotiations are likely to throw up further moments of tension, creating greater uncertainty. So, while we expect the sweet spot

to continue, directors contemplating a sale might do well not to postpone the decision indefinitely.

As ever, this issue addresses some of the topics which may be of interest to directors of privately owned companies.

- The private company deal making market showed no signs of a hangover after the bumper third quarter as both values and volumes of transactions remained remarkably robust across all segments, **rounding out a vintage year** (pages 2 to 5).
- For companies looking to pay a dividend but without sufficient distributable reserves, **a capital reduction may be the answer, but directors need to be careful if they are to avoid exposure to any liability** (pages 6 to 7).
- After a strong 2017 for global financial markets, **we consider some low-probability but potentially significant risks for the year ahead** and assess the possible implications for different types of assets (pages 8 to 9).

Best wishes for a happy and successful 2018!

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More of the same, please

In our last issue, we said that we appeared to be on course for the strongest year for values since 2010 or even 2007. Here, Jim Keeling of corporate finance advisor Corbett Keeling assesses the final quarter of 2017, declares it a vintage year and looks forward to the 12 months ahead.

It seems a long time since the mid-year uncertainty caused by the General Election in early June. Those jitters were rapidly cast aside as the second half of 2017 showed itself to be a period of exceptional strength for deal making activity in the United Kingdom. While the bumper third quarter proved impossible to match, both values and volumes held up remarkably well across all market segments. That added up to the strongest total value of transactions since 2007.

The market backdrop remains supportive: the economy is proving resilient, funding is cheap, and buyers have plenty of money to put to work after successful fund raisings last year

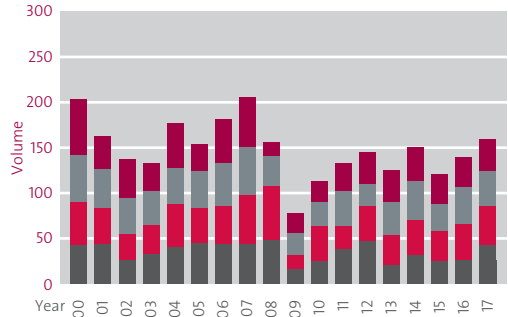
The question now is whether this momentum can be carried over into the new year. Our view is that there is no obvious reason why deal values and volumes shouldn't remain robust, albeit perhaps not at quite the levels reached in the second half of last year. For one thing, the market backdrop remains supportive: the economy is proving resilient, funding is cheap, and buyers have plenty of money to put to work after successful fund raisings last year. Furthermore, our personal experience of the market place shows no sign of a let-up in activity: the pipeline of deals looks very healthy. Finally, our survey of market participants reveals a good deal of optimism for the coming months.

But let's not get ahead of ourselves. First, we should take a look at the hard data for the final quarter of 2017.

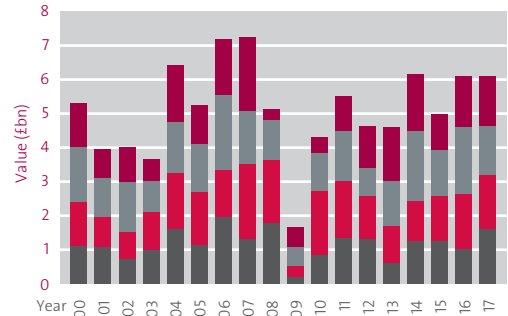
- Activity in the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) remained very robust. The volume of deals dipped slightly, from 39 to 35, but the total

■ Q1 ■ Q2 ■ Q3 ■ Q4

Sub £150m Buy-outs by Volume



Sub £150m Buy-outs by Value



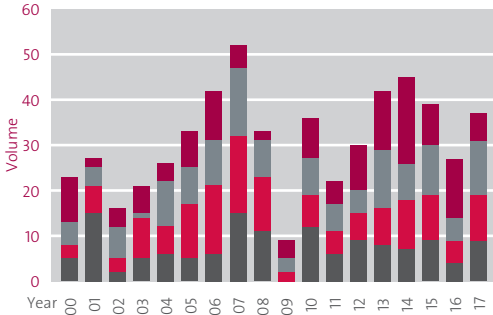
value was almost unchanged at £1.4 billion. In volume terms, it was the strongest year since 2007 and, once any late deals are accounted for, the same may be true for values.

The larger buy-outs sector had deals worth £7.9 billion, and the total value for 2017 was comfortably the highest since 2007

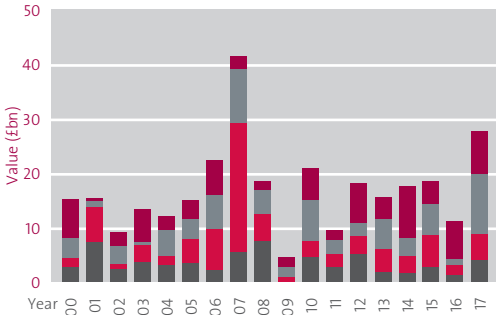
- While the **larger buy-outs** sector (enterprise value of £150 million or above) failed to match its bumper third quarter – the best for over ten years – it actually maintained momentum remarkably well. Even though the number of transactions fell

from 12 to six, the value came in at £7.9 billion. Only two quarters since 2007 have surpassed that figure, notably the previous quarter's £10.9 billion. Not surprisingly, the total value for 2017 was comfortably the highest since 2007.

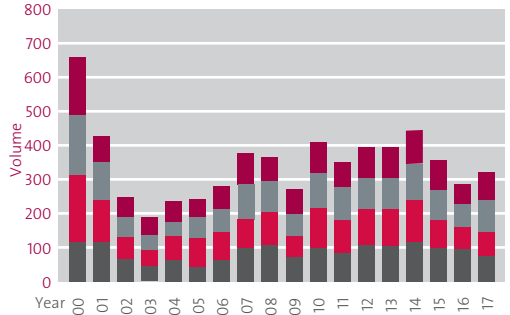
£150m+ Buy-outs by Volume



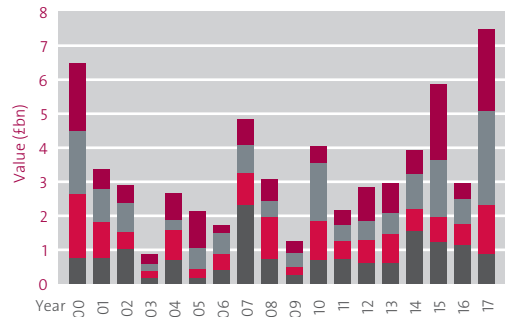
£150m+ Buy-outs by Value



Early-Stage/Expansion Deals by Volume



Early-Stage/Expansion Deals by Value

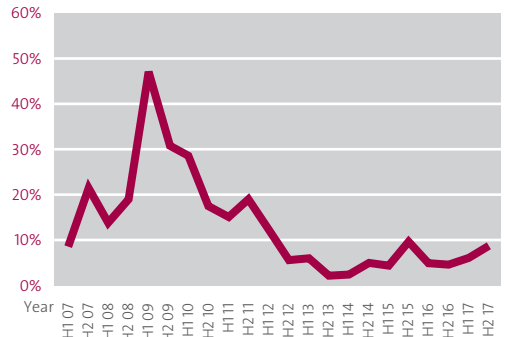


With all equity buy-outs showing potential signs of a resurgence in the third quarter with six deals recorded, they fell back to earth in the final three months of the year. Only two such transactions were completed.

Early stage and expansion capital deals remained very strong. The total value for 2017 was the highest in the history of our data series

- It was a similar tale for **early stage and expansion capital deals**: both volumes and values, though down on the third quarter, remained very strong. In fact, the total value for 2017 was by some margin the highest in the history of our data series, which dates back to 2000. The number of deals dipped from 93 to a solid 80, while their value – at £2.4 billion – was the second highest since 2000, beaten only by the previous quarter's £2.8 billion.

All Equity Funded Buy-outs to All Buy-outs



2017 was an unusually strong year for deal activity, and sentiment remains broadly positive, suggesting that momentum could well be maintained in 2018

So it's now official that 2017 was an unusually strong year for deal activity. But let's see what our latest survey of market participants says about the future. It confirms what we have witnessed in the market – that sentiment remains broadly positive, suggesting that momentum could well be maintained in 2018.

- As in the third quarter, none of our respondents forecast a decrease in activity over the coming months. The number predicting an actual increase in deal volumes was twice as high for the lower value segment of the market as for the higher value segment.
- However, one market participant who was positive on the outlook for the higher value segment noted the large amount of “dry powder” among larger private equity firms after significant fund-raising in 2017.
- Debt is expected to remain readily available in 2018. Half of the respondents thought debt availability would actually increase further; the remainder thought it would stay broadly at current levels. One respondent noted the increasing importance to the market of specialist credit funds.

- Asked if Brexit was making it harder to do deals, a third of respondents said they thought it was. However, two thirds thought it was having little impact. One noted that it should become easier to complete deals once we have greater clarity about what the post-Brexit landscape will look like.

The transaction window is wide open and the sun is shining

The overwhelmingly positive tone of our survey suggests no impediment to deal making in the months ahead. And that matches our reading both of current activity levels and the market environment. The transaction window is wide open and the sun is shining.

Directors of private companies may wish to take advantage of what seems an unusually favourable time to bring businesses to market

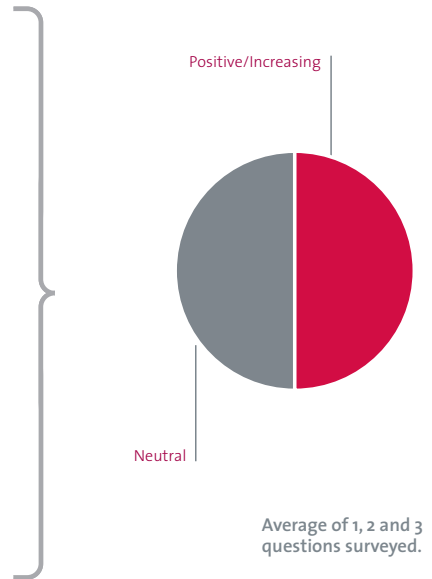
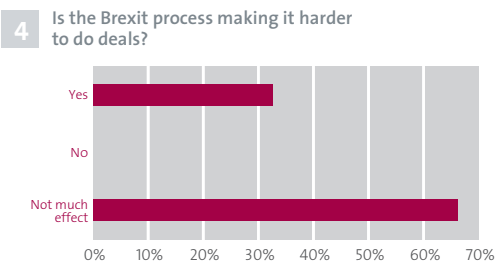
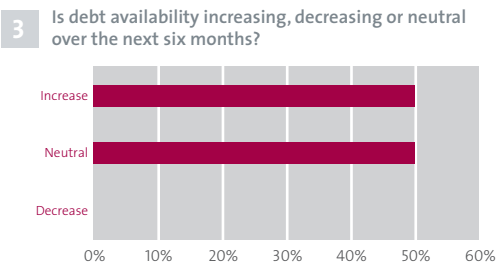
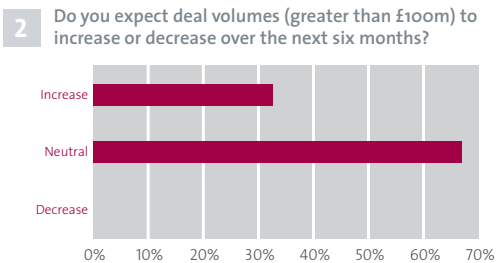
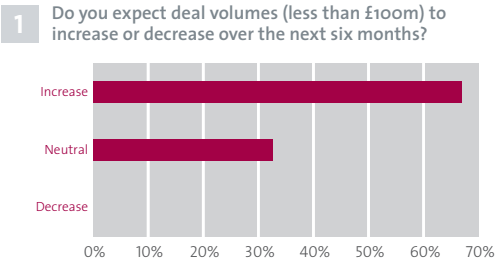
However, the longer-term outlook is inevitably less certain. So, while we see no imminent reasons for that window to shut any time soon, directors of private companies may wish to take advantage of what seems an unusually favourable time to bring businesses to market.

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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.

■ Q4 2017 predictions



How to capitalise on your reserves

Companies cannot pay dividends unless they have distributable reserves. However, it may be possible to convert share capital or other undistributable reserves so that you can pay a dividend which would otherwise be trapped. Philip Corser of law firm Hogan Lovells explains the procedures and how to protect directors against any associated liability.

Companies often have cash or other assets they would like to distribute to shareholders. However, they may be unable to do so, because they have insufficient distributable reserves (their accumulated realised profits less their accumulated realised losses). Broadly, this corresponds to the profit and loss account (or retained earnings) in the company's balance sheet, though this should always be confirmed by accountants.

If a company makes losses initially, it will normally need to generate realised profits equal to the accumulated losses before it can pay dividends, and then it will only be able to pay the surplus. However, if it wants to pay dividends sooner, the company may have other options for creating distributable reserves. These include a gift to the company – often a release of liabilities by a group company – or a group reorganisation, perhaps through the establishment of a new holding company. However, probably the commonest approach is to reduce the company's existing share capital.

Effect of a capital reduction

A direct capital reduction can involve repaying some of the company's capital straight to shareholders, transferring cash (or other assets) equal to the amount of the reduction. This has the advantage that all the proceeds can be paid out, ignoring the accumulated negative distributable reserves. However, only this one immediate payment can be made.

Alternatively, the amounts arising from the capital reduction can be credited to the company's profit and loss account. No immediate payment is made to shareholders, but the credit is normally treated as a realised profit and so increases the company's distributable reserves commensurately. Any surplus distributable reserves thus created (after setting off

the existing negative balance) can be paid to shareholders in the form of one or more dividends from time to time (subject to future losses).

Only the company's issued share capital, share premium account, capital redemption reserve and redenomination reserve can be reduced, in whole (bar one share) or in part. Obviously, that limits the potential size of the resultant distributable reserves. However, if the company has another undistributable reserve such as a merger or revaluation reserve, this can normally be capitalised by using it to issue bonus shares to shareholders. The resulting additional share capital can then be reduced.

Choice of capital reduction procedure

Nowadays, private companies almost always use capital reductions supported by a solvency statement from the company's directors. This procedure is straightforward and, when the relevant supporting information is available, can be completed within a day.

Alternatively, a company can apply to the court for approval of a capital reduction. However, this process takes weeks and requires the company to satisfy the court that its creditors will be protected. It is therefore typically only used if the directors are uncomfortable about making a solvency statement.

Making a solvency statement reduction

Each director of the company must make a statutory solvency statement. It is then sent to shareholders, who pass a special resolution to reduce the capital. Finally, the solvency statement and resolution are filed at Companies House.

In the statement, each director must declare he has formed the opinion that:

- as regards the company's situation at the date of the statement, there is no ground on which the company could then be found unable to pay (or otherwise discharge) its debts; and
- the company will be able to pay (or otherwise discharge) its debts as they fall due during the year following that date (or, if the company is to

be wound up within the following year, the company will be able to pay (or otherwise discharge) its debts in full within twelve months of the start of the winding up).

In forming these opinions, the directors must take into account all the company's liabilities, including any contingent or prospective liabilities.

Meaning of the solvency statement

The High Court considered the meaning of the first part of the solvency statement in a case in 2016 (*BTI 2014 LLC v Sequana SA & others* [2016] EWHC 1686).

The court rejected the defendant company's argument that the test was the same as the one used to determine whether a company can be wound up on the basis that it is unable to pay its debts. It also rejected the claimants' argument that the opinion the directors must form is that there is no possible basis, even if the worst case scenario arises, for concluding that the company is unable to pay its debts.

Instead, the court held that the test is not a technical one but a straightforward one applying the words of the section: the directors must look at the situation of the company at the date of the statement and, taking into account contingent or prospective liabilities, form an opinion whether the company is able to pay its debts.

This decision rules out some overly strict interpretations and makes it clear that the test is a question of judgement for the directors based on the company's particular circumstances. In this case, the judge approved the approach taken by one director of working out the best estimate of the company's liabilities and then leaving a substantial margin in the company's assets.

Although the second part of the solvency statement refers to a limited period of twelve months, the case clarified that, in respect of the first part of the statement, directors need to take into account contingent and prospective liabilities even if they may fall due after more than twelve months. However, the judge did recognise that longer-term future debts have a lower present value than imminent debts. Again, this is a subjective evaluation, and the directors should consider both the nature of the liabilities and what assets will be available.

Director liability for solvency statements

If a director makes a solvency statement without having reasonable grounds for the opinions expressed, he is committing a criminal offence and may well have a civil liability for breach of his duties.

However, the solvency statement is not a guarantee that the company will remain solvent; it is merely a statement of opinion. Even if a director's opinion is wrong, the court will not find against him if the opinion was formed in good faith after due consideration of all relevant factors and was an opinion which a reasonable person in that position might have formed.

Protecting directors from liability

Directors have a duty to exercise reasonable care, skill and diligence in forming their opinions and must consider enough information about all relevant factors. Usually, directors rely mainly on current management accounts, plus any additional information (such as cash-flow projections) needed to assess the company's current financial position and to identify its liabilities and the resources reasonably expected to be available to meet them. This will include contingent and prospective liabilities, such as litigation, environmental issues and pensions.

In addition, the directors should consider any other factors that appear relevant, including the company's anticipated trading performance and any material risks, such as the loss of a major customer. It is important to minute the directors' deliberations, especially on risks.

If there are any doubts, it may be prudent to improve the company's position. For example, to address liquidity concerns, intra-group debts could be deferred or a committed facility could be obtained.

Conclusion

A capital reduction is a useful tool for allowing companies to overcome technical restrictions on dividends. The procedure is straightforward and, as long as they are diligent, the directors are unlikely to be exposed to any liability.

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Tails of the unexpected

Markets are inherently unpredictable. Each year, financial, economic, geopolitical or other surprises occur which can have a powerful impact on individual stocks or even entire asset classes. Here, Mouhammed Choukheir, Chief Investment Officer of Kleinwort Hambros, outlines some tail events he is thinking about in 2018 and how they might affect portfolios.

Before the start of every year, we like to reflect on possible future events which few observers think likely but which we think could have a powerful impact on financial markets if they occurred. These reflections help us to assess potential sources of risk in portfolios and adjust our positioning where we think necessary. Let's look at the three tail events which currently top our list.

1. Biff, boom, Powell – US Inflation returns with a bang, forcing the US Federal Reserve to raise rates five times, ending the year at 3%.

■ **Everyone expects slow and steady, but inflation's rise may in fact be fast and furious:** While US equities have continued to hit record highs, the difference between ten-year and two-year US government bond yields has dropped below 0.60% for the first time since November 2007. Short-term yields are moving up as the Fed raises rates, but a subdued economic outlook is keeping long-term yields anchored. Most analysts are watching for any signs of the spread entering negative territory, which generally signals recession.

■ **What the consensus view in not pricing in:** Markets may well be missing the woods for the trees. US consumer price index (CPI) inflation is already at 2%, and core CPI ended the year at 1.8%. Unemployment is as low as 4.1%, indicating little if any output gap in the economy. Moreover, now that the Trump administration has finally got its tax cuts passed, infrastructure spending may soon increase. All of this could drive inflation up to 3%, forcing Donald Trump's nominee as Fed Chairman, Jay Powell, into severe monetary tightening.

■ **Potential market reactions:**

Gold sells off, given the re-emergence of yield.

Bonds plummet as rates go up but then stabilise, with yields at a new high of 4%.

Equities suffer a major correction as higher rates make stocks look less attractive value and as rising yields in other assets attract flows from equities.

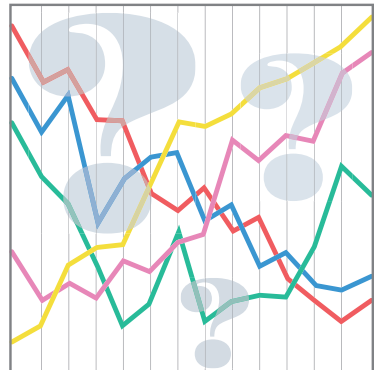
Cash becomes the asset class of choice in 2018, because it offers both a real yield and no risk of any drawdown.

■ **Our positioning:** We hold fair amounts of cash and are short duration across fixed income. If momentum turns negative for gold or equities, we would take it as a signal to cut exposure.

2. The Apple falls far from the tree – The stock of the world's most powerful company drops by 20%.

■ **Gravity finally starts to exert its pull:** In 2017, Apple stock gained 50% as its star product, the iPhone X, smashed sales forecasts. With a market capitalisation now above \$900 billion, Apple is by far the world's most valuable publicly listed company, worth more than Exxon Mobil, Procter & Gamble, Coca-Cola and Goldman Sachs combined.

■ **What the consensus view in not pricing in:** Sheer momentum and excitement after Apple's spectacular results have persuaded many



investors that Apple has some magic all of its own. In fact, it owns few physical assets and relies on its intangible design and software. These are two of the most difficult strategic beachheads to defend, and Apple has not innovated much beyond the iPhone. The experience of Blackberry a decade ago and Nokia 10 years earlier prove that companies in this space can appear impregnable while being anything but.

- **Potential market reaction:** Apple's weight in the index makes its performance tremendously important. It accounts for 12% of the NASDAQ, 4% of the S&P 500 and 2.3% of the MSCI AC World. In addition, Apple largely sets the tone for the collective tech complex. So poor results at Apple have the potential to scupper global equities, arguably more potential than any single company has ever had.
- **Our positioning:** We remain vigilant about our exposure to any one sector, region or style of investment; diversification is one of the few free protections investors are afforded. Specifically, we are wary of increasing valuations in the tech sector, finding better value in financials and energy.

3. Drill, fill, overkill – Oil slips back to \$40.

- **Supply/demand and the prisoner's dilemma:** One of the highest areas of consensus in markets is that oil prices will oscillate in the \$50 to \$60 range. The argument is perfectly logical: higher prices will draw in more US shale production, leading to oversupply and falling prices; in turn, the falling prices will help to correct the oversupply, keeping oil prices range bound.
- **What the consensus view in not pricing in:** This logic may not hold. The International Energy Agency has lowered its forecast for oil demand in 2018, blaming a 60% rally in prices since June. On the supply side, the IEA expects non-OPEC production – mostly from US shale producers – to increase again next year by 1.4 million barrels per day. Rising supply and falling demand should lead to a lower price, particularly in tight, elastic markets.

Furthermore, a pillar of the crude rally though 2017 has been the OPEC-led production agreement. Prices were languishing in the mid-\$40s when it was initially agreed; now they are in the mid-\$60s. However, the agreement's success rests on two factors: the deal's participants not cheating; and US shale producers not increasing production dramatically in response to higher prices. US shale producers have already increased production. In 2018, the urge to break the agreement may well prove irresistible as Russia, Saudi Arabia and others are running huge budget deficits.

- **Potential market reaction:** Early in 2016, the three-month rolling correlation between oil prices and the FTSE 100 hit a multi-year peak of about 60%. That is, oil and UK equities were moving largely in tandem. Since then, the correlation has fallen back to its long-run average of 15% and now down to its current level of 1%: essentially, oil prices are having little impact on equity markets. However, there is plenty of historical precedent for the correlation to re-assert itself.
- **Our positioning:** We have little direct exposure to commodities, through either basic metals or energy.

Market overview

As always, pollsters, prognosticators, pundits and punters will be wrong about many of their predictions for 2018. Even where they are right, they may be surprised by the market's reaction. At the start of 2017, populism was seen as a huge risk; few expected the benign markets conditions which drove powerful returns from global equities.

Overall, we remain broadly optimistic, expecting the current momentum in equity markets to continue, supported by a strong global economic backdrop. However, current valuations temper our expectations of future returns, keeping us well-grounded and our portfolios well-diversified.

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