Q3 2019

UK Private Company Director

Welcome to the October 2019 issue of UK Private Company Director, the quarterly newsletter for directors of owner-managed, family and private equity backed businesses.

We cover financial, legal, tax, wealth management and similar issues crucial to both building and realising the value of your business. Corbett Keeling's report on deal activity in the private equity markets also provides a clear insight into financial investor appetite.

The current issue highlights:

- Private company deal making remained remarkably solid in the third quarter of the year, with particular strength in the lower value segment of the market (pages 2 to 4).
- Letters of intent can have a significant impact on the course of the sale of any business. We discuss some of the key issues to watch out for (page 5).
- As we advance further into the current bull markets for equities and bonds, a more balanced approach to asset allocation is warranted, but equities still appear to offer the best value among the major asset classes (page 6).

Best wishes,

Megan Peel

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Corbett Keeling Corporate Finance

Dechert LLP

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Holding up well

Last quarter, we saw some signs of a downturn in the market's mood, which we thought might signal a possible slowing of deal making activity over the rest of the year. However, when assessing the latest quarterly data, Jim Keeling of corporate finance advisor Corbett Keeling finds that activity remained remarkably solid.

The market for private company transactions shrugged off continued political and economic uncertainty and kept doing deals at a steady pace over the last three months. Reassuringly, the buoyancy was broad-based, with solid volumes across the board. However, as in the second quarter, the early stage/ expansion deals segment of the market led the way, with a particularly strong three months.

As ever, the key question is: can it continue? We have seen some press reports recently of a drop in deal making. But our experience is that the market seems as busy as ever, and we see several reasons why.

First, private equity funds have plenty of money to invest in promising businesses.

Secondly, banks have money to lend – and at interest rates which make many deals attractive.

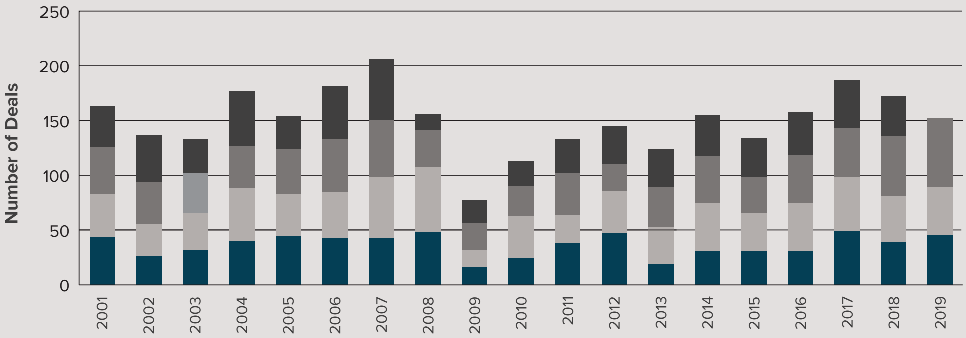
Thirdly, many company owners, faced with political uncertainty and the possibility of a less business-friendly government at some point, are keen to sell while the current Capital Gains Tax regime remains in place.

Lastly, with the pound under persistent pressure from the uncertain political outlook, many overseas buyers continue to look through the short-term fog and pick up strong British businesses at what are for them relatively cheap prices.

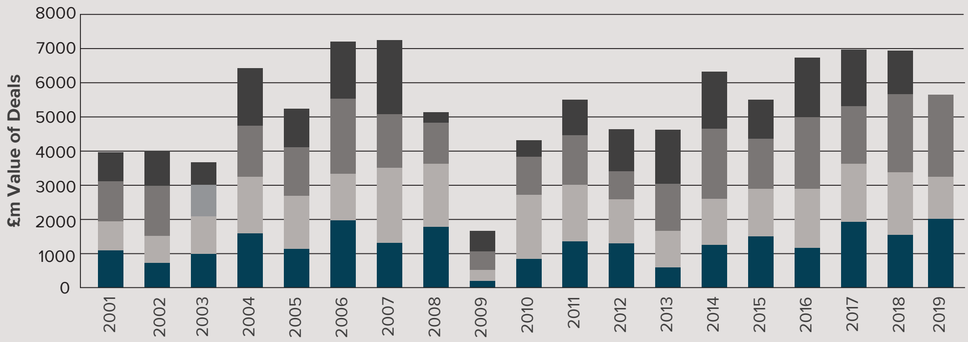
Assessing the deal data

Activity in the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) rebounded over the last three months. The volume of deals rose from 36 to 51, the second highest quarterly figure since the global financial crisis. The value of deals also increased, from £1.2 billion to £2.3 billion, taking the total for the year so far to just under last year's record number.

Sub-£150m Buyouts by Volume



Sub-£150m Buyouts by Value



Key:

Q4

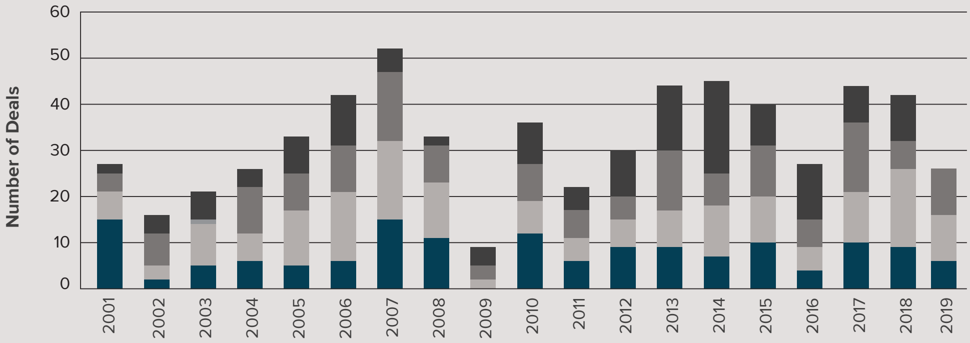
Q3

Q2

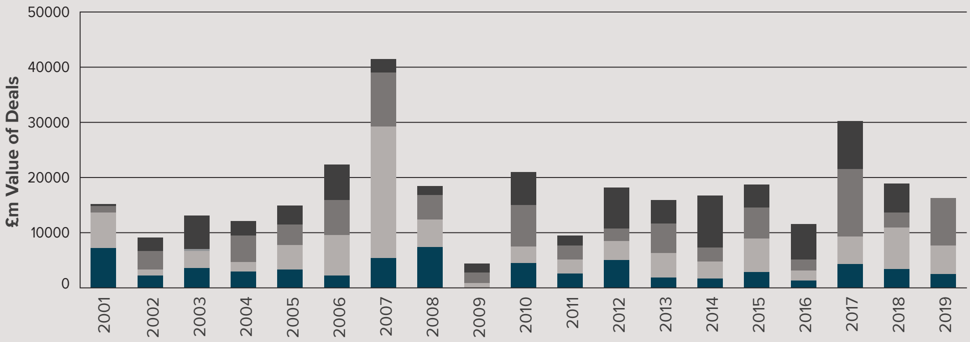
Q1

The **larger buy-outs** sector (enterprise value of £150 million or above) stayed remarkably strong and stable. Ten deals were completed, the same total as the previous quarter, while their value rose from £5.1 billion to £8.6 billion, the fifth highest quarterly figure of the past two decades. That said, both the volume and the value of deals for the first nine months of this year are well down on the same period of the bumper 2017.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value



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- Q4
- Q3
- Q2
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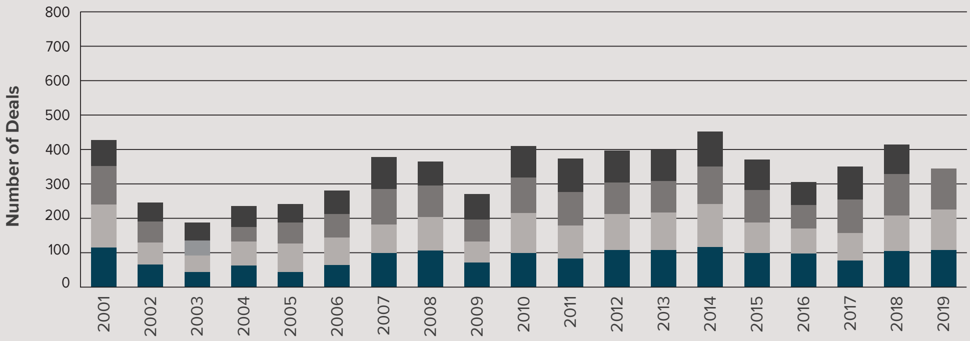
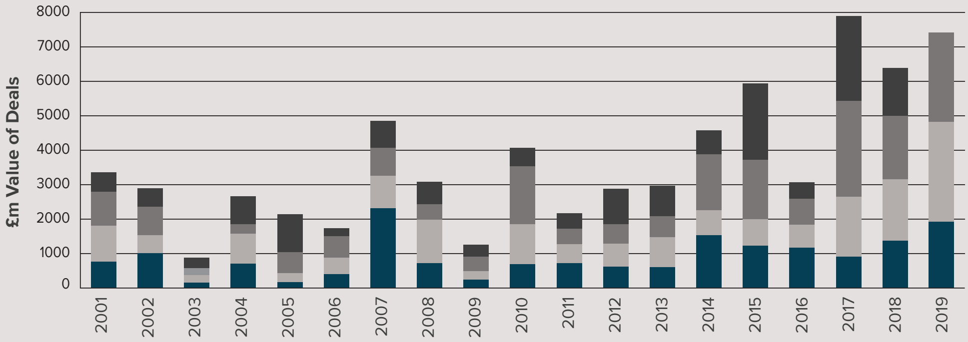
Early stage and expansion capital deals were also little changed from the previous quarter. The number of transactions over the quarter remained exactly the same, at 119, while the value of deals dipped a little from £2.9 billion to £2.6 billion, still a strong figure. In fact, the total value for the year so far is easily the highest since the data series began in 2000.

Volume of Early Stage/Expansion Deals



Value of Early Stage/Expansion Deals



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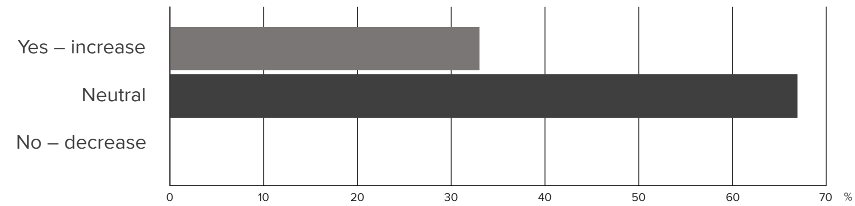
So what does our latest survey suggest?

Clearly, the data from the last three months reflect continued strength, and we have discussed some reasons why that may be. But does our survey of market participants suggest that the next quarter will remain as strong? We are pleased to report that their responses indicate a more sanguine mood, with slightly fewer positive responses but far fewer negative ones than last quarter.

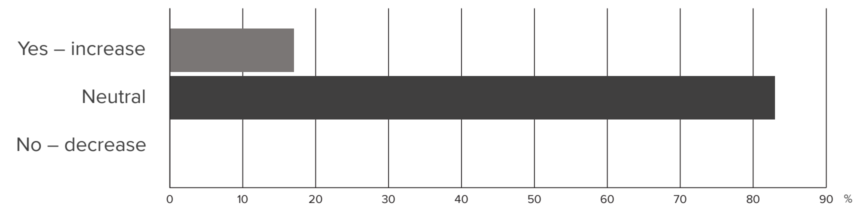
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months has dipped slightly to 33%. But the proportion expecting lower levels of activity has plunged from 38% to zero.



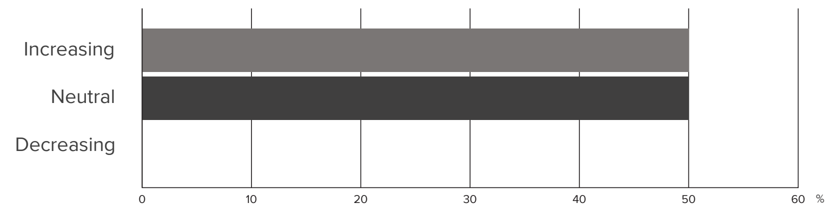
2 Do you expect deal volumes >£100m to increase or decrease?

It's a similar story for the larger value segment. While the percentage forecasting an increase has also dipped from 25% to 17%, the number predicting lower activity has again fallen to zero.



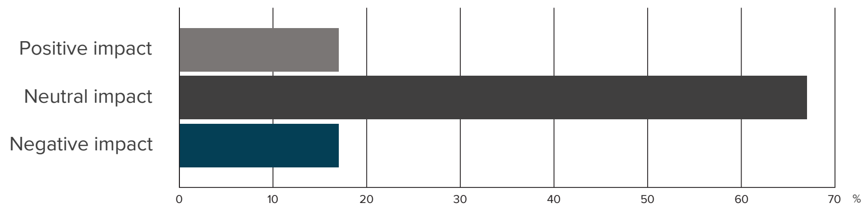
3 Is debt availability increasing, decreasing or neutral?

Those saying that debt availability is increasing has risen significantly to 50%. And the remainder are neutral on the topic, whereas 13% had been negative at the time of last quarter's survey.



4 Has uncertainty over the Brexit negotiations affected investment decisions?

Perhaps surprisingly, respondents also appear less pessimistic when asked about the impact of the Brexit negotiations on investment decisions. While the number reporting some positive impact from Brexit is little changed, the percentage observing a negative effect has plummeted from 63% last quarter to 17%, with the remainder – some two thirds – seeing no impact either way.



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Letters of intent: is your word really your bond?

Letters of intent (LOIs) set out the key legal and commercial terms agreed between parties to a transaction. While generally not legally binding (save for certain provisions), they have an important bearing on the course of negotiations. Heidi Fitchett of international law firm Dechert LLP discusses the key features of LOIs and outlines some strategic points to consider.

LOIs, also called heads of terms or memoranda of understanding, hold considerable moral influence and show the intentions of the parties to contract on particular terms. Parties should be mindful that documenting their agreement will limit their flexibility in subsequent negotiations. Including too much detail in a LOI may commit parties to a position which later becomes untenable in light of due diligence, wasting time and costs.

Key provisions

The most common form of LOI in M&A transactions is a partially binding one. It should be clear from the document (and the parties' subsequent conduct) which provisions are intended to be legally enforceable (binding), and which are not.

Non-binding provisions may cover:

- **Structure** – including whether the transaction will take the form of a share or asset sale and management equity arrangements.
- **Consideration** – detailing the amount and form of consideration, payment mechanics and timing.
- **Conditionality** – for instance, whether regulatory or competition authority approvals are required.
- **Warranties and indemnities** – including intended scope and financial and time limits.
- **Transaction timetable** – setting targets for signing and completion and allocating drafting responsibility.

This highlights issues at an early stage, preventing the parties from spending significant time and costs on a deal where a commercial agreement can't be reached. Producing a signed document also lends weight to communications about the transaction, which may be useful when approaching lenders or convincing shareholders that a deal is worth pursuing.

The LOI may also incorporate binding legal obligations, such as:

- **Confidentiality** – ensuring information about the target business will be held in confidence and not leaked to competitors.
- **Exclusivity** – providing a period of certainty for the buyer where the seller is restricted from soliciting other offers.
- **Costs** – documenting the apportionment of transaction expenses between the parties, including if the deal fails.
- **Governing law** – specifying which jurisdiction will govern any disputes.

These obligations protect the parties against certain reputational, goodwill and financial risks, allowing them to proceed with greater confidence.

Strategic issues

When negotiating and drafting a LOI, it is important to strike the right balance on the level of detail. To avoid the inefficiencies of negotiating a deal twice over, it is better to stick to overriding principles, rather than delving into the detail.

This will be particularly pertinent for buyers who, at the time of drafting the LOI, are unlikely to have conducted substantial due diligence. Buyers will generally wish to avoid conceding major points before they are fully informed of potential liabilities. For sellers, it will be advantageous to secure the buyer's agreement to limitation of liability before a full review has occurred.

A possible compromise is to consider stating the material assumptions on which particular terms have been agreed, while retaining the right to reconsider if those assumptions later become inaccurate. Including a statement that the LOI is intended to be non-exhaustive can also provide additional flexibility.

Although LOIs are non-binding in principle, they retain significant influence over the overall trajectory of a transaction. Consequently, it is advisable to involve lawyers and other advisers at an early stage.

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The power of balance

After rallying strongly over the first half of the year, global equity and bond markets' gains turned more modest in the third quarter, and concerns about the outlook are growing in some quarters. Fahad Kamal, Chief Market Strategist of Kleinwort Hambros, argues that the current circumstances warrant a neutral positioning for investors.

So far, 2019 has been an excellent year for investment returns. But, with the bull market for equities nearing its eleventh year and the bull run for bonds close to four decades, some investors are turning more nervous. Economic growth is slowing globally, as fears of a trade war are increasingly translating into lost output. Within manufacturing, survey data indicates contractions in industrial production and capital expenditure, and this could well spill over into services, a much larger sector of the economy.

A number of geopolitical warning lights are also flashing ominously. In early September, about half of Saudi Arabia's daily output of oil was briefly halted by a drone attack. If armed conflict were to break out in the Middle East, oil prices would be likely to soar, which could turn the current economic slowdown into an outright recession. Closer to home, Brexit continues on its tortuous path, and sterling is consequently trading with a volatility typical of emerging market currencies.

So there are plenty of potential triggers for an end to the equity bull run. However, we also see several mitigating factors. Consumers remain well supported for now and are providing critical impetus to growth. Confidence and spending are both robust, and wages are well above inflation in most major markets. Moreover, China and the US have struck a more conciliatory note in recent statements, raising hopes of a temporary ceasefire in the trade war. Both sides have more to gain than lose by striking a deal, which could prove an important fillip to the world economy.

Markets also continue to receive powerful support from central banks. Over the quarter, the European Central Bank announced wide-ranging easing, and the US Federal Reserve cut rates again. The Bank of England may well also join the party, depending on how Brexit unfolds. While monetary policy is admittedly suffering from diminishing returns, there is evidence that fiscal policymakers will be increasingly more active.

The bottom line

This is the slowdown phase of the current business cycle, when global growth is still positive. Slowdowns tend to be favourable for risk assets and can last for years. In addition, while equities are between fair value and expensive, they remain in an upward trend but are surrounded by negative sentiment, which we see as a favourable contrarian signal. Equities are also currently far more attractive than cash or government bonds.

We tend to ignore the noise from geopolitics, as financial history shows it is rarely a good guide to overall risk allocation. Nevertheless, Brexit has implications for sterling, which can seriously impact portfolios referenced in that currency. Instead of guessing at unknowable political outcomes, we prefer to position portfolios to deal with, or indeed benefit from, large swings in sterling. Depending on the portfolio, this can include using hedging selectively or maintaining a higher than usual global exposure.

We remain neutrally positioned. For balanced mandates, equities are still our most significant allocation. However, this year, we have been steadily bolstering clients' defences, notably by lengthening the duration of government bonds and increasing allocations to gold.

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