Q2 2019

UK Private Company Director

Welcome to the July 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.

This issue highlights:

- Private company deal making appeared to lose some momentum in the second quarter of the year, although the total value of deals in the early stage and expansion capital segment surged (pages 2 to 4).
- After strong rallies in financial markets since the start of the year, assets have generally become more expensive, and greater prudence may be called for (page 5).
- IPOs and private M&A sales each have their pros and cons, but sometimes a dual-track approach may help to preserve competition and achieve the best price (page 6).

We hope you enjoy this edition of UK Private Company Director. If you have any questions, please do not hesitate to get in touch.

Best wishes,

Megan Peel

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Corbett Keeling Corporate Finance

Dechert LLP

Kleinwort Hambros

Societe Generale Group

Corbett Keeling
Corporate Finance

Signs of a softening?

With Brexit deadlines coming and going and political transitions in Brussels and Downing Street, it's not surprising that we see some evidence of uncertainty in our latest survey of market participants and slightly lower volumes of deals across all segments, compared with the same period last year. Yet, as Jim Keeling of corporate finance advisor Corbett Keeling observes, the overall value of deals was bolstered by a strong showing from the lower value segment.

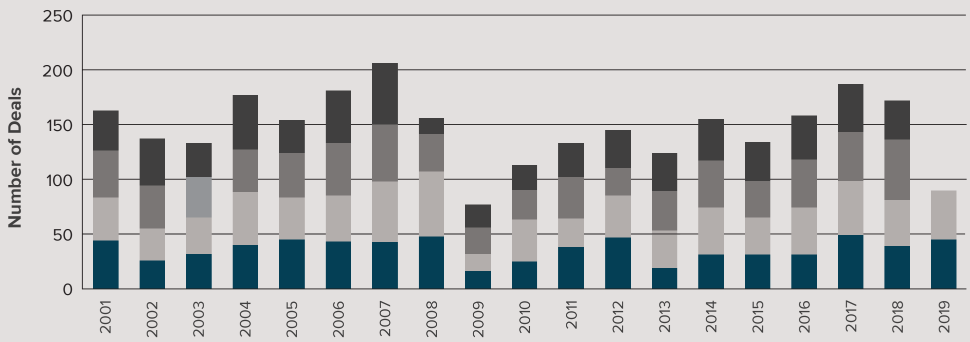
In the last issue of this newsletter, we noted that activity had got off to a solid start in the first quarter of the year, broadly maintaining the momentum from the second half of 2018. It was a similar picture in the second quarter. In fact, the overall value of transactions increased compared with the first three months of the year. We saw particular strength in the early stage and expansion capital segment, which had easily its best first half in the 19 years since our data began.

Of course, this may have been a case of buyers and sellers making hay before the rains come. Our most recent survey of market participants reveals a fall in expectations for deal volumes in the months ahead. Sentiment has clearly taken a turn for the worse, and we see signs of greater caution in the market. Nevertheless, deals are still being done, and we take some encouragement from the fact that the monthly data showed activity picking up in May and June after a disappointing April. Certainly, the strong average values paid over the past quarter suggests that buyers are still happy to pay high prices for good businesses.

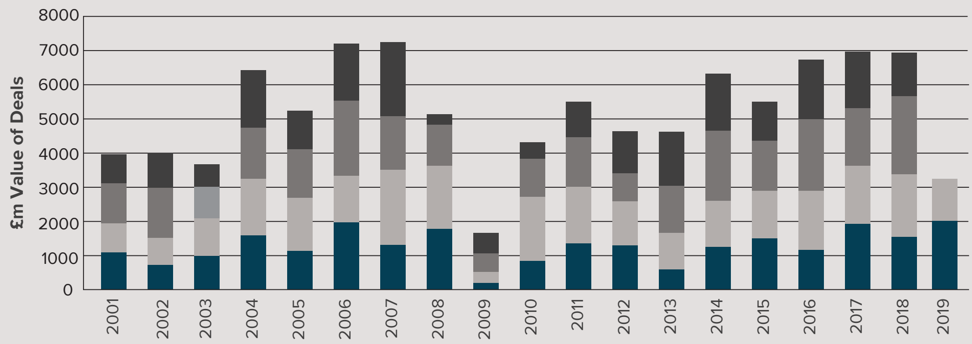
Assessing the deal data

Activity in the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) was down slightly over the last three months. The volume of deals fell to 36 from 45, while the value declined from £2.0 billion to £1.2 billion. Nevertheless, the totals for the first six months of the year were perfectly respectable, and we draw some encouragement from the fact that the volumes grew each month after a disappointing April.

Sub-£150m Buyouts by Volume



Sub-£150m Buyouts by Value

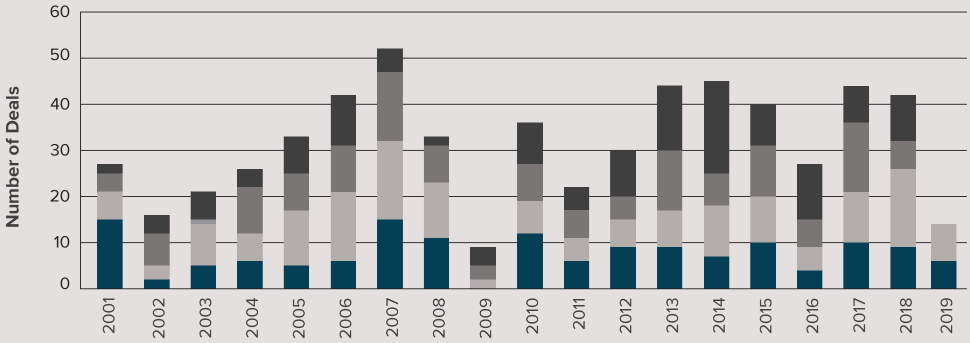


Key:

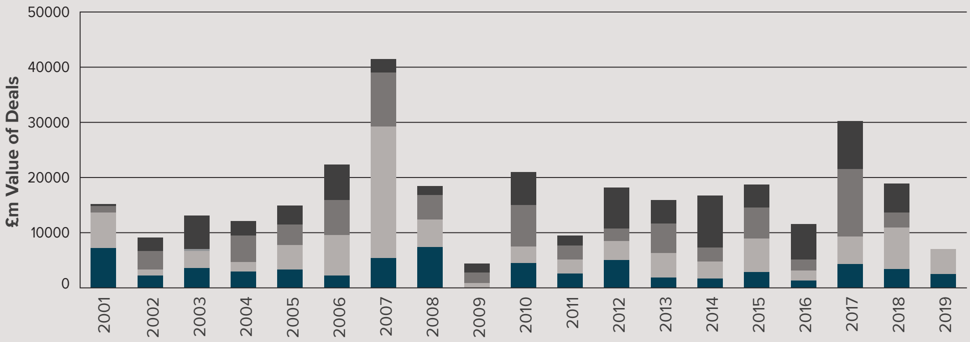
- Q1
- Q2
- Q3
- Q4

The **larger buy-outs** sector (enterprise value of £150 million or above). enjoyed something of a rebound after a lacklustre first quarter. The volume of deals rose from six to eight, while the value leapt from £2.5 billion to £4.5 billion, around the levels we were seeing in the second half of last year.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value



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Q1

Q2

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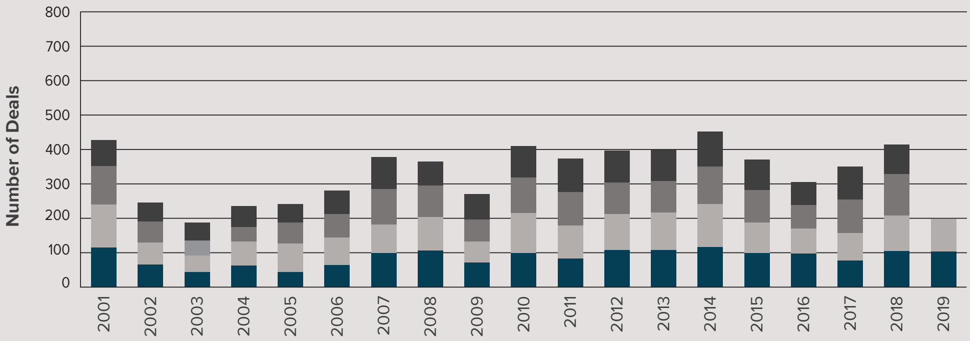
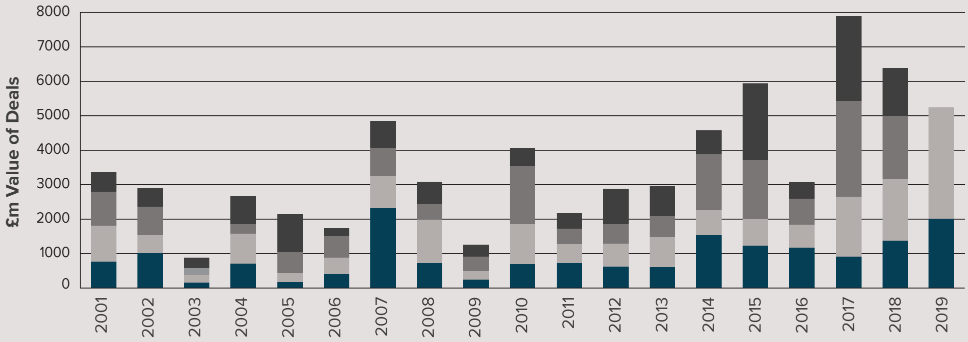
Q4

Early stage and expansion capital deals had a good second quarter. The number of transactions was down slightly, from 103 to 94 recorded so far. But the value of deals rose sharply from last quarter's £2.0 billion to £3.2 billion, making this the highest quarterly total for this segment of the market since the data series began back in 2000.

Volume of Early Stage/Expansion Deals



Value of Early Stage/Expansion Deals



Key:

Q1 Q3

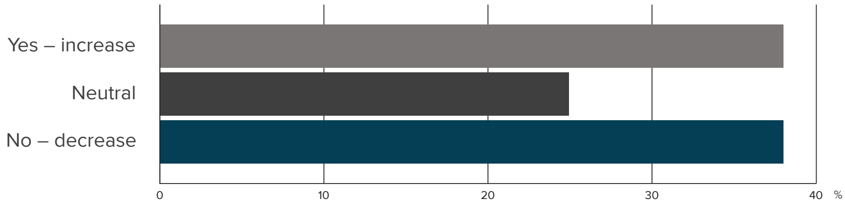
Q2 Q4

So what does our latest survey suggest?

Overall, then, the data from the past quarter showed some signs of slowing, at least relative to the strong pace of activity this time last year. But what does our latest survey of market participants tell us about the market's mood at the moment? Though far from gloomy, sentiment has clearly dipped.

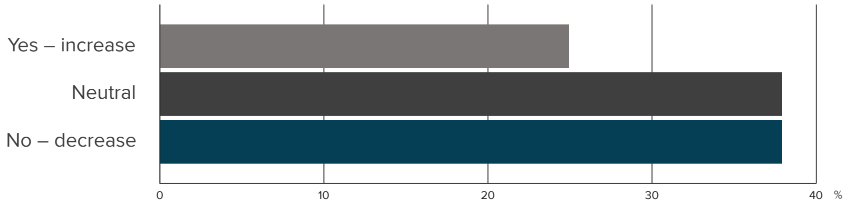
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the number of respondents predicting a rise in volumes over the next six months has actually risen, from just shy of 30% to 38%. However, the number expecting a decrease has gone up from 14% to 38%.



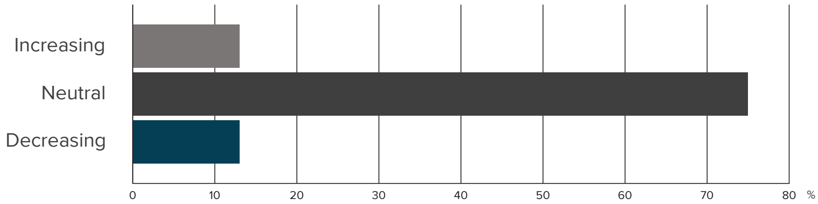
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment of the market, the number forecasting an increase has fallen from 43% to 25%, while the number predicting lower activity has gone up from 14% to 38%.



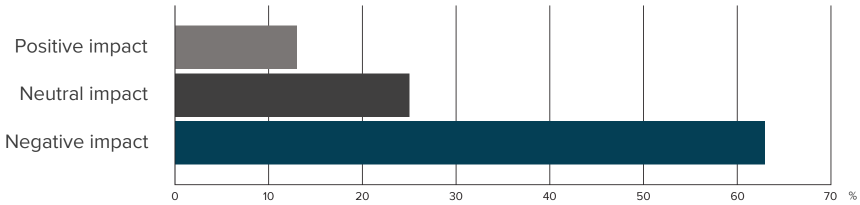
3 Is debt availability increasing, decreasing or neutral?

As last quarter, debt availability is expected to be little changed. Three quarters of respondents say they think the supply and cost of debt will remain broadly at current levels, while the rest are evenly split between negative and positive views.



4 Has uncertainty over the Brexit negotiations affected investment decisions?

As the uncertainty over Brexit persists, the percentage of respondents saying they have seen some adverse impact from Brexit on investment decisions has increased noticeably. While the number observing some positive impact from Brexit has stayed the same, the negative number has risen from 14% last quarter to 63% now, with the remainder seeing no impact either way.



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Half steam ahead

Financial markets continued their rally during the second quarter of the year. While momentum remains strong, valuations of many assets have become slightly less attractive, and Fahad Kamal, Chief Market Strategist of Kleinwort Hambros, argues that a bit more caution is warranted.

After a strong first three months of the year, global equity and bond markets continued to rise in the second quarter. However, global equities' gains were more muted – the MSCI All-Country World Index was up 2.9%, versus nearly 11.6% in the first quarter. They were also more volatile, with a sharp sell-off in May sandwiched between strong surges in April and June. In contrast, global bond markets made stronger gains than in the first quarter, as concerns grew about trade wars and as key central banks shifted towards looser monetary policy.

Both of these factors remain powerful drivers of sentiment. At the G20 summit in late June, the US softened its position on China. A quick resolution to the trade conflict is unlikely, and tariffs are set to continue for now. However, both sides simply have too much to lose from a protracted conflict; we still think the most likely outcome is a deal by year-end.

Moreover, while trade tensions have contributed to a global economic slowdown – particularly in manufacturing – services have so far remained relatively resilient. That is thanks to robust domestic consumer markets, supported by lower unemployment and higher wages in the developed world and by tax cuts in China. The Chinese authorities will probably increase stimulus measures to mitigate the impact of US tariffs.

Financial conditions remain accommodative across the board. The US Federal Reserve's shift to a dovish stance has helped tighten credit spreads and lift risk assets. The Fed has hinted that interest rate cuts are possible, as inflation expectations have dropped sharply, and growth momentum is easing. In the eurozone, where the economy is also losing momentum, the European Central Bank has less room to manoeuvre. Deposit rates are already negative, and a new round of asset purchases is not yet on the cards. Fiscal easing may well prove necessary.

In the UK, the Brexit can has been kicked down the road to October 2019 at the earliest, with the increasing possibility of the incoming Conservative Prime Minister pursuing a hard Brexit. Another deadline extension or an early General Election appears likely. The Brexit uncertainty is reflected in weakening sentiment and slowing corporate profit growth, as well as sterling volatility. Nevertheless, we expect an eventual deal of some kind, with sterling grinding upwards over the next year.

The bottom line

After their recent rise, equities are now between fair value and slightly expensive, depending on the particular market. Nevertheless, we remain sanguine: equities are in a strong upward trend, but without the over-bullish sentiment which would be a red flag. We also have allocations to investment grade bonds, high yield credit and emerging markets debt, which are buoyed by low inflation, dovish central banks in developed economies and limited default risks.

Yet prudence is called for. Over the second quarter, we increased duration in our government bond holdings – going from short to neutral – despite uncomfortable valuations. While yields have fallen further since, we still believe government bonds offer poor value in absolute terms. That said, they remain critical in offsetting risks from equities and other risky assets, as do our positions in gold and low volatility alternative strategies.

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Dechert LLP

IPO exits and dual-track processes

When selling, owners of private companies can choose from a range of available exit paths. Dawid Malinowski of international law firm Dechert LLP notes that offering the company's shares to the public via an initial public offering (IPO) can sometimes be a successful alternative to a trade or private equity sale or a buy-out. He also examines the option of a dual-track process.

The opportunities of an IPO

An IPO can enhance the company's market standing and future prospects. Over and above the injection of fresh capital, being a listed company offers potentially easier access to future fund-raising. The listing may also bring the company positive publicity and an enhanced market profile, potentially making it a more interesting acquisition target. An IPO timed to coincide with advantageous market conditions may attract a higher valuation than other private-sale exit strategies, enhancing returns for sellers of private companies. Although shareholders will hold on to some of the company's shares after the IPO (such lock-ups typically last six months), they could benefit from a more liquid public market for a future exit and from a potentially higher share price after the IPO.

The drawbacks

Conversely, IPOs can also have drawbacks as an exit route. Market interest and conditions may change during the IPO process, adversely impacting the company's business and its valuation. Such increased uncertainty, relative to a private M&A sale, poses a risk to a selling shareholder.

IPOs are lengthy and laborious, often involving an extensive pre-IPO internal rearrangement, lasting from four to six months. This can distract the company's management from their day-to-day jobs. Moreover, during and after its IPO, the company and its management will have to comply with extensive rules, disclosure obligations and securities regulations. And, as noted above, no outright clean exit can be achieved on day one, since investors would be locked in to hold some shares after the IPO, in order to preserve the market valuation and confidence in the company.

In general, the overall transaction costs of an IPO exit route will be higher than via a trade sale or a sale to financial investors, particularly for underwriting and professional fees.

Can a dual-track exit be the answer?

In dual-track exits, the company pursues an IPO of the company whilst running a parallel private M&A sale, with the aim of preserving competitive tension. In pursuing dual-tracks, the approach may be proactive, openly seeking prospective buyers while working towards an IPO, or reactive, only considering purchase offers as they receive them. Although potentially conferring greater initial flexibility, dual-tracks are in practice more complicated and costly than focusing on a single process (such as a private M&A sale) and may also pose greater risks.

Given the requisite extensive public disclosures to roadshow investors, dual-track processes usually don't continue beyond the start of the roadshow. It should also be noted that most dual-track processes end in private sales, as opposed to successful IPOs.

Given the benefits and trade-offs of IPO exits, with the complexity of the process and the costs involved, private company owners should consider their own particular circumstances and the current market outlook in determining the best approach. There is no one size fits all strategy here.

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