Q1 2021

UK Private Company Director

Welcome to the April 2021 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 private equity markets provides specific insight into financial investor appetite.

This issue deals with important current topics:

- The market for private company M&A started the year with an exceptionally strong quarter, and we think the current environment should be good for buyers and sellers alike (pages 2 to 4).
- Synthetic warranty coverage is the latest development in the warranty and indemnity insurance market. We explain how it works and what buyers and sellers need to know (page 5).
- As the global economy emerges from COVID lockdowns, inflation looks set to rise. We consider whether this is likely to be lasting or temporary and assess what it might mean for markets (page 6).

Best wishes

Megan Peel

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Corbett Keeling Corporate Finance
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Win-win market in the strongest start this century

Deal activity in the private company market was exceptionally strong, marking the best first quarter of a year this century. Here, Jim Keeling of corporate finance advisor Corbett Keeling explains why he thinks this is a good time for buyers and sellers alike.

The year has got off to an excellent start, with strength in both values and volumes of deals across the market.

This result – perhaps surprising amid continuing end of lockdown gloom – is being driven by an exciting combination of factors. First, strong trade buyers are emerging. Those businesses which have managed to stay cash rich during the pandemic are now looking to take advantage of opportunities as the economy re-opens.

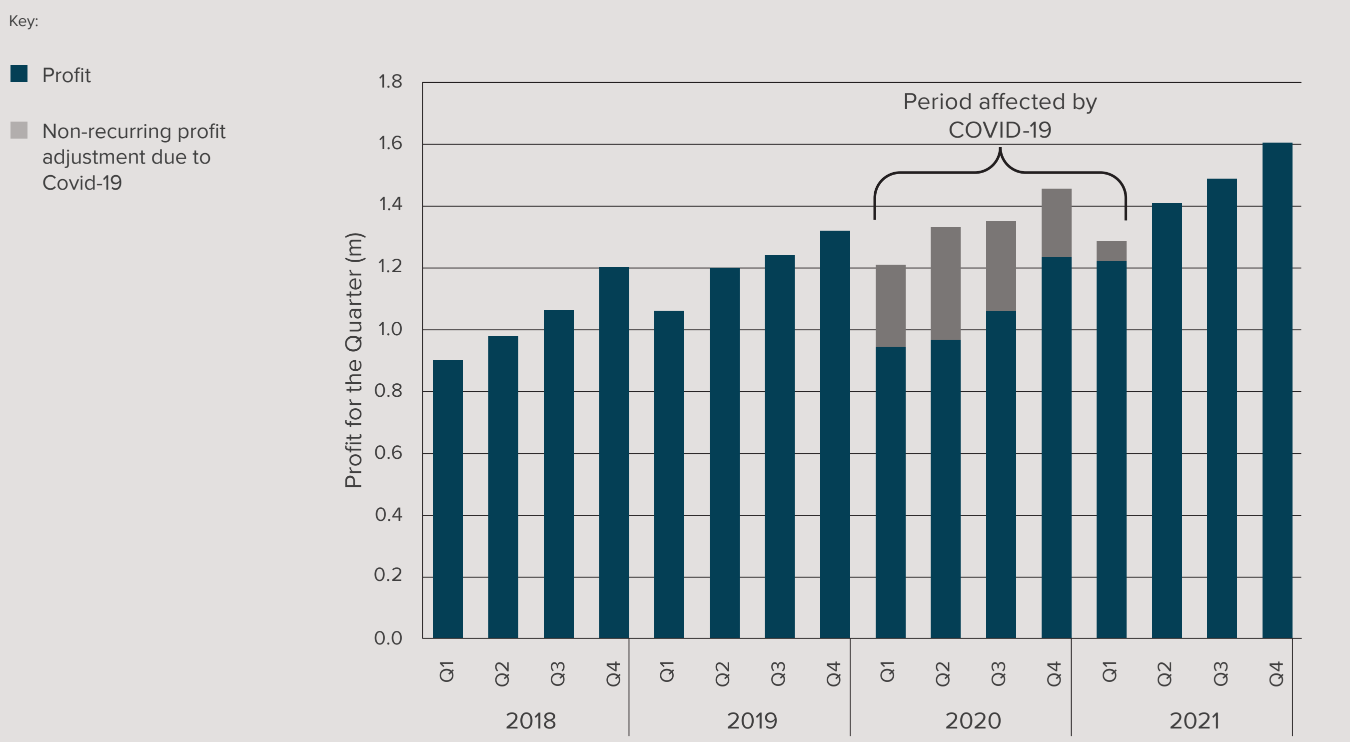
Second, financial buyers (such as private equity funds) were well funded at the start of the pandemic but have mostly waited to see whether lockdown would have a lasting impact on their portfolio companies. Generally they found it has not and, now, they are all the hungrier to buy, having been starved of new deals for a while.

Third, many owners are wondering whether to avoid another downturn by selling now or to wait for an upturn. Some are concerned about achieving a fair value if prospective buyers base their valuations on a multiple of profits which have suffered in the lockdowns. We have developed a model to demonstrate that the damage done was temporary and how the business is projected to recover in future quarters. This helps to reassure buyers that valuations should be based on future, not "lockdown", profits.

Corbett Keeling was established on the belief that a good deal can satisfy all parties. I was brought up with an old family story about my grandfather negotiating the rent for his new office. He was delighted to have secured premises but realised that, flushed with success, he had left his umbrella in the meeting. When he got back to the office, he found the landlord dancing round the umbrella, in celebration of finding a new tenant! The lesson – that any successful deal should make both sides happy – stood my grandfather in good stead over a long career and has subsequently been passed on into the DNA of Corbett Keeling.

So I firmly believe that the current "hot" market for transactions can be good for buyers and sellers alike, with deals done at prices satisfying both parties.

Non-recurring profit adjustment due to Covid-19



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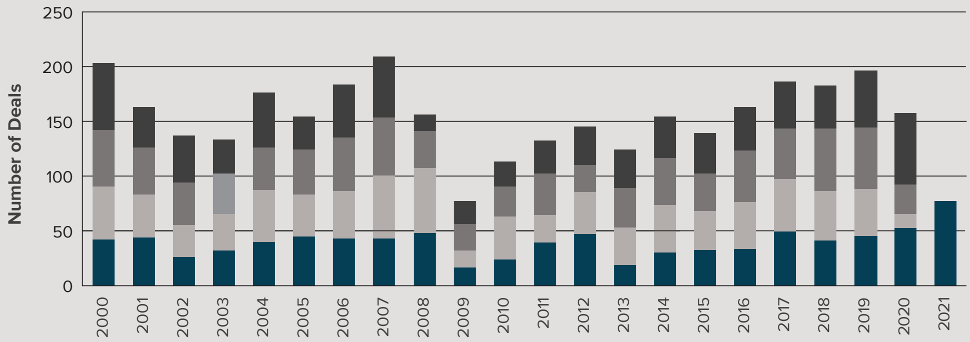
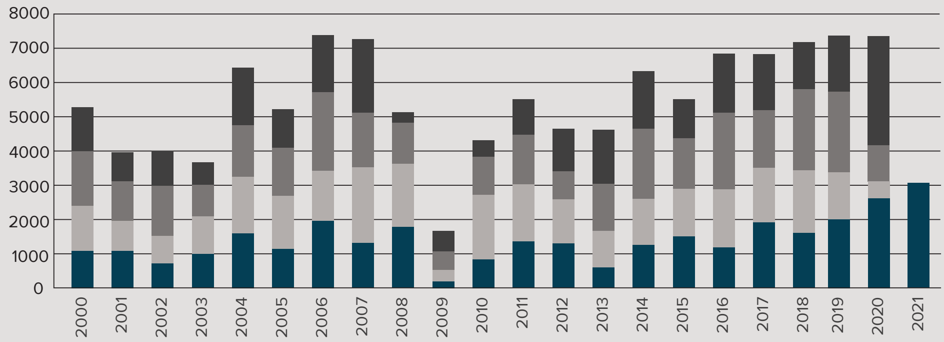
Assessing the deal data

After a bumper end to last year, the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) forged ahead strongly, making this the best start to a year this century. The volume of deals rose from 65 in the fourth quarter of 2020 to 77, a new record. Their value dipped slightly to £3.1 billion, just down from the previous quarter's all-time high of £3.2 billion.

Sub-£150m Buyouts by Volume



Sub-£150m Buyouts by Value

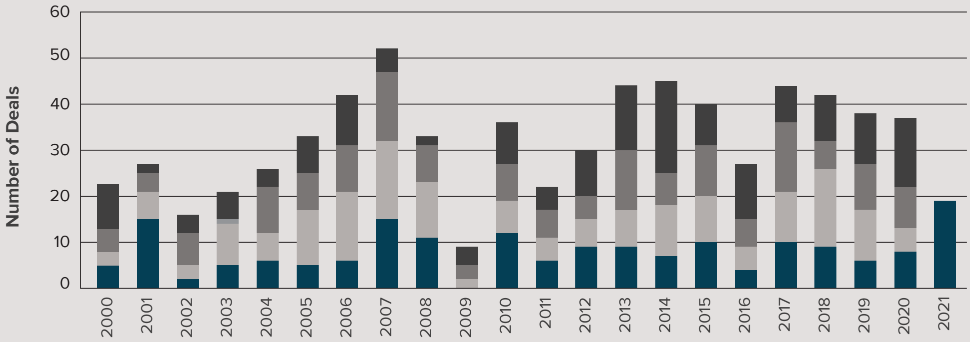


Key:

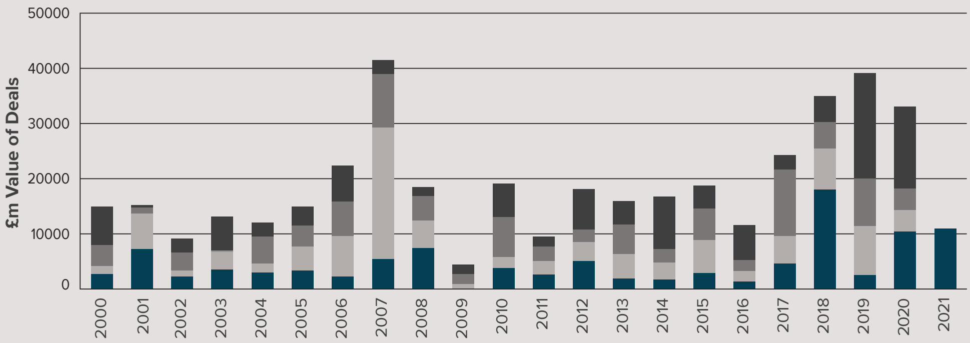
- Q4
- Q3
- Q2
- Q1

We saw a similarly strong start in the **larger buy-outs** sector (enterprise value of £150 million or above). The volume rose from 15 to 19, the second strongest quarterly total on record. The value of these transactions came to £10.9 billion, down slightly on the previous quarter's £14.8 billion. That represents the second strongest start to the year for this sector.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value



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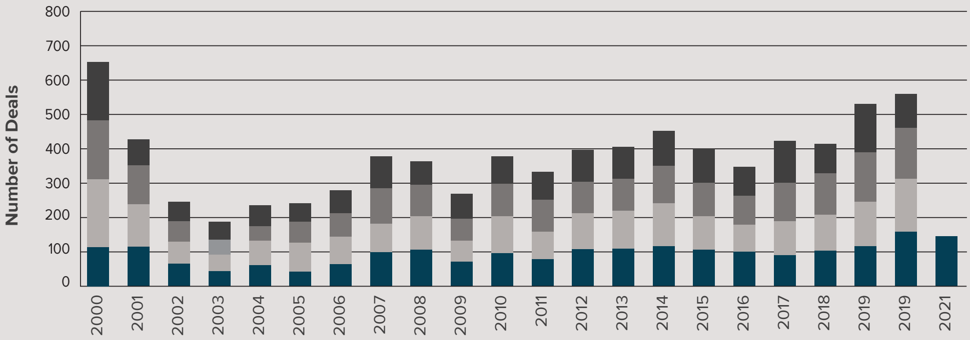
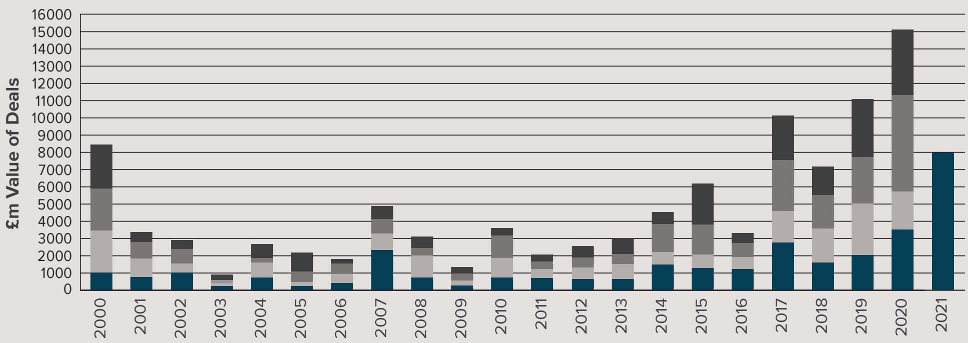
The picture was even rosier for **early-stage and expansion capital deals**. The number of transactions, which dipped 99 in the final quarter of 2020, rebounded to 145, around the average for the first three quarters of last year. But the great news for anyone looking to sell a company is that the values achieved rose from £3.8 billion to a fraction below £8 billion. That smashed the previous record, with this one quarter matching half of 2020's record annual total.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



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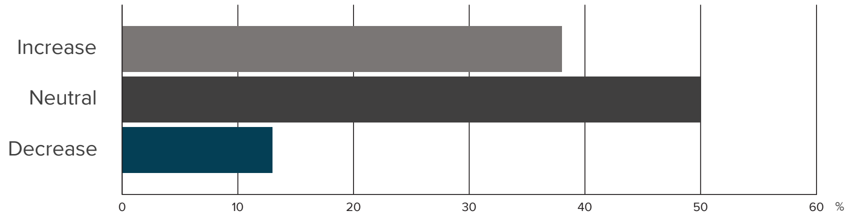
So what does our latest survey suggest?

With uncertainty persisting over the re-opening of the economy, it would be little surprise if market participants were feeling a little cautious. But our latest survey shows an overall improvement in mood, which suggests that the strong start to the year may continue.

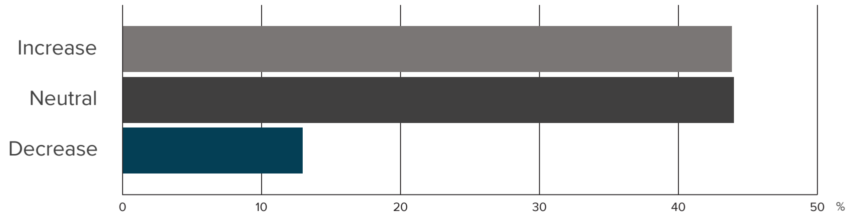
1 Do you expect deal volumes <£150m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months was down marginally from 42% to 38%, but 50% were expecting little change. The proportion predicting a decline was up from 8% to 13%.



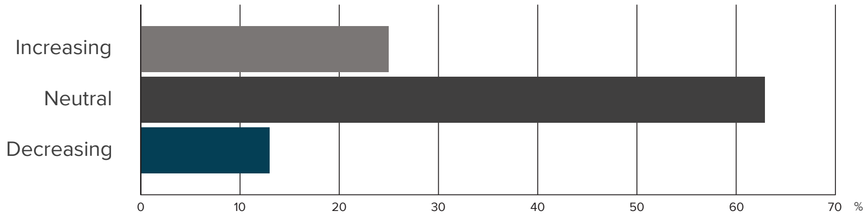
2 Do you expect deal volumes >£150m to increase or decrease?

For the larger value segment, sentiment showed a big improvement from the previous quarter. Nearly 90% expect a rise in activity or little change, while the percentage forecasting a drop halved from the previous quarter's 25%.



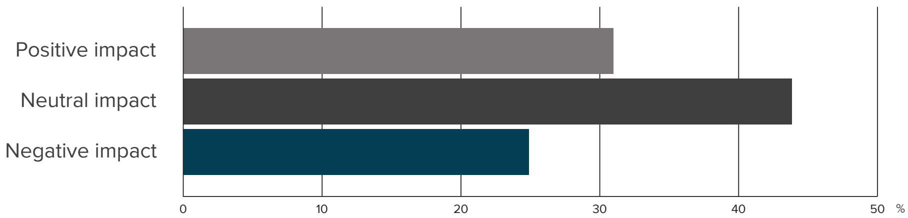
3 Is debt availability increasing, decreasing or neutral?

Respondents' recent concerns about debt availability appear to be fading. The proportion saying that debt is becoming less available plummeted from 58% to 13%, and a quarter reported seeing an increase, up from 17% in the last quarter of 2020.



4 On balance, how has the impact of COVID-19 affected your portfolio companies?

When asked whether COVID-19 would have a lasting impact on portfolio companies, 31% expected a positive effect, up from 25% last quarter. However, the proportion expecting a negative impact also rose, from 17% to 25%.



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Dechert LLP

The ins and outs of synthetic warranty insurance

The use of warranty and indemnity (W&I) insurance for UK private company transactions has continued to grow in recent quarters. Tom Clarke and Alasdair Austin of Dechert LLP explain why any private company director considering a deal should be aware of the latest development in the W&I insurance market: synthetic warranty coverage.

Traditional W&I insurance covers the breach of the insured warranties the seller gives to the buyer under the sale and purchase agreement (SPA). With a normal buy-side policy, if a warranty is breached, the seller pays an initial amount (usually equal to the policy excess) to the buyer, which then recovers any additional loss (up to the policy limit) from the insurer. This insurance provides a clean break for the seller and assures the buyer that it will recover its losses if a warranty is breached.

A synthetic policy covers the breach of warranties contained in the W&I policy, not the SPA. So, for a buy-side policy, any negotiations about the scope and limitations of the insured warranties will be between the buyer and the insurer.

Synthetic W&I insurance may be preferred where sellers are unable or unwilling to provide warranties or where the buyer wants to streamline the transaction by avoiding warranty negotiations with the seller.

Enhancements or fully synthetic policies?

Buyer and seller need to consider whether a full synthetic policy is needed or whether certain synthetic enhancements may resolve any warranty-related disagreements.

Synthetic warranty enhancements can be used to cover particular risks for which the seller might refuse to provide a warranty. Often, they are used for tax warranties, capping the seller's exposure at £1. These enhancements can also effectively remove warranty qualifiers (e.g., knowledge or materiality) or extend the limitation periods for claims.

Fully synthetic policies can expedite the deal. Instead of one set of negotiations between buyer and insurer and another between buyer and seller on disclosure and warranties, you have one set of negotiations, between buyer and insurer. Moreover, by removing a potential source of disagreement between buyer and seller, you reduce the risk of a deal failing.

Increased costs

A synthetic W&I policy theoretically poses an increased risk to the insurer. With a traditional policy, the insurer partly relies on the seller's negotiation of the insured warranty package and a thorough disclosure process (motivated by the seller's residual liability for the policy excess) to mitigate the risk of a successful claim under the W&I policy. So, for a purely synthetic policy, the insurer may charge a higher premium and the scope of the warranties covered may be narrower.

The buyer's due diligence process needs to be comprehensive, as the insurer relies on it when preparing the policy, given the lack of protection from a disclosure letter or schedule.

Practical points

If opting for a fully synthetic policy, the buyer should approach insurers as soon as possible, to avoid any delays to the deal. Delays may occur particularly if:

- the insurer wants to carry out its own due diligence;
- seller and management engagement to support the buyer's due diligence process is lacking;
- the parties aren't familiar with how synthetic policies work;
- more time is needed for discussing how to quantify damages if claims arise under the policy, especially for complex distressed asset deals.

Conclusion

The use of synthetic W&I insurance products looks likely to grow significantly in the years ahead. We think it will be increasingly important for buyers and sellers of private companies to understand how they work and the opportunities they can provide.

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Inflation: The great rate debate

As the world economy starts to emerge from the COVID shock, inflationary pressures are likely to build. Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, notes that inflation could pose a huge risk to the market.

On the horizon lies a post vaccination world where a surge in economic activity could lead to a rise in inflation. Several arguments support this view:

1. While neither quantitative easing (QE) nor deficit spending are new, the sheer scale of the programmes today certainly is. In the US, the newly elected Biden administration has pushed through a $1.9 trillion stimulus package on top of the $900 billion support bill passed in December – together, they amount to a staggering 13.4% of GDP.
2. The money supply has shot up dramatically, particularly in the US. In previous rounds of QE, nothing on this scale occurred. Then the money multiplier remained low: with little demand for loans from households and businesses, much of the liquidity from QE got stuck on banks' balance sheets.
3. Given the rapid roll-out of vaccinations in most developed countries, expectations are that spending will surge once restrictions on mobility are lifted later this year, with the services sector benefiting in particular. Many economists are concerned that this unleashing of pent-up consumer spending will overheat the global economic recovery and stoke inflationary pressures.

For these (and other) reasons, inflation expectations have surged from their historical lows in the throes of the pandemic last year. If inflation continues to rise, central bankers may have to start raising interest rates. That could call into question the current prices of stocks, which are historically high relative to corporate earnings.

However, while inflation is a risk, I am not particularly worried at present. I see several mitigating factors:

1. The jobs market – there are wide output gaps in the labour market. US employers now report 10 million fewer jobs than before the pandemic, and US unemployment is at 6.3%, compared with 3.5% last year. Wide swathes of the public across developed economies depend on cash injections simply to stay afloat; this is where the stimulus is largely targeted.
2. Property – there is enormous underutilised capacity for office and retail property. If these difficulties are representative of the retail industry in general, the process of finding new owners and recognising losses for existing owners and lenders will be long and painful.
3. Energy – in March 2021, OPEC estimated that global demand for oil fell by roughly 10% in 2020. Given that their productive capacity did not shrink, the major OPEC producers showed remarkable restraint in cutting supply in order to maintain the price. But can it last? Several factors suggest it cannot – one being that all major producers have come under increased financial pressure since the pandemic started.

So prices may rise in the short term because of pent-up demand as economies experience post-vaccination bonanzas and subsequent increases in money velocity. However, I expect this increase to prove transitory, not structural. Moreover, this spending surge should lead to robust economic growth and higher employment. That should allow companies to increase sales and profits while maintaining margins, thus supporting the case for equities and risk assets.

Finally, I believe central bankers when they say they don't intend to raise interest rates until unemployment and economic activity are firmly back to pre-pandemic levels. They are more likely to act to curb higher bond yields by purchasing long-dated bonds, for example, than they are to raise rates and thus endanger a nascent recovery.

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