Q2 2021

UK Private Company Director

Welcome to the July 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 the private equity markets also provides a clear insight into financial investor appetite.

In this issue, we deal with some current topics of importance for directors:

- After a remarkable first three months of the year, private company deal making remained robust in the second quarter, with sellers continuing to achieve high valuations thanks to strong buyer interest (pages 2 to 4).
- The precise ways equity incentives vest after a sale may sound like an arcane legal point, but a proper understanding could make a big financial difference to directors and senior managers (page 5).
- As the global economy bounces back, investors have recently been spooked by the spectre of inflation, particularly in the US. But any near-term rise in inflation is likely to fade over the next 18 months (page 6).

Best wishes,
Megan Peel, Editor

meganpeel@ukprivatecompanydirector.com

Corbett Keeling Corporate Finance

Dechert LLP

Kleinwort Hambros
Societe Generale Group

Corbett Keeling Corporate Finance

An exceptional first half of the year

Was the record start to 2021 for deals in the private company market just a post-pandemic rebound? Jim Keeling of corporate finance advisor Corbett Keeling assesses the data and sees evidence of continuing strength, with significant interest from potential buyers.

The remarkable pace of deal making in the first quarter of the year undoubtedly owed something to the completion of deals put on hold at the start of the Covid crisis. However, I also noted in our last issue that we currently appear to be in a "win-win" market. By that, I meant that we were seeing plenty of cash-rich trade buyers and private equity funds looking for targets at the same time as owners of private companies were looking to sell. This was leading to a large number of transactions done at prices which were attractive to both buyers and sellers.

And the good news is that this happy combination seems to have persisted into the second quarter of the year. While the figures for the value and volume of deals couldn't quite match the heady levels of the first quarter, most sectors of the market remained robust, resulting in a very strong first six months overall.

I expect that to continue, setting us on course for an excellent 2021. The economy is rebounding, as the success of the vaccination programme brings the end of lockdown restrictions. Meanwhile, I have seen little negative impact so far from Brexit. Indeed, there are some signs that the lifting of Brexit-related uncertainty and businesses' swift adaptation to the new arrangements, as well as the implementation of new trade deals, will inject renewed positivity into the market and spur more investment in the UK.

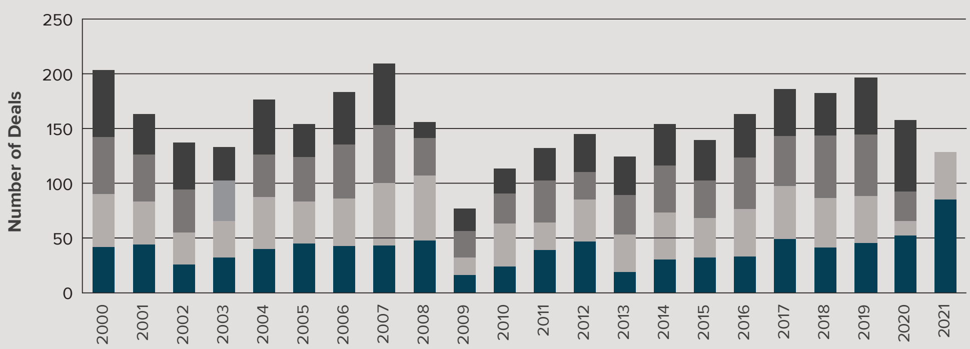
For sellers, the values achieved so far this year are extremely encouraging. In addition, there has been no sign yet of an increase in Capital Gains Tax, which has long been mooted as a possible cash generator for the Treasury. However, the Chancellor may at some point raise CGT as he seeks to repair the nation's finances after the pandemic.

In short, this still seems to be a good time for any private business owners who are contemplating a sale.

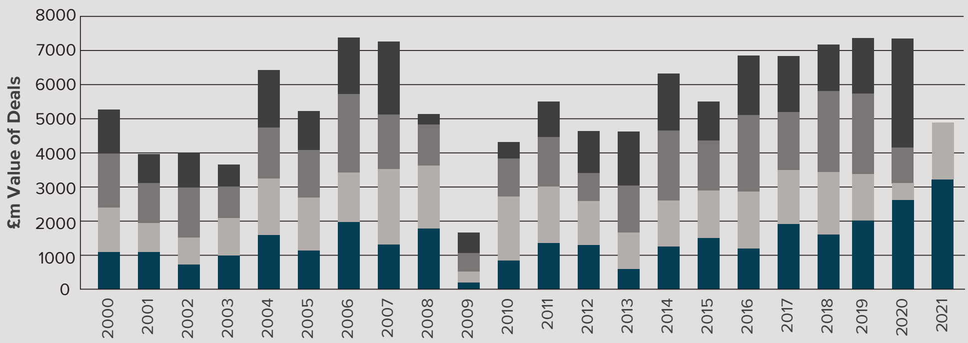
Assessing the deal data

While the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) failed to match the record levels of the previous quarter, we still saw a respectable amount of activity. The volume of deals was well down from a record 85 in the first quarter to 43, while their value also declined from £3.2 billion to £1.7 billion.

Sub-£150m Buyouts by Volume



Sub-£150m Buyouts by Value



Key:

Q4

Q3

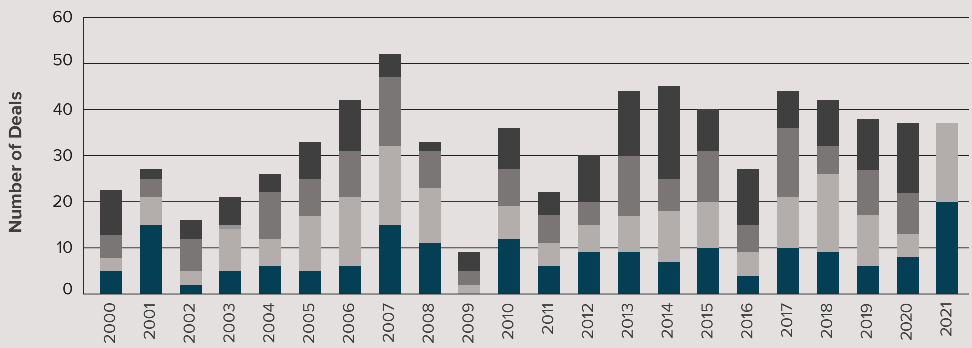
Q2

Q1

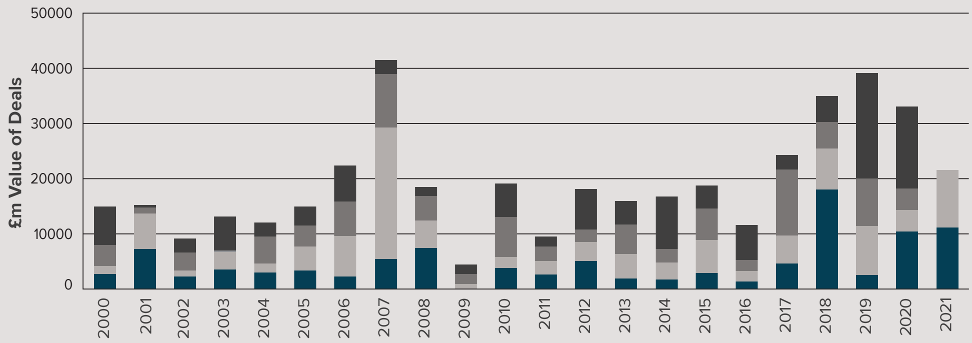
Corbett Keeling Corporate Finance

The **larger buy-outs** sector (enterprise value of £150 million or above) held up remarkably well, with totals nearly matching the previous quarter's robust start to the year. The volume of transactions dipped only slightly, from 20 to 17, taking the figure for the first six months to 37, the same as in the whole of last year. Their value edged down from £11.1 billion to a still strong £10.5 billion.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value

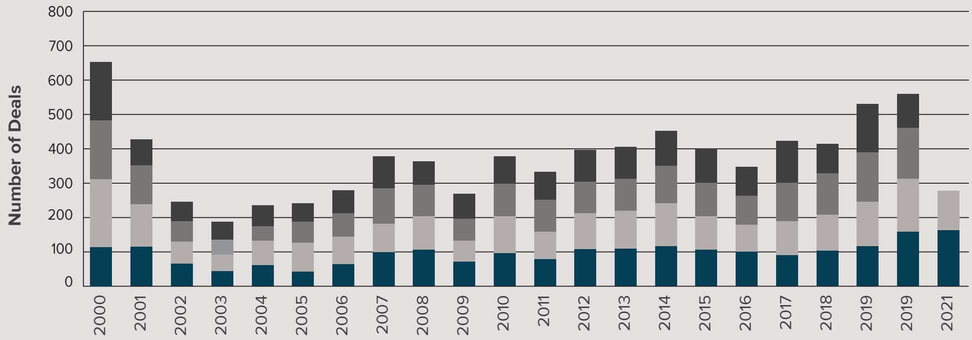


Key:

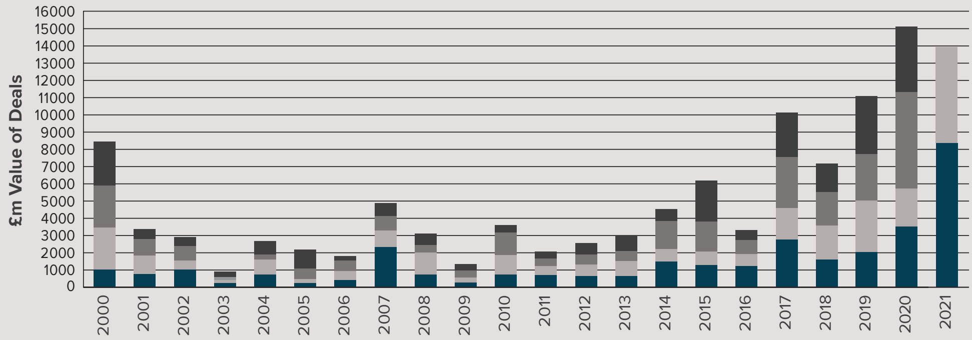
- Q4
- Q3
- Q2
- Q1

While **early-stage and expansion capital deals** failed to equal the first quarter's totals, the pace of activity stayed strong, with companies still achieving very high prices. The number of transactions was down from 163 to a respectable 115. But the value of deals, though down from the previous quarter's record £8.4 billion, was the third highest ever, at £5.5 billion. Over the first six months, the value of transactions topped £13.9 billion, more than any **annual** total except for 2020.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



Key:

- Q4
- Q3
- Q2
- Q1

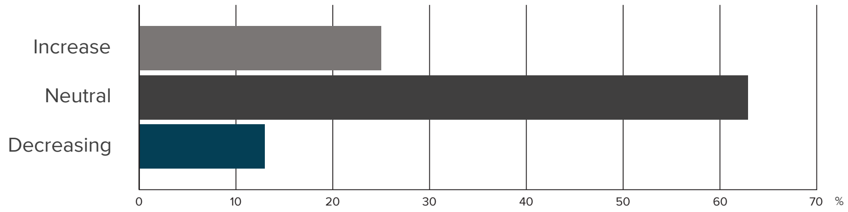
Corbett Keeling
Corporate Finance

So what does our latest survey suggest?

The mood of the market seems broadly positive. Although the overall tone of responses to our survey was down marginally on the previous quarter, a majority of answers were neutral, chiming with our view that the outlook for deal values and volumes remains buoyant.

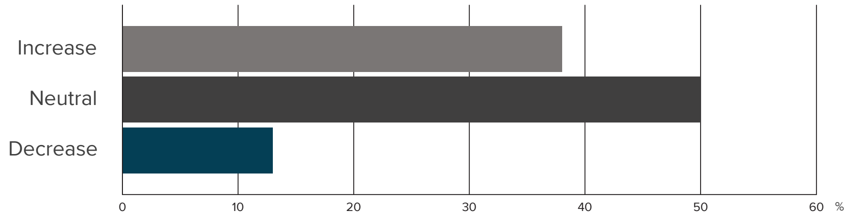
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months was down from 38% to 25%, but 50% expected little change. The proportion forecasting a fall was unchanged, at 13%.



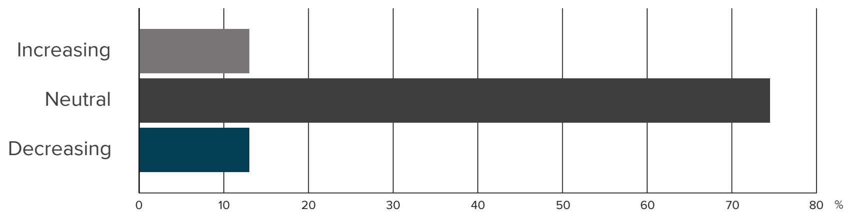
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment, sentiment held remarkably steady. The percentage projecting a rise in the volume of deals edged down from 44% to 38%, but those reporting a neutral response rose from 44% to 50%.



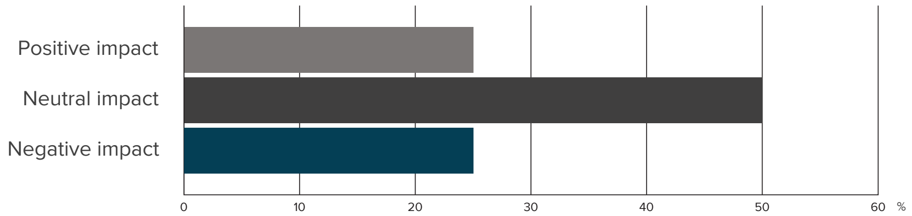
3 Is debt availability increasing, decreasing or neutral?

The concerns about debt availability we saw last year have practically vanished. Three quarters of respondents reported no change in availability, and only one eighth reported that debt was harder to come by.



4 Will Covid-19 have a lasting impact on your portfolio companies?

When asked whether COVID-19 would have a lasting impact on portfolio companies, half of respondents expected little or no long-term effect. The rest were evenly split between predicting a positive and a negative impact.



Contact us

Jim.Keeling@corbettkeeling.com

Dechert LLP

Equity incentives: understanding single and double triggers

Share options and other equity incentives are often issued to directors and senior employees of private companies as performance incentives. Here, Thomas Clarke of Dechert LLP explains the differences between single and double trigger vesting structures and discusses what they mean for managers.

Equity incentives are an effective way to align the interests of a private company's managers with those of its investors. As a result, they are a common feature in UK private companies backed by venture capital or private equity, and equity participation can be an important component of a manager's compensation.

When equity incentives are awarded, the terms of the grant document generally specify certain criteria that must be met for the economic benefit of the incentives to accrue (or "vest") to the individual manager. For example, the incentives tend to vest over a defined period. A manager who voluntarily leaves the company before the end of this vesting period will be likely to lose at least the unvested portion of the incentives.

Sometimes, this vesting may be accelerated – that is, some or all of the incentives will vest before the original vesting period is over – as a result of one or two trigger events relating to the company or the individual.

Single trigger vesting

This is where the vesting is brought forward if one event occurs. Usually, that event is the sale of the company, or a transaction that realises the value of most of the company's assets.

Single trigger vesting is rare in the UK. Clearly, it is attractive for the managers (usually founders or key management), who might argue that their incentives should be focused on achieving an exit, especially ahead of schedule. However, investors generally don't like single trigger vesting. After all, a buyer may well question whether it will be too costly – or even possible – to retain and motivate these managers once the deal is done, and that will in turn make the company less attractive as a target.

Double trigger vesting

This is where vesting is brought forward only if two events both occur. Usually, these triggers will be the sale of the company and the termination of the manager's employment "without cause" – in other words, where the manager has not committed a "bad act", such as a material breach of their employment agreement. If a sale occurs part way through a vesting period and double trigger vesting applies, any vested incentives are normally paid straight away. However, any unvested incentives will continue to vest on the original schedule unless the second trigger occurs and causes accelerated vesting.

Double trigger vesting is more common in the UK market, as it strikes a compromise between rewarding the individual for a successful exit and continuing to incentivise performance after the transaction.

From the manager's perspective, double trigger vesting often represents a fair result: you still have the chance to earn further equity incentives; but, if you are dismissed without cause, the acceleration occurs and so you don't lose the opportunity for further vesting. This can be particularly important for a manager who is worried about being dismissed as the company is integrated into the buyer's group.

Whether single or double trigger vesting is used, the structure of equity incentive schemes is nuanced from both a legal and tax perspective, and not "one size fits all". Managers may wish to seek advice so that they understand the terms of the particular scheme and what that may mean for them in future.

Contact us

Robert.Darwin@dechert.com

KLEINWORT HAMBROS

SOCIETE GENERALE GROUP

Inflation: the price will be right

Sometimes, the market focuses on a single data point that reflects the spirit of the age. After the global financial crisis, it was US house prices. A year ago, it was the daily number of new confirmed COVID-19 cases. Today, it is the inflation rate, especially in the US. Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, investigates whether inflation may prove lasting and what that might mean for markets.

Inflation is a concern as price pressures are building in several key areas. In the US, money supply growth has reached historical highs of over 20% ever since May 2020, hourly earnings have been rising by 4.6% on average since January 2020, and fiscal spending plans announced since last December amount to over 30% of GDP. In addition, commodity prices have surged 62% over the past twelve months, while supply bottlenecks (for example, in semi-conductors) are sparking fears of steep price rises.

The rapid progress in vaccinations has fuelled hopes that the pandemic will soon be over. Now that more than 50% of the US population has received at least one dose of a vaccine, traffic related to shopping and leisure activities are almost back to normal. This has bolstered business confidence, with one index hitting an all-time high and the fastest rates of new business growth on record in both the manufacturing and the services sectors.

Not surprisingly, some market participants have begun to fret about rising prices. One key measure of inflation expectations (US swap contracts for five-year expected inflation in five years' time, known as 5y5y swaps) has risen from lows of 1.22% in March 2020 to 2.52% today. Another measure (US 10-year breakevens) touched a recent peak of 2.35%.

These increases matter because inflation expectations have enormous influence over monetary policy, bond yields and valuations in the stock market. Bond prices have tumbled as yields on ten-year US Treasury bonds rose from 0.51% last August to 1.47%. This has a knock-on impact on stocks because Treasury yields are a key element for equity investors when calculating the net present value of future cash flows. As a result, growth stocks (where high valuations rely on earnings continuing to grow many years into the future) are particularly vulnerable to rising rates.

However, these inflationary worries are largely a US phenomenon. Market expectations for inflation have risen in the eurozone, but not to the same extent – 5y5y swaps are up from the March 2020 crisis low of 0.72% to 1.58% but remain well below the European Central Bank's 2% inflation target. And the market consensus expects eurozone headline inflation to peak at 1.7% in 2021 before easing back to 1.3% next year. In China, both headline and core inflation are below 1%, and the country is much further ahead in its recovery from the pandemic than its Western counterparts.

In conclusion, we expect prices to rise further this year as economies re-open and pent-up consumer demand is unleashed. But this inflation should prove transitory as many structural factors are still putting downward pressure on prices. Gaps between actual and potential output in the economy are still wide, and there is enormous slack in the jobs market, as well as massive spare capacity in commercial real estate. In addition, ageing populations, supply-chain efficiency and technology-driven productivity gains will continue to exert lasting disinflationary pressures. We believe that inflation will fall back in 2022, which will be good news for businesses and market prices.

Contact us

Ben.Whitworth@kleinworthambros.com

Contributors

Corbett Keeling
Corporate Finance

Contact us

8 Angel Court
London EC2R 7HP
+44 (0)20 7626 6266

Jim Keeling,
Chairman
Jim.Keeling@corbettkeeling.com

We guide owners of private companies on raising capital, selling their business and building value by M&A. For 25 years our bespoke, personal service has delivered the optimal mix of Cash, Certainty and Chemistry for our clients, on average we achieve >40% uplift in sale value for our clients and we are proud to have a >90% deal completion record. Our broad sector expertise combined with access to global trade and financial buyers means we will find the best investor or buyer for you.

corbettkeeling.com

Dechert LLP

Contact us

160 Queen Victoria Street,
London EC4V 4QQ
+44 (0)20 7184 7000

Robert Darwin,
Partner
Robert.Darwin@dechert.com

Dechert is a leading global law firm with 26 offices around the world, 900+ lawyers and a top-ranked PE and M&A practice offering clients innovative solutions to deal-specific issues and on the legal and technical aspects of complex, cross-border transactions.

dechert.com

KLEINWORT HAMBROS

SOCIETE GENERALE GROUP

Contact us

8 St James's Square
London SW1Y 4JU
+44 (0)20 3207 7136

Ben Whitworth,
Head of Entrepreneurs & Senior Executives
Ben.Whitworth@kleinworthambros.com

Kleinwort Hambros has over 200 years' experience in British banking and a network of offices across the UK and Channel Islands. It offers its clients individually tailored wealth management solutions delivered with a highly personal service.

kleinworthambros.com