Q2 2022

UK Private Company Director

Welcome to the July 2022 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, while Corbett Keeling's report on deal activity in the private equity markets provides a clear insight into investor appetite.

This issue tackles some topics which should be of interest to directors of privately owned businesses:

- Deal making remains in a sweet spot, with plenty of sellers achieving strong valuations from willing buyers, but such conditions are unusual and surely won't last (pages 2 to 4).
- How Environmental, Social and Governance "ESG" are becoming a driver for value creation in private companies (page 5).
- Inheritance tax can be a concern once you've sold your business, but too much focus on simply minimising IHT liabilities can be a mistake (page 6).

All the best!

Megan Peel

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Making the most of the sweet spot

The pace of deal activity remains brisk, with many private companies still achieving strong valuations on sale. But how long will these favourable conditions last? Jim Keeling of corporate finance advisor Corbett Keeling assesses the evidence.

The post pandemic boom in transactions continues. The market continues to enjoy a rare sweet spot where cash rich, deal hungry buyers are finding plenty of business owners who are eager to sell.

Buyers are still sitting on a pile of cash, much of it accumulated during the lockdowns, and they don't show any sign of losing their appetite to put this cash to work. However, appetites can fade quickly.

And on the other side of the table, we are coming across a lot of owners who have built up their businesses over decades and managed to survive 2 or 3 recessions and the tricky trading conditions through the pandemic but who are now reassessing their lifestyle and looking to sell. And the prospect of a possible recession has certainly focused their minds.

The economic outlook appears unusually murky. The cost of living crisis is putting pressure on consumers and businesses alike, and the Bank of England is raising interest rates to tame inflation, causing concerns about the availability and cost of debt.

What is more, the Ukraine war and the COVID-related lockdowns in China continue to cause supply chain problems across a range of industries. As a new cold war with Russia and China reverses some of the globalisation of recent decades, these issues are likely to persist – witness the recent joint statement by the FBI and MI5 on efforts to counter Chinese espionage, both military and economic.

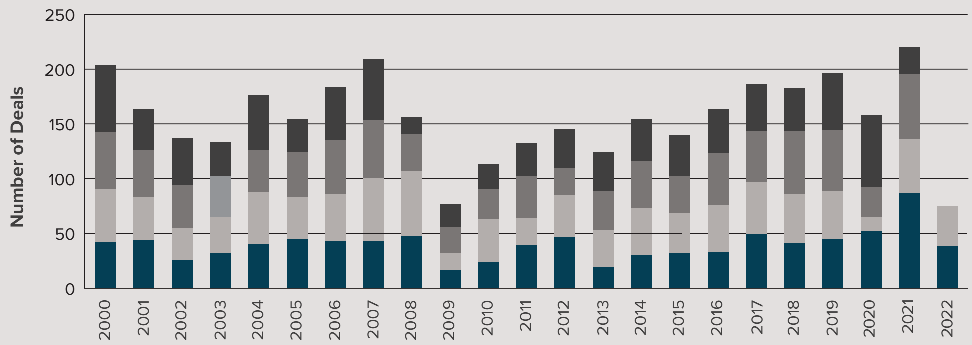
So we would encourage any owners who are considering a sale not to delay. The current market environment is highly unusual, and we know from past experience that it can't last indefinitely.

These favourable conditions are reflected in the latest quarterly data, which we now turn to.

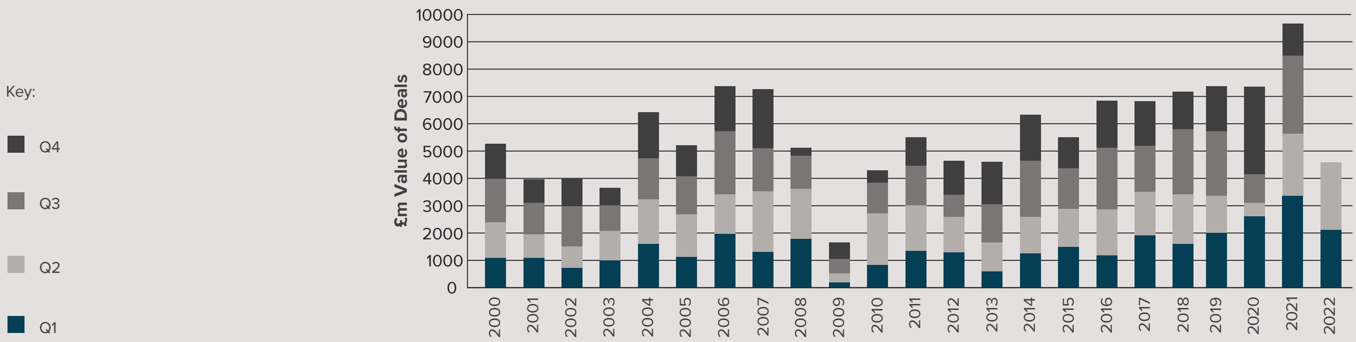
Assessing the deal data

Activity in the **smaller buyouts** sector (transactions with enterprise value of less than £150 million) held steady in the second quarter of this year. The volume of deals dipped very slightly from 38 to 37, but their aggregate value jumped from £2.1 billion to £2.5 billion.

Sub £150m Buyouts by Volume

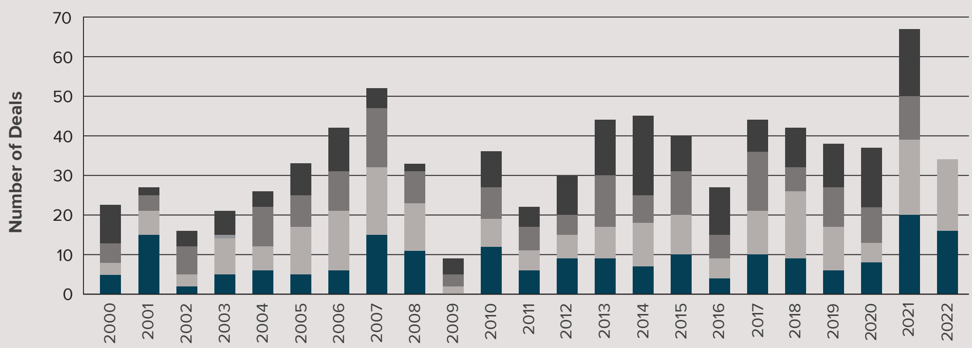


Sub £150m Buyouts by Value

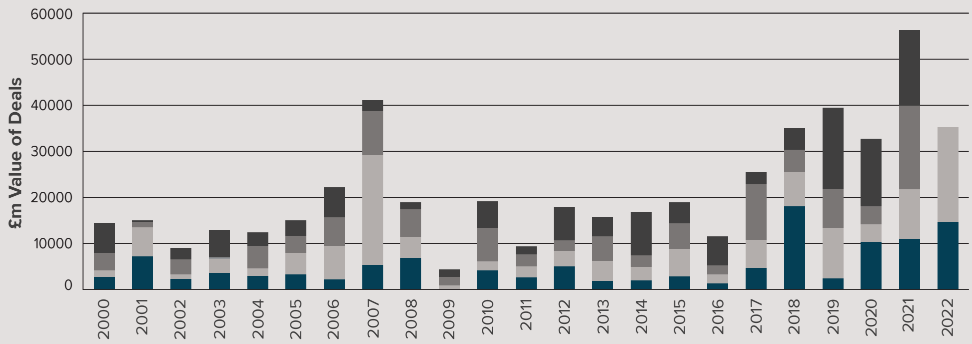


The **larger buyouts** sector (enterprise value of £150 million or above) enjoyed a very strong quarter. While the number of transactions edged up from 16 to 18, their overall value soared from £14.8 billion to over £20.9 billion, the second highest quarterly figure on record. That takes the total for the first half of 2022 to nearly £36 billion, the strongest ever start to a year.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value

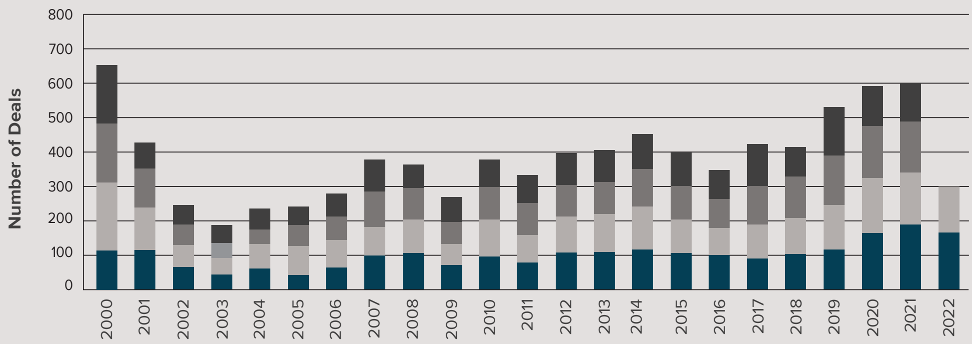


Key:

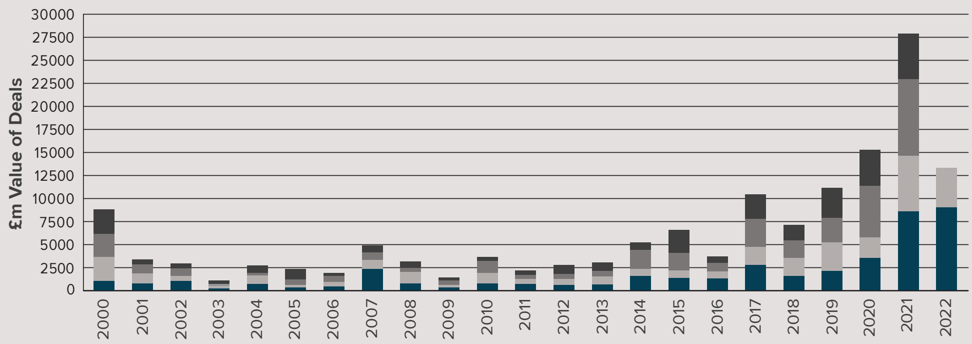
- Q4
- Q3
- Q2
- Q1

Early-stage and expansion capital deals were the least strong segment of the market. The number of transactions declined from 166 to a still robust 134. But the average value was down more significantly, as the total value of deals fell from £9.1 billion to £4.3 billion.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



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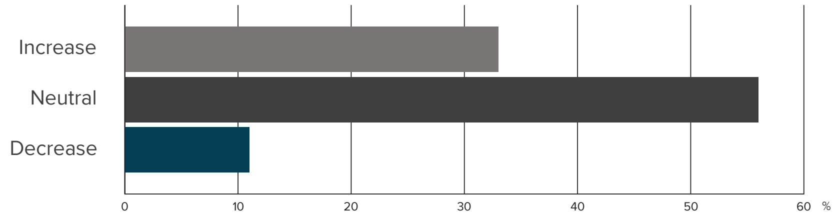
So what does our latest survey suggest?

The economy has had a lot to contend with, given rising inflation, tightening financial conditions, disrupted supply chains and the worsening situation in Ukraine. Nevertheless, our quarterly survey of market participants suggest that the market's mood remains pretty sanguine.

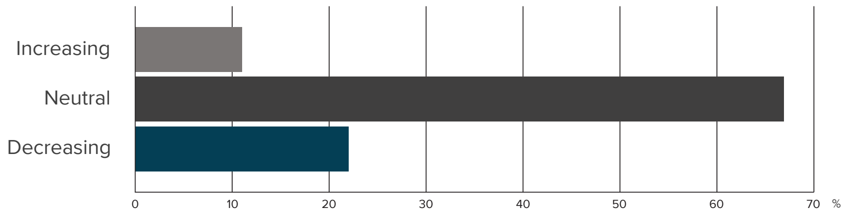
1 Do you expect deal volumes to increase or decrease?

Most respondents still expected that deal volumes would either increase (one third) or be little changed (56%) over the next few months. Meanwhile, over the quarter those forecasting a decline halved, from 22% to 11%.



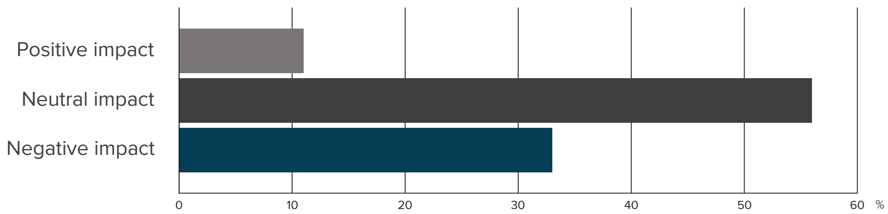
2 Is debt availability increasing, decreasing or neutral?

Concerns about the ease of debt financing are ticking up. Those expecting an increase in availability fell from 22% to 11%, with a corresponding rise in those predicting less availability.



3 Has Russia's invasion of Ukraine had an impact on your portfolio companies?

As the war in Ukraine continues, respondents see it having a more significant adverse effect on portfolio companies. While 11% still think it is having a positive impact, the number citing it as a negative factor has risen to one third.



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A board's guide to oversight of ESG

The past few years have seen increased focus from investors on environmental, social, and governance ("ESG") principals, especially as a driver for value creation amongst private companies. An ESG programme is often wide-ranging and priorities may differ from industry to company, but the obvious content of ESG programmes covers:

- climate change and environmental impact;
- fostering diversity and inclusion initiatives; and
- managing human capital.

Given the heightened focus from investors (and regulators), ESG is now a critical boardroom topic – boards need to show that their commitment to ESG starts at the highest level of the company. Management teams need to ensure that their companies' ESG programmes are well-defined, appropriate for the company and take account of any relevant material risks.

A 2021 PwC survey reported that 72% of private equity investors always screen target companies for ESG risks and opportunities at the pre-acquisition stage, and 56% have refused to enter general partner agreements or turned down investments on ESG grounds.* It is therefore widely accepted that good ESG performance can give private companies a competitive advantage and a robust programme is a strong indicator of future success.

ESG is now an inextricable part of how companies do business

ESG issues are now embedded throughout companies' operations, as they cover such diverse areas including energy management, company ethics and employee wellbeing. They are therefore inextricably linked to company strategy and the creation of sustainable long-term value.

As a board has a responsibility to act in the best interests of its company, it may wish to oversee the following ESG matters:

- **Clear and consistent strategy** – a board should shape the company's ESG narrative by aligning the company's purpose and long-term strategy with consideration and measurement of ESG objectives. Additionally, articulating an ESG-focused strategy can help a company to connect with its stakeholders, who are becoming ever more concerned about ESG issues. For B2B businesses, their customers may also face policy pressure on ESG and so will be keen to deal with like-minded organisations.

- **Management of risks** – a board should understand ESG risks throughout the organisation, and should seek to implement a feedback mechanism for identifying, assessing and mitigating those risks. For companies with enterprise risk management ("ERM") solutions, a board should review whether these solutions adequately address evolving ESG risks. A board should particularly oversee ESG risks and opportunities in the context of capital allocation decisions.

- **Measurement of performance** – a board should ensure there is a transparent mechanism for internally tracking ESG goals. Furthermore, a board should seek reporting on the company's external performance through benchmarking against peers and competitors. For larger companies, a board may wish to appoint a standalone ESG committee or taskforce that is accountable for ESG performance, with members having appropriate capacity, interests and skills.

- **Incentive structure** – a board can explicitly connect its ESG programme to company performance by adopting ESG metrics in its incentive plans, which signals the importance of ESG issues at the company to potential investors and employees.

The ESG Challenge: Measurement of Success

While ESG programmes are of increasing strategic importance for private companies, a board's measurement of its company's ESG programme can be challenging given there is no universally standardised ESG metric.

Regulation in the UK public markets requires listed companies to make standardised disclosures in line with the recommendations from the Task Force on Climate-related Financial Disclosures; however, most private companies set their own goals or use the UN's Sustainable Development Goals as a benchmark for their progress.

A board should therefore be mindful of balancing achievable goals and strategy, with meeting established ESG expectations, in order to remain attractive to employees and investors. As certain standards and frameworks converge, a board should also periodically review the adequacy of its company's ESG programme.

Conclusion

A strong ESG programme and sufficient board oversight is critical for sustainable value creation. As performance on ESG issues has become a key benchmark used by potential acquirers to assess a target company's success, boards should keep ESG at the heart of their decision-making and their companies' risk management strategies.

* https://www.pwc.com/gx/en/services/sustainability/publications/private-equity-and-the-responsible-investment-survey.html

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The IHT implications of a sale

Running your own company can be a fantastic way to mitigate inheritance tax (IHT), because qualifying businesses can claim relief. However, once you sell up, you could significantly increase your potential IHT liability. Spike Godwin of Arbuthnot Latham explains what you can do to ensure your hard-earned wealth is passed efficiently to the next generation.

Just like the tax due on the sale of a business, IHT is a known future liability and, at 40%, a significant one. The good thing about known liabilities is you can plan for them. The downside is that IHT is a political hot topic and the rules may well change. So it is important that any IHT planning ensures future flexibility, rather than simply reducing tax under today's rules.

What is the inheritance tax rate?

The IHT rate is 40% for the tax year 2022/2023. It is applied when the value of an estate is above the Nil Rate Band (NRB) threshold, which is currently £325,000. The taxable part of any estate above the applicable threshold, after exemptions and allowances, will be subject to IHT.

If your estate is below the NRB or if you leave everything to your spouse or civil partner or a charity, there may be no inheritance tax to pay. You can also transfer any unused percentage of the inheritance tax NRB to your surviving spouse or civil partner. The survivor's NRB can never be increased by more than 100%.

In addition to the NRB, you may also qualify for the Residence Nil Rate Band (RNRB) if certain conditions are met. For married couples and civil partners, unused RNRB can be transferred if the survivor dies after 5 April 2017, irrespective of when the first of the couple died. The RNRB is currently £175,000. The RNRB reduces where the value of the estate immediately before death exceeds the £2 million taper threshold. The residence nil rate band will reduce by £1 for every £2 that the estate is worth above £2 million.

A reduced IHT rate of 36% is payable on certain assets if you give away 10% or more of the net value of your estate to charity. Additionally, gifts made in the years before death may be subject to taper relief.

When do you pay inheritance tax?

IHT must be paid by the end of the sixth month after the person's death, or HMRC will start charging interest. The executors can choose to pay the tax on certain assets, such as property, by instalment over ten years, but interest will be charged on the outstanding tax amount.

How can I maximise inheritance for beneficiaries?

Clients often ask wealth planners how to avoid inheritance tax, but this should never be the focus of your strategy. Rather, you should ensure you have a financial structure designed to help you live your life and allows you to financially support those you love, both throughout your life and post death.

Strategies to maximise inheritance:

- Decreasing the value of your taxable estate
- Making use of annual allowances
- Gifting during your lifetime
- Passing assets into a trust for your children
- Leaving your estate to your spouse or civil partner
- Holding assets that are exempt from IHT on your death
- Leaving a legacy to charity

An experienced and qualified wealth planner can help you structure a plan that meets your goals, preferences and lifetime access to capital or income as well as maximising IHT efficiency and the financial legacy you wish to leave.

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