Q4 2021

UK Private Company Director

Welcome to the January 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.

In this issue, we address some of the key topics for directors of privately owned businesses as we enter the new year:

- While the volume of private company transactions declined in the final quarter, the year as a whole set a new record for the value of deals, and conditions remain strong for buyers and sellers alike (pages 2 to 4).
- While it is often hard to set and achieve environmental, social and governance goals, a credible ESG strategy can help companies to create long-term value and become an attractive acquisition target (page 5).
- The recent surge in inflation should prove temporary, which should be positive for riskier assets such as equities, though it is still wise to have some safer assets within your investment portfolio (page 6).

We wish you a happy, healthy and rewarding 2022!

Megan Peel

Megan Peel, Editor
meganpeel@ukprivatecompanydirector.com

Corbett Keeling Corporate Finance · Dechert LLP · Kleinwort Hambros Societe Generale Group

A record-breaking year

The private company M&A market enjoyed a very strong 2021, with the overall value of deals completed setting new all-time highs. But can this extraordinary strength continue? Jim Keeling of corporate finance advisor Corbett Keeling considers the outlook for the new year and explains why business owners contemplating a sale may do well to start the process soon.

While the pace of deals slowed slightly after a hectic first nine months of the year, the market place remains busy. And, with plenty of interest from cash-rich buyers, sellers continued to achieve high valuations. The result was a slower but solid final quarter – and a year to remember for the market.

For 2021 as a whole, the total value of companies sold set all-time highs in every segment of the market. While early stage and expansion capital was the only sector where the volume of deals failed to set a new peak, it made up for it by smashing the previous record for values, set in 2020.

How far this momentum continues into 2022 remains to be seen. The Omicron variant is one potential fly in the ointment, as the respondents to our latest survey note. Fortunately, it seems that infection rates may already be peaking with markedly lower hospital cases than for previous variants, so I am hopeful that the impact on businesses will be mild and short-lived.

For now, certainly, there are plenty of opportunities for both buyers and sellers, which is reflected in the rapid pace of activity in the market place.

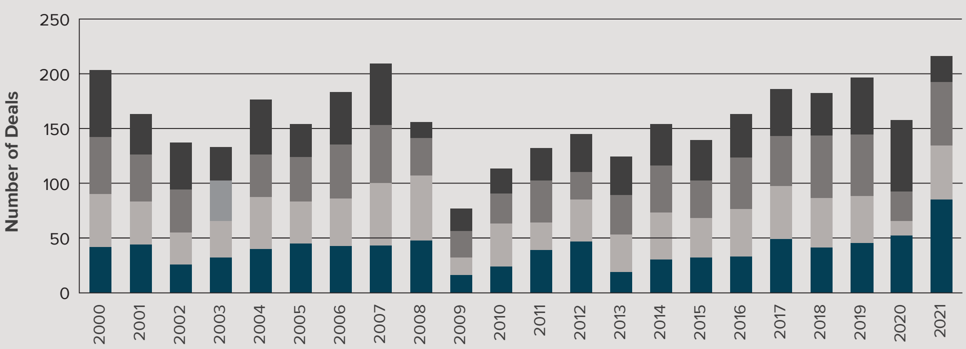
However, while conditions remain favourable in the short term and market sentiment seems robust, we at Corbett Keeling urge anyone thinking of selling their business not to delay too long, as the sale process is generally time-consuming and market conditions can change quickly.

Let's look at the data.

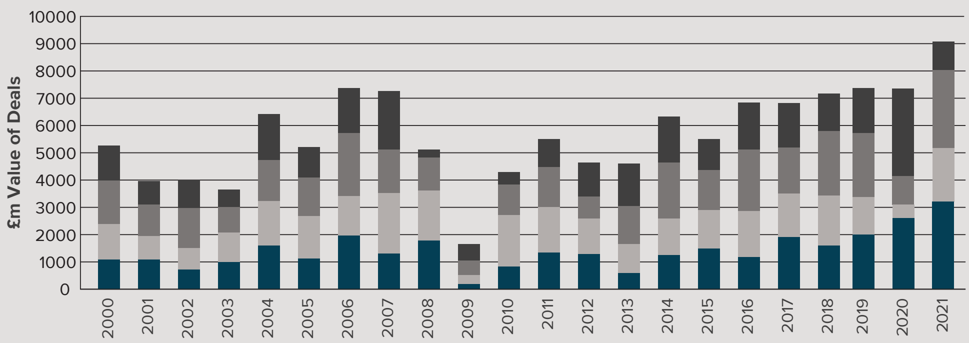
Assessing the deal data

After an exceptional first nine months of the year, activity in the **smaller buyouts** sector (transactions with enterprise value of less than £150 million) faded in the final quarter, although good valuations were still being achieved on sale. The volume of deals fell from 58 in the third quarter to 24, while their aggregate value declined from £2.8 billion to £1.1 billion.

Sub-£150m Buyouts by Volume



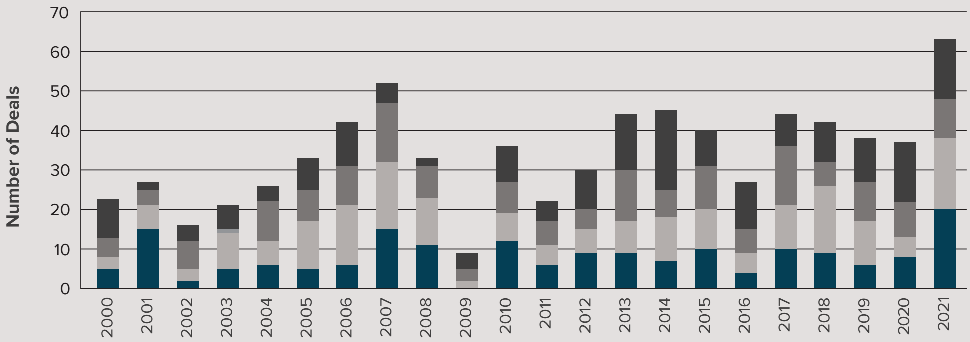
Sub-£150m Buyouts by Value



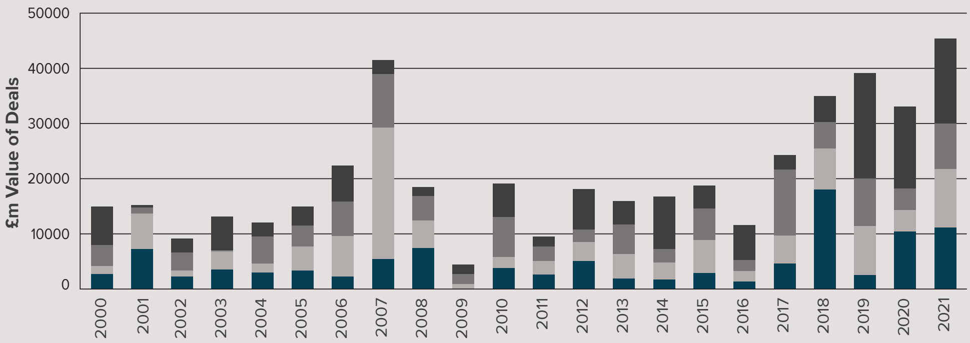
Key:
- Q4
- Q3
- Q2
- Q1

The **larger buyouts** sector (enterprise value of £150 million or above) had a strong end to a remarkably strong year. The number of transactions picked up from 10 to 15, but the real strength was in the value of deals, which soared from £8.2 billion to £15.4 billion. That was enough to take the sector to new all-time annual highs for both the volume and the value of deals.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value

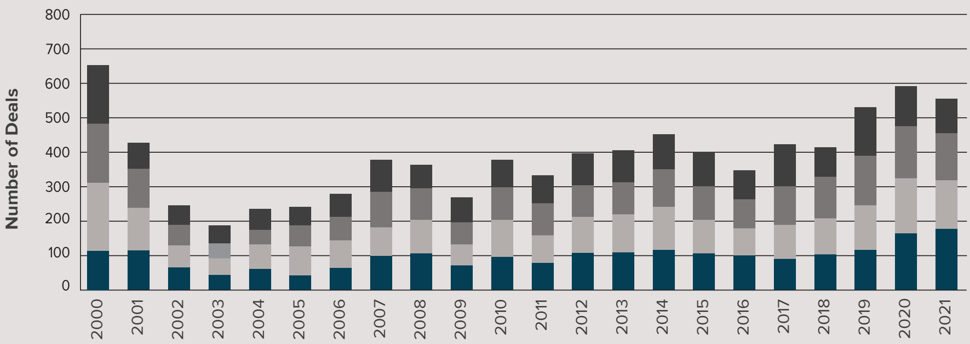


Key:

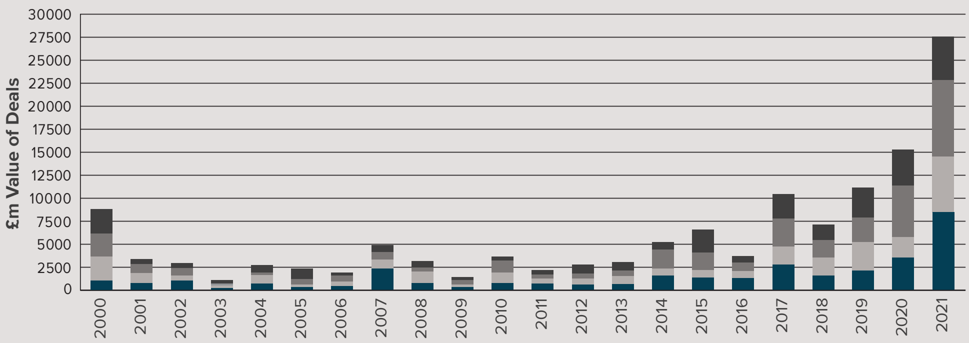
- Q4
- Q3
- Q2
- Q1

Early-stage and expansion capital deals saw continued strength in the final quarter, though the number of transactions couldn't match the heady pace of the first nine months of the year, with the volume of deals down from 138 in the third quarter to 99. The overall value of transactions also tailed off somewhat when compared with the first three quarters of the year, declining from £8.5 billion to a still very strong figure of £4.7 billion.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



Key:

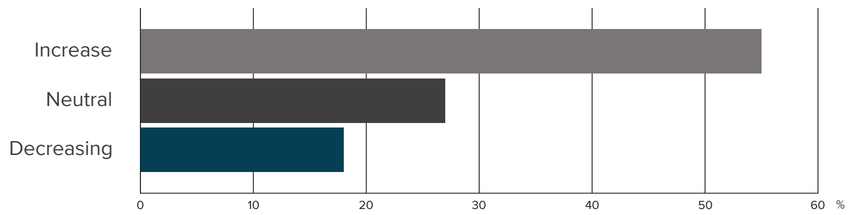
- Q4
- Q3
- Q2
- Q1

So what does our latest survey suggest?

After such a bumper vintage as 2021, the market seems to be broadly optimistic as we enter the new year. However, uncertainty about the Omicron variant continued to cast a slight shadow over sentiment, with concerns about the near-term impact on businesses.

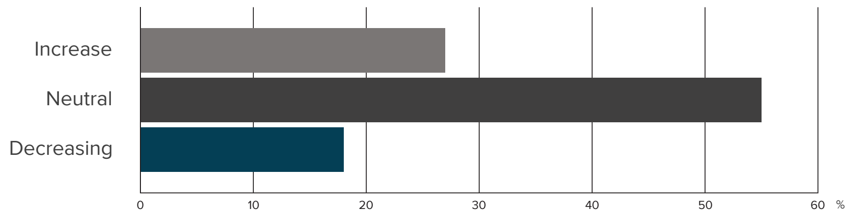
1 Do you expect deal volumes to increase or decrease?

The overwhelming majority of respondents expected that deal volumes would either increase (55%) or stay roughly the same (27%). On the other hand, 18% expect a decline. Given the extraordinary level of recent activity, that doesn't come as a total surprise.



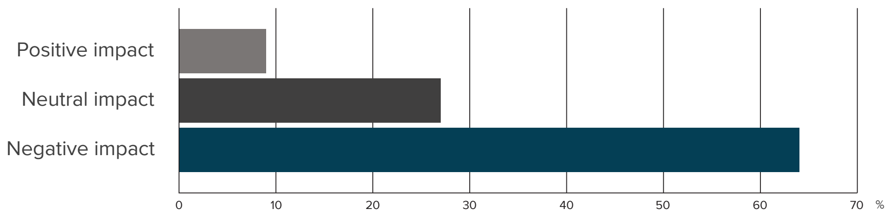
2 Is debt availability increasing, decreasing or neutral?

A rise in the Bank of England's official interest rate for only the third time in 15 years has – not surprisingly – dented confidence in debt availability. Some 18% of respondents thought debt is becoming less available, up from 0% last quarter, while the proportion reporting an increase in availability has dropped from 59% to 27%. Nevertheless, the responses are on balance positive.



3 How do you anticipate the spread of Omicron will affect your portfolio companies in Q1 of 2022?

If there is a drag on market participants' optimism, it appears to come from the seemingly never-ending blight of COVID. Nearly two thirds of respondents said they expected the Omicron variant to have a negative effect on portfolio companies in the first quarter of 2022, while only 9% expected a positive impact.



Contact us

Jim.Keeling@corbettkeeling.com

Dechert LLP

The rising importance of ESG in M&A

It was a record-breaking year for private equity backed M&A deals, with $818.4 billion (£608.2 billion)* of transactions globally in the first nine months, more than double the figure for the same period in 2020. Meanwhile, the world faced social upheaval as we continued to navigate the pandemic. Against this backdrop, companies have increasingly focused on improving their performance on environmental, social and governance (ESG) issues. Here, Jonathan Burke and Maddie Drabble of international law firm Dechert outline some key ESG considerations for private companies.

ESG generally refers to a set of standards for company operations which focus on issues such as climate change, data security, tax transparency and diversity, equity and inclusion. Private equity firms are increasingly required to integrate ESG considerations into their operations and investment strategies. And this task is complicated by the fact that ESG priorities differ from one company – and one industry – to another.

Addressing ESG issues – the benefits...

Shareholders and employees alike should benefit if the company has a clear focus on ESG issues which reflects its values. Crucially, a strong ESG policy can position the company as a more attractive potential deal partner. Indeed, a sizeable percentage of global investors now say that ESG risks are an important factor in their investment decision making. A focus on ESG can also help a company to connect with its customers, 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 likeminded organisations.

Ultimately, performance on ESG issues has become a benchmark used by potential acquirers to assess a target company in their due diligence alongside more traditional metrics, such as sales revenues or net profit margin.

...and the challenges

For companies seeking investment or to be acquired, it can be hard to define, measure and achieve ESG goals. That's largely because there are no universally standardised ESG metrics, reporting requirements or regulations. Some companies set their own metrics, often using the UN's Sustainable Development Goals as a yardstick for their progress. Yet it is difficult to strike the right balance between generating a return for investors and meeting ESG goals. If a company lags on meeting established ESG expectations, it may have a smaller pool of potential acquirers or may find it more challenging to secure investment, particularly from private equity investors.

Meanwhile, private equity funds seeking acquisition targets can find themselves at a disadvantage when bidding for a target with material ESG risks and opportunities if a competing firm has more mature ESG capabilities to draw on. After all, there is a limited pool of ESG appropriate companies to invest in. Over 50% of private equity partners say that ESG considerations have sometimes led them to turn down investments or refuse to enter general partner agreements.

Conclusion

With private equity assets expected to increase by 30-40% worldwide over the next five years, the importance of ESG considerations in (potential) portfolio companies' operations will presumably grow. A credible ESG strategy can better position an investee company to create long-term value, differentiate its brand, strengthen its bottom line and make itself attractive to acquirers.

*Data from Refinitiv.

Contact us

Robert.Darwin@dechert.com

KLEINWORT HAMBROS

SOCIETE GENERALE GROUP

Inflation: new year, old problem

As 2022 begins, we face a long-dormant foe: high inflation. While growth in developed economies remains robust, inflation has increased by around 5% this year in the UK and the eurozone and by nearly 7% in the US, the highest rate since 1982. As Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, explains, the biggest risk for markets in 2022 is how aggressively central banks – particularly the US Federal Reserve (Fed) – act to tame inflation.

Although Fed tapering of quantitative easing and raising rates is largely priced into market prices, measures to shrink its balance sheet are not.

In a best-case scenario, liquidity remains ample and economic momentum is strong enough to withstand slightly higher rates. Moreover, central banks can run down their balance sheets slowly by not buying new bonds while holding the bonds they already own until maturity. Eventually, they resume normal open market operations, reducing their balance sheets by selling more bonds back to the market than they buy. If done when economic growth is strong enough, the likely result is a reduction in debt without destabilising markets.

In a worst-case scenario, liquidity dries up, economic momentum falters and central banks go too fast from "run off" to "sell off", as the European Central Bank did in 2013 and 2014. This would probably prompt an adverse reaction from markets, with declines and high volatility.

We believe the actual path will be closer to the former than the latter, allowing central banks to tighten policy slowly. Why? Mainly because the current high levels of inflation are being driven by temporary factors.

One, most of today's apparent surge is due to the base effect. In January 2021, the price of a barrel of Brent Crude oil was close to $50, compared with $80 now. This has been the single largest factor behind the rise in inflation. Few expect oil prices to soar again (though admittedly it's possible).

Two, there have been marked shifts in our consumption patterns. At its peak, post pandemic consumption of durable goods was 34% higher in real terms than before, as spending on services has been slashed. This overwhelmed supply chains and drove up the prices of many weighty components in inflation indices, such as used cars. Now, consumption patterns appear to be moving back towards normal, and supply chain blockages are easing.

Finally, perhaps the single most important indicator that inflation may become entrenched is spiralling wage growth. This forces companies to raise prices, thus leading workers to demand higher wages, a vicious cycle which will be familiar to anyone who lived through the 1970s. In the first quarter of 2021, the OECD's measure of gross pay and social security per employee reached 5.0%, worryingly high by past standards. However, it eased to 4.5% and 4.4% in quarters two and three and is likely to have peaked as pandemic era benefits dry up and COVID restrictions abate.

The bottom line

We believe the case for taking increased risks in investment portfolios is supported by the robust economic backdrop, strong momentum and still tolerable valuations of riskier assets. However, we are cognisant of the remaining downside risks, including the possibility that inflation surprises us by remaining stubbornly high. As a result, the portfolios we manage for clients continue to hold a stable of safe-haven assets including cash, government bonds, gold and defensive alternatives.

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 nearly 30 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 22 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