Q1 2023

UK Private Company Director

Welcome to the April 2023 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.

As always, this issue tackles some of today's pressing issues for directors of privately owned businesses:

- While activity remained weak in the larger deals segment during the first quarter, the smaller end of the market remained buoyant, with a notably large volume of transactions (pages 2 to 3).
- The death or serious illness of a key person is always traumatic, but it needn't jeopardise your business, just as long as you have the right protections in place (page 4).
- Liability management transactions are one of the latest financial trends to cross the Atlantic. We explain what they are and what business owners need to know (page 5).

All the best,

Megan Peel

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Corbett Keeling Corporate Finance

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Chalk and cheese

While the larger deals segment showed clear signs of weakness during the first quarter of 2023, the rest of the M&A market held up well. And, as Jim Keeling of corporate finance advisor Corbett Keeling observes, activity remains particularly strong at the smaller deals end of the market.

It's sometimes hard to keep data in perspective. But it's always important to make sure you are comparing like with like. Not surprisingly, the period immediately after the pandemic was exceptionally strong for M&A activity in the UK, as deals delayed by COVID-related uncertainty came through in a rush.

So what are activity levels really like now? Yes, they are down on last year. But, to get a fair comparison, you have to look back over a longer timeframe. If we evaluate the whole period since the global financial crisis, we can see that the larger deal end of the market is weak at the moment, with both the volume and the value of deals down significantly on what we would consider normal levels.

But, in the lower/mid-size deal segment, the volume of deals is as high as it ever was in the decade leading up to the pandemic. In fact, we see a ton of activity as thriving companies meet buyers who still have plenty of cash to invest in the right businesses.

Despite what you might read in the press, business owners are still achieving good valuations at the lower/mid-size end. Where the overall value of deals in this segment is somewhat down, I think that largely reflects the size of the businesses being sold, not that buyers are less willing to pay fair prices.

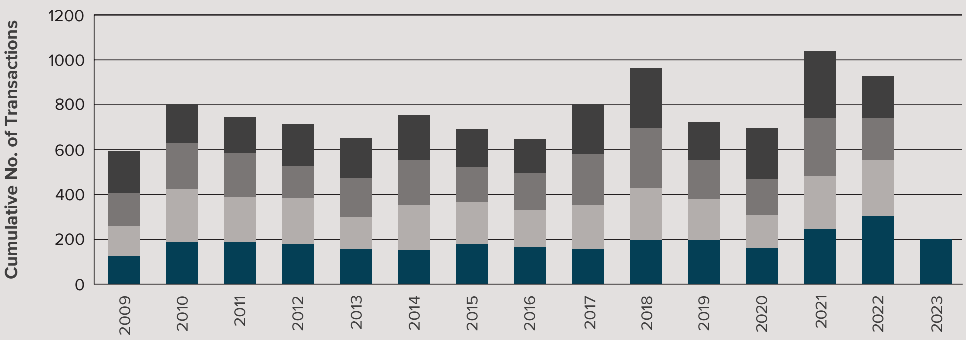
Furthermore, market sentiment shows signs of turning more positive again, after becoming a bit downbeat in the second half of last year. That was not surprising, given the inflationary shock, the Ukraine war, increasing economic uncertainty and decreasing debt availability. But now the market seems to have adjusted and is getting on with business, as it always does.

So let's look at the transaction data for the first three months of the year.

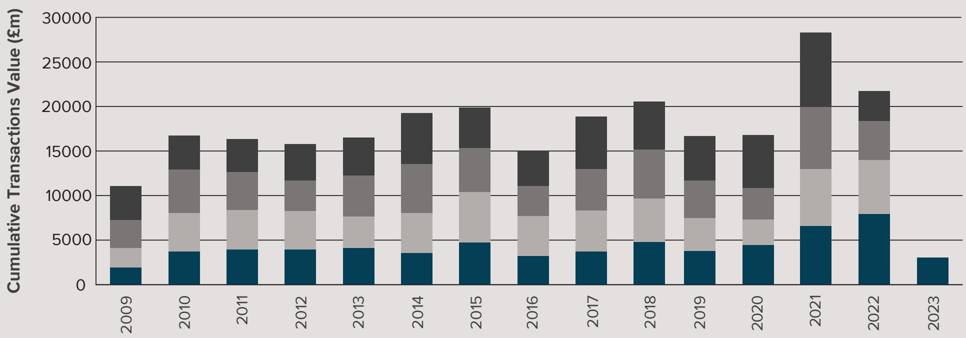
Assessing the deal data

Activity in the **smaller deals** sector (transactions with enterprise value of less than £150 million) was buoyant over the first quarter of the year. The volume of deals actually increased from the previous quarter's 187 to reach a total of 199. In volume terms, it was the strongest start to a year since the global financial crisis, excluding the pandemic period. However, the aggregate value of transactions declined slightly, from £3.4 billion to £3.1 billion.

Sub £150m Transactions by Volume



Sub £150m Transactions by Value



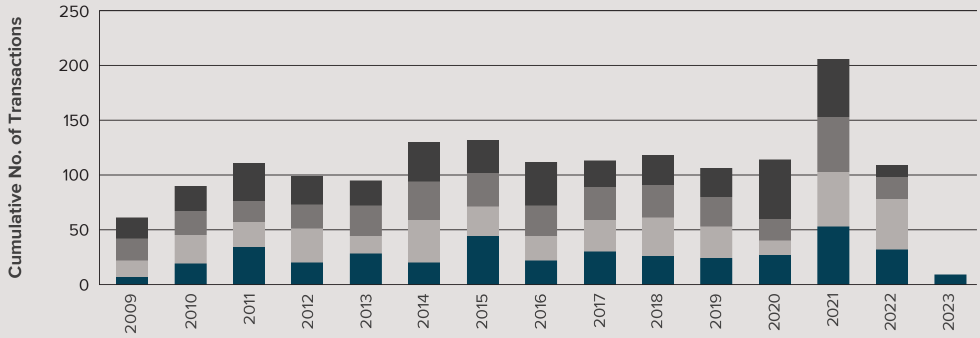
Key:

Q4 Q3 Q2 Q1

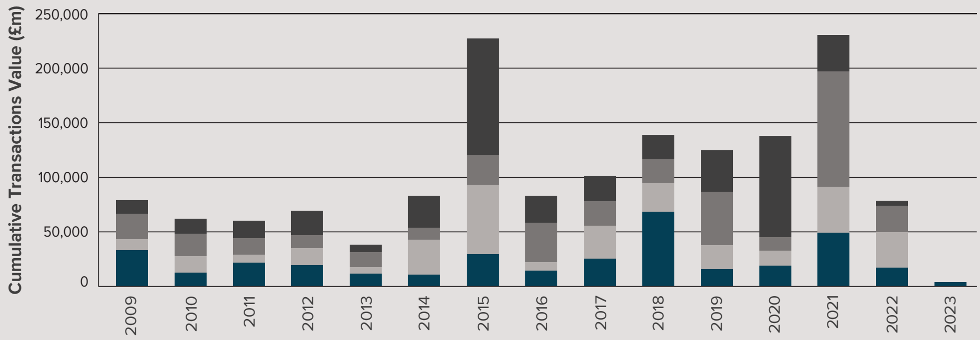
Data supplied by Thomson Reuters Eikon.

It was another weak quarter for the **larger deals** sector (enterprise value of £150 million or above). The number of transactions fell from 11 the previous quarter to 9, the second lowest since 2000. Meanwhile, the total value of deals dipped from £4.4 billion to £3.9 billion, setting a new quarterly record low.

£150m+ Transactions by Volume



£150m+ Transactions by Value



Key:

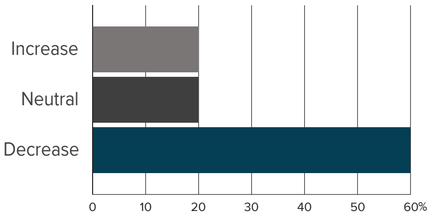
Q4 Q3 Q2 Q1

Data supplied by Thomson Reuters Eikon.

So what does our latest survey suggest?

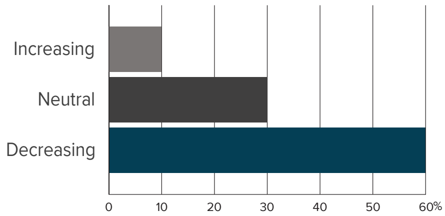
While market participants' responses are rather downbeat, they have become appreciably less negative overall than they were in the previous quarter.

1 Do you expect deal volumes to increase or decrease?



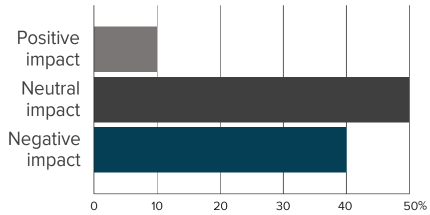
The number of respondents expecting deal volumes to increase over the next few months rose from 11% to 20%, while those forecasting a decrease fell from 78% to 60%, with the remaining fifth in the neutral camp.

2 Is debt availability increasing, decreasing or neutral?



Not surprisingly, market participants are still concerned about debt financing. However, the proportion reporting an actual decrease in availability dipped from 67% to 60%.

3 What impact has the current economic climate had on your portfolio companies overall?



It was a similar story when asked whether the current economic climate is adversely affecting their portfolio companies. The percentage reporting a negative impact edged down from 44% to 40%, while half said they had seen little effect one way or the other.

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Protecting your business

You can't stop the unexpected from happening, but you can ensure events don't derail your business completely. By putting in place the right business protection, you can create a financial cushion to reduce the impact from the absence of a shareholder, senior manager or key person. This could allow you to fill a role, meet financial obligations or even keep control of your business. Daniel Ryan of Arbuthnot Latham outlines the key risks – and solutions.

Control or ownership risk

Surprisingly, 60% of business owners say they have no financial protection to cover the cost of buying shares should an owner die.

Depending on the shareholder agreement, shares and associated voting rights are often passed on as part of the deceased's estate. The beneficiary may choose to take a role in the running of the business – or to sell the shares, possibly to a competitor.

Shareholder protection provides the surviving shareholders with the funds to buy the shares of the deceased shareholder from the estate. This can be a good solution if the company is unlikely to have sufficient capital or retained profit to purchase the shares directly.

Operating or business continuity risk

Sometimes, one person's effect on turnover or profit is so great that the business would struggle to survive without them. The resulting loss of confidence could lead to suppliers requesting payment upfront, financial providers limiting credit lines, a fall in the share price, brand damage or customers seeking alternatives.

So it's essential to have a business continuity plan setting out how the business will operate and manage its obligations and continued profitability if circumstances change.

Key person protection can help meet the financial needs of the business while a replacement staff member is found or a restructure is undertaken. Identifying the key people in your business can help you quantify the financial risk to the business if one of them becomes critically ill or dies.

You will need suitable life or critical illness cover, with the sum assured payable directly to the business. This cover could help your business to meet its financial obligations and provide stability for customers, employees and shareholders at an uncertain time.

Default risk

To support their growth plans, many businesses borrow via commercial loans, overdrafts, mortgages or directors' loans. Should a key person become critically ill or die, repaying debt may become an immediate issue.

Business loan protection differs from key person protection as the amount insured is typically in line with a specific loan repayment term.

Retention and staff benefits

Attracting and retaining quality employees is fundamental to a business. So it's important to offer a comprehensive employee benefits package.

Relevant life cover allows businesses to offer employees a death-in-service benefit and is available to small businesses where group life insurance schemes are not available or practicable.

This protection is only for employees who take a PAYE salary from the business. Any plan proceeds are paid for the ultimate benefit of the nominated dependants of the deceased. The business can benefit from corporation or income tax relief on the premiums paid by the employer. There are also tax advantages to the employee.

Executive benefits

Senior management remuneration typically encompasses pension contributions, dividends and commission. Where staff are unable to work due to illness or injury, they may not be able to meet their basic income needs.

Executive income protection is designed for owners and high-earning employees of SMEs. Any claim proceeds are paid to the employer, which then pays the insured person via PAYE. Cover can include employer pension contributions and national insurance contributions.

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The ins and outs of liability management transactions

In recent years, some distressed US borrowers have taken liability management transactions to increase their liquidity or extend their debt maturities. Now, these sorts of transactions – which are often intended to favour one class of creditors over others – are increasingly occurring in European jurisdictions, including the UK. Lewis Grimm of Jones Day explains what they are and why borrowers should be aware of them.

These liability management transactions – often referred to by the names of prominent companies which have done them, such as J.Crew, Chewy, Serta and Revlon – fall into three main categories:

- **Uptiering** – improving the payment priority or security ranking of all or part of a debt class relative to any other debt classes – for example, by converting unsecured into secured debt.
- **Drop-downs** – putting a business's 'crown jewel' assets out of reach of the secured creditors. This could be either to raise new debt or to provide additional collateral for existing debt (for example, in exchange for extending the debt's maturity). For example, a drop-down could be achieved by designating a subsidiary that owns material intellectual property as an unrestricted or excluded subsidiary.
- **Phantom debt** – incurring new debt that exists only temporarily in order to reach the required consent threshold to take actions under the terms of the debt documents.

These measures can be seen as an opportunity or a threat, depending on the interests of the party concerned. In the US, many lenders have tried – with varying degrees of success – to insert blocker provisions aimed at preventing these sorts of transactions from occurring.

So can these transactions occur in Europe? So far, there have been only a few prominent European transactions. They have included dropdowns from McLaren and Intralot and an uptiering from Cineworld. However, there are a few key differences in Europe relative to the US:

- **Legal fees** – many European jurisdictions require the losing party to pay the legal costs of the winner. This can be a strong disincentive against taking aggressive manoeuvres.
- **Director liability** – some European jurisdictions impose civil or even criminal liability for trading while insolvent. This could result in directors avoiding any actions they consider too risky.
- **Legal framework** – it is important to consider the legal principles that apply in the relevant jurisdiction to protect both borrowers and lenders (including minority lenders), both in and out of bankruptcy, since they often differ in material ways. For example, English law has 'anti-abuse' restrictions limiting the majority creditors' ability to exercise power to the detriment of the minority. This could make the majority creditors more reluctant to take aggressive actions that impair the interests of the minority.
- **Market implications** – both borrowers and private equity sponsors will want to consider whether their actions could impact their ability to borrow or enter into amendments or waivers in the future, especially if they need to engage with the same counterparties.

A borrower or lender which wants to engage in – or is concerned about – a liability management transaction will need to think carefully about the above points and their legal and business implications.

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The views and opinions set forth herein are the personal views or opinions of the author; they do not necessarily reflect views or opinions of the law firm with which he is associated.

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Arbuthnot Latham was founded in 1833. It has evolved and grown over the years and today offers private and commercial banking and wealth management designed around you. At Arbuthnot Latham, relationships are everything. It is through knowledge, understanding and trust that we can help you on your personal and professional journey.

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