Q1 2024

UK Private Company Director

Welcome to the April 2024 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 provides clear insights into the current activity in buying and selling UK companies, reflecting investor appetite for acquiring businesses.

In this issue, we address some of the issues of most concern to directors of privately-owned businesses:

- Despite the weak initial numbers for activity in the private M&A market, there are increasing signs pointing towards a resurgence in deal-making as we move further into the year (pages 2 to 3).
- We look at ways to help strike a balance between mitigating risk and maintaining crucial relationships between the buyer and any management sellers who remain with the company (page 4).
- Ceding control of a private business to the next generation can be complicated. Through careful, long-term succession planning, we explore how to ensure a seamless transition and secure your legacy (page 5).

All the best,

Megan Peel

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Corbett Keeling Corporate Finance

SG Kleinwort Hambros

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Spring forward?

Last quarter, we saw promising signs for an upturn in 2024. Yet these signs haven't shown up in the actual data for private market M&A deals. However, as Jim Keeling, a corporate finance advisor at Corbett Keeling, observes, the market is busy and participants' mood has turned noticeably upbeat, possibly heralding a more benign outlook.

Last year was disappointing overall for private M&A activity in the UK as the bounce-back from the post-pandemic surge finally faded. And as the latest figures show, this sluggish trend has continued into the first quarter of 2024.

But there's a curious contrast in the air. The mood among market participants has turned considerably more optimistic. How will this gap between mood and data resolve itself? We have several grounds for thinking that the survey results are showing the way, and activity will pick up as the year unfolds.

First, even with recent, slightly disappointing inflation figures, the Bank of England is still widely expected to start cutting interest rates later this year as inflation falls back to its 2% target. This would boost the economy and make funding more accessible for potential buyers in the market.

Second, both trade buyers and private equity firms are sitting on significant funds ready for acquisitions. Over recent months, we have seen plenty of evidence – including our survey – that they are now showing greater willingness to put those funds to use and are actively seeking deals.

Third, the government will almost certainly call a General Election this year, and it is likely to lose. A change of government might be seen as beneficial in some quarters, leading to a boost – at least in the short-term. Also, some business owners, fearing Capital Gains Tax rises if Labour wins, might consider selling now.

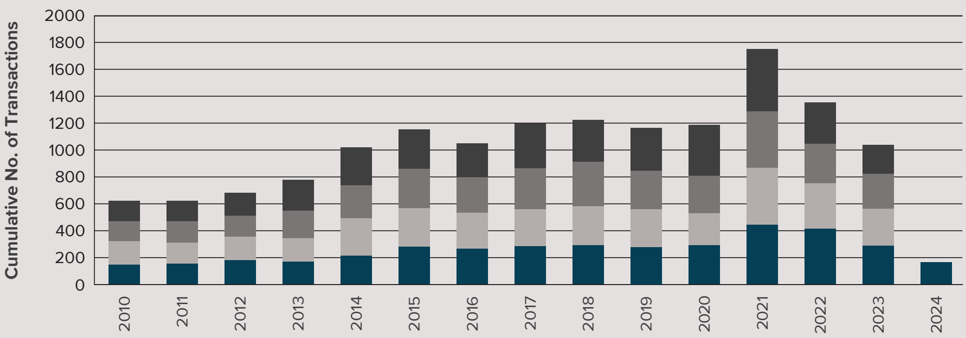
And let's not forget the big summer of sports ahead – with the Olympics in France and Euro 2024 in Germany to name but two. Is it too much to hope that success on the sports fields could translate into redoubled optimism in the world of business? It will certainly be beneficial for some sectors of the economy.

Because of all these factors, we expect the forward-looking surveys and market sentiments to soon outpace the lagging indicators of past deal data.

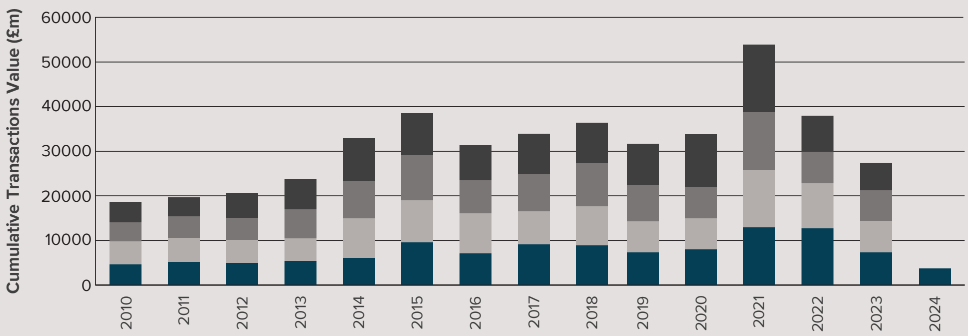
Assessing the deal data

Activity in the **smaller deals** sector (transactions with an enterprise value of less than £150 million) declined over the first three months of 2024, with the number of deals falling from 218 to 165. The value of transactions also decreased from £6.1 billion to £3.7 billion. On both measures, it was the worst start to a year since 2010.

Sub £150m Transactions by Volume



Sub £150m Transactions by Value



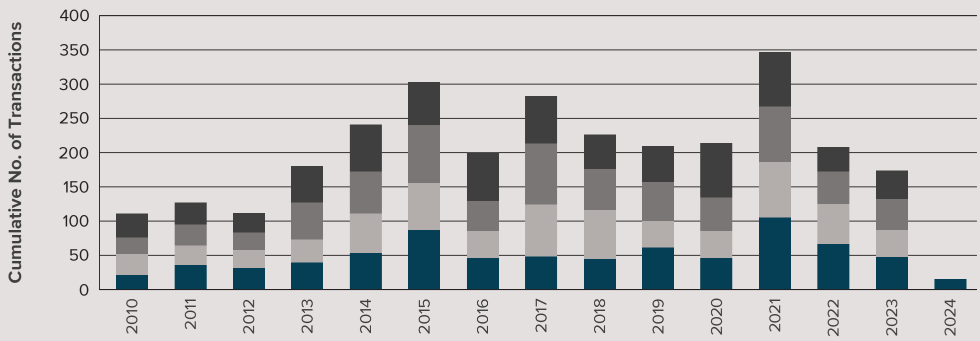
Key:

Q4 Q3 Q2 Q1

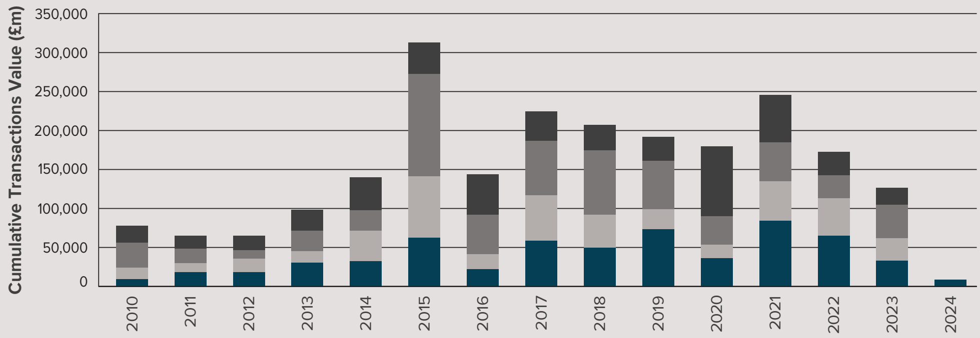
Data supplied by PitchBook.

It was a similar story in the **larger deals** sector (transactions with an enterprise value of £150 million or above). The number of transactions fell from 42 to 15, and their total value declined from £21.2 billion to £8.7 billion. That made it by some distance the weakest first three months of a year for this segment.

£150m+ Transactions by Volume



£150m+ Transactions by Value



Key:

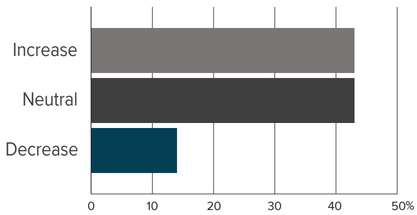
Q4 Q3 Q2 Q1

Data supplied by PitchBook.

So what does our latest survey suggest?

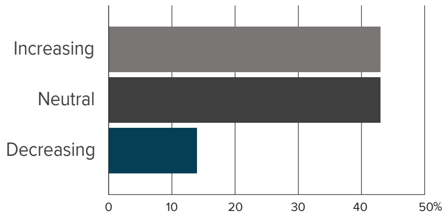
Last quarter, our survey of market participants indicated a possible turning of the tide, though from a previously low watermark. This quarter, the mood among market participants is categorically buoyant.

1 **Do you expect deal volumes to increase or decrease?**



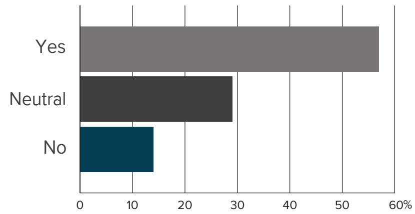
The percentage of respondents forecasting an increase in deal volumes over the coming months doubled to 43%, while those predicting a decline fell from one-third to 14%. The remainder expected little change either way.

2 **Is debt availability increasing, decreasing or neutral?**



There was also a decided change in the reported availability of debt. Last quarter, only 11% thought it was increasing, compared to 43% this time. The proportion reporting a decline also fell from 33% to 14%.

3 **With a reduction in inflation and interest rates expected to fall, do you think the overall M&A environment will improve in 2024?**



This shift is reflected in the overall outlook for the M&A environment this year, with just under half expecting an improvement and most of the rest (29%) predicting a fairly stable backdrop.

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Managing risk exposure in acquisitions

Buying an owner-managed business can give rise to particular challenges. However, with careful planning, those challenges can be addressed so as to respect the legacy of the management sellers while protecting the purchaser's interests. Leon Ferera and Mathis Bredimus of law firm Jones Day explain how parties can manage the delicate balance between mitigating risk and preserving the relationship between the purchaser and any management sellers who are to be retained in the target business after closing.

Catering for the seller profile

The acquisition of an owner-managed business can involve tricky questions of buy-side risk management, especially if individual sellers are to be retained after completion as part of the target company's management.

The buyer will normally require the sellers to provide warranties and indemnities in the purchase agreement. However, it may have a limited appetite, or ability, to enforce them.

This may be due to the need to maintain a good working relationship with the sellers (at least for a period after the sale) and benefit from their expertise and know-how, or because the sellers might not have the financial wherewithal to satisfy any claim.

There are various ways of addressing these issues, but each will require some planning and thought at an early stage of the transaction.

Deferred payment with set-off right

One way for a buyer to preserve its ability to enforce a warranty or indemnity claim is to withhold part of the purchase price, with a set-off right for the buyer in the event of a claim.

The purchase agreement will frequently provide that the buyer's set-off right arises only once the claim has been finally determined in its favour by a court.

Key areas for negotiation on deferred payments include the amount and duration of the retention and whether the funds are retained by the purchaser or held by a third party escrow agent, and the circumstances in which a party should have the right unilaterally to instruct the escrow agent to pay out funds.

Parties can agree to structure a deferred payment as an earn-out which requires the buyer to pay an additional amount after closing if performance targets are achieved or certain events occur. Among other benefits, this can further align the sellers' and buyers' interests for a period after closing.

However, both parties should bear in mind certain considerations, such as the complexity of drafting objective milestones for payment, the burden of monitoring post-closing performance, the potential for manipulation of metrics, and the possible impact of extrinsic factors.

For sellers, a deferred payment and set-off mechanism has the advantage that, if their liability under the purchase agreement is limited to the amount of the deferred payment, they know the full extent of their exposure.

Yet there is a drawback: even if no claims arise, sellers will experience a delay in receiving payment of the full purchase price.

W&I insurance

One option which has become commonplace is warranty and indemnity (W&I) insurance. This can provide recourse for a buyer without directly implicating the sellers, thereby helping to preserve – at least to some extent – their relationship after closing.

However, both parties will need to consider certain potential drawbacks. These include deductible and coverage exclusions or limitations (for matters which may include known problems, pension deficits, pollution, product liability, asset condition, sanctions and fraud).

Another potential disadvantage is the cost of obtaining W&I insurance, especially for smaller acquisitions.

Security over the sellers' assets

One further option would be for the buyer to take security over some of the sellers' assets (such as a bank account, real property or other investments) to secure any potential claims under the purchase agreement.

This approach is rare for several reasons. For one thing, any such arrangement will be legally complex. Also, sellers may understandably be reluctant to pledge their assets. Moreover, it may not help to preserve good relations between the buyer and any management sellers who are retained in the target business.

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Passing on the business gene

When you run a family business, planning your legacy will be a recurring theme along the entrepreneurial journey. Andrew Dixon, Head of Wealth Planning, at SG Kleinwort Hambros outlines how to prepare the next generation, when ceding control of the family business and the tax implications of transferring your assets.

A well-crafted succession plan can provide many benefits, principally ensuring a smooth transition of wealth to future generations. It should also help the next generation to make informed choices about the business and their possible place in it and should allow you to guide them forward in a spirit of stewardship.

But planning a successful business succession can take years, so it's never too soon to start thinking about the process.

Preparing the next generation

If you're a business founder or owner, at some point you will pass the control of your business to the next generation, possibly to your children. If so, the earlier you can start planning for that transition, the better.

A common approach is to have children work in different areas of the business to gain invaluable insights into its history and operations. Start when they're young, taking them to work and introducing them to the people who help run your company.

As they get older, children can play a more active role, first coming to events or helping you with minor management. Later, they can take on more responsibilities – for example, being included in leadership meetings. Once they develop an interest in a particular role or department, a formal internship can teach them about the business. Moving children through the different levels of the organisation gives them a chance to learn about the different areas of the business.

Tax implications

Succession planning can also address any legal and potential tax concerns before they become problematic.

Start with some key questions. Are you planning to give your business away, in whole or in part? Or will your children be buying it? If they are acquiring some or all of the shares of the business, will they need to secure financing?

If you're looking to pass on your business to your children, one way is to transfer share ownership to them. However, any such transfer may have Capital Gains Tax (CGT) or Inheritance Tax (IHT) consequences unless certain reliefs apply. Additionally, some business owners or entrepreneurs prefer a less direct method of gifting.

One way of managing this kind of transfer – as long as you and your business qualify for hold-over relief – is to consider putting the company shares into a Trust and hold over any capital gains at the point of transfer so they are not immediately payable. The Trust would have to pay tax on the gains when any eventual sale completes, but the original owner might not have to pay anything at all. Of course, nature of the business and timing are crucial as is the availability of business asset disposal relief (Entrepreneurs Relief), so it's important to get advice before taking any action.

However, please note that SG Kleinwort Hambros does not provide tax advice. The level of taxation depends on individual circumstances and the levels and bases of taxation can change. You should seek professional tax advice to understand any applicable tax consequences.

If you are passing on your business to your children, you can protect your spouse's financial position by making suitable investment, pension and life insurance arrangements.

In conclusion, roles and relationships within private businesses can be complex. Yet almost every founder will be passionately focused on the legacy they have created and being a steward for future generations. A good succession plan can help secure that legacy.

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Corbett Keeling guides owners of private companies on selling their business, raising capital and acquisitions. For 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 compared to initial expectations 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.

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Jones Day is a global law firm with more than 2,400 lawyers in 40 offices across five continents. The Firm is distinguished by: a singular tradition of client service; the mutual commitment to, and the seamless collaboration of, a true partnership; formidable legal talent across multiple disciplines and jurisdictions; and shared professional values that focus on client needs.

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SG 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.

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