Q3 2023

UK Private Company Director

Welcome to the October 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:

- We look at the latest private M&A data and confirm that potential sellers of sound businesses continue to get deals done at good prices (pages 2 to 3).
- As global supply chains come under increasing pressure, we explain why directors should not delay getting to grips with the legal risks (page 4).
- While a cautious approach to listed investments has not paid off so far this year, that doesn't mean it's time to switch to a more bullish outlook (page 5).

All the best,

Megan Peel

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Corbett Keeling Corporate Finance

Jones Day

RATHBONES

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Better than it looks?

As some statistics point to a weakening in the private M&A market, Jim Keeling of corporate finance advisor Corbett Keeling evaluates current conditions and offers reassurance to potential sellers that it remains realistic not just to get deals done but to complete them at good prices.

The humourist Bill Nye said that "Wagner's music is better than it sounds." As someone with a degree in physics, I learnt to trust data. And yet sometimes the initial conclusions one might draw from the statistics don't reflect either the detail that underlies them or our experience.

Last quarter, I noted a divergence between activity in the larger and the smaller deal segments of the market. This quarter, the volume of deals in the smaller segment has also weakened, slightly. In addition, our latest survey of market participants reveals a rather more sombre mood than before.

That shouldn't come as a total surprise, given the more difficult environment of higher inflation and interest rates. And the pace of activity during the post pandemic boom couldn't last for ever.

But, at the same time the year to date volume of deals in our market (sub £150m enterprise value) is broadly in line with recent "good" years, and any perceived "weakness" certainly doesn't reflect our experience on the ground, where things are as busy as ever. We are still talking to lots of businesses which are not just surviving but thriving. And we are also finding plenty of private equity investors and trade buyers who are very interested in those businesses.

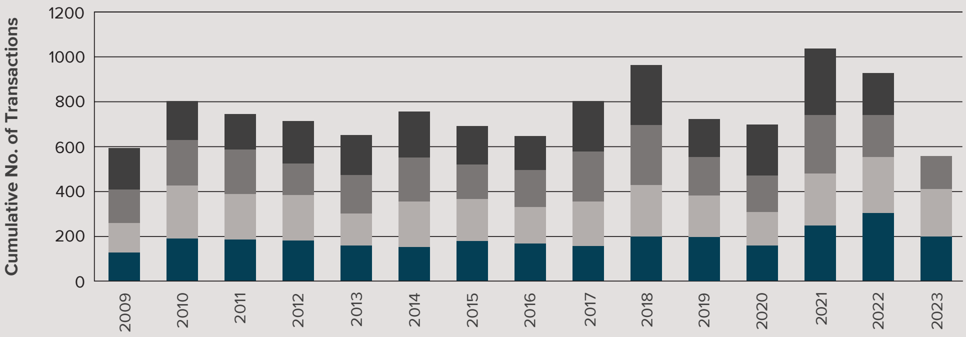
Of course, when it comes to selling a business, the timing is always crucial. Three different factors need to match up: the personal aspirations of the shareholders; what makes sense for the business itself; and finally the state of the M&A market in your sector.

The good news for anyone looking to sell a business at the moment? If the time is right both from your personal perspective and that of the business, I am pleased to say that the M&A market for sub £150m deals, remains absolutely strong enough to get you a good price.

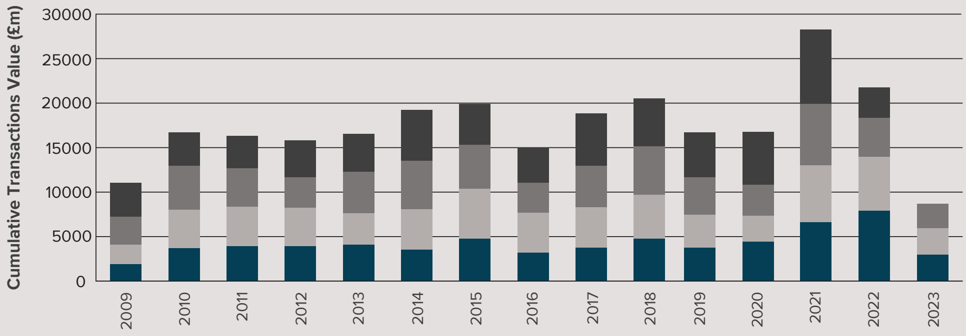
Assessing the deal data

Activity in the **smaller deals** sector (transactions with enterprise value of less than £150 million) declined over the quarter. The number of deals completed fell from 211 to 146. The decline in the aggregate value of transactions was less marked, down from £3.0 billion to £2.7 billion. But for the first nine months of the year, the volume of deals is around the pre-pandemic average.

Sub £150m Transactions by Volume



Sub £150m Transactions by Value



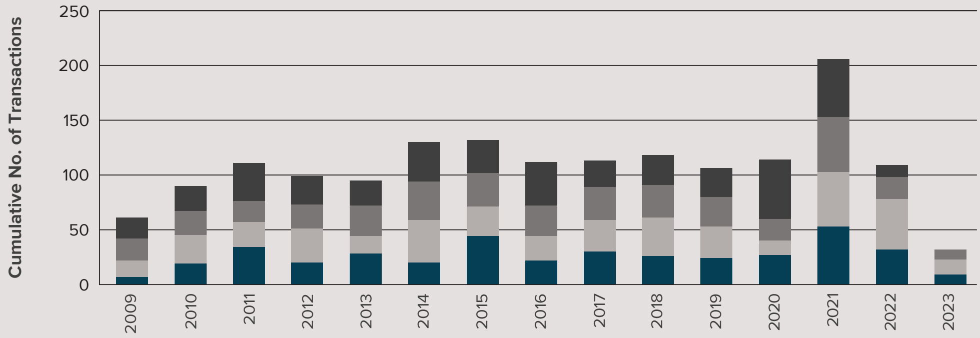
Key:

Q4 Q3 Q2 Q1

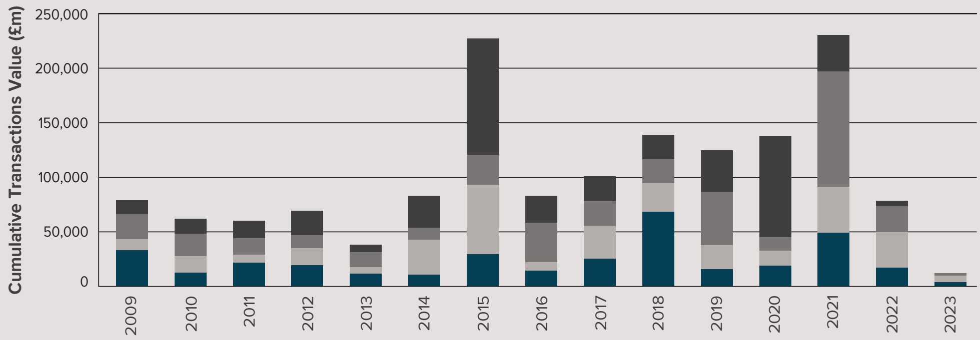
Data supplied by Thomson Reuters Eikon.

Tentative hopes that the **larger deals** sector (enterprise value of £150 million or above) might have turned the corner were dashed in the third quarter. The number of transactions fell from 14 to nine, and their total value was down from £5.8 billion to £2.3 billion, the lowest quarterly total since our data began. Barring a major turnaround in the final quarter, this sector is on course for a record bad year.

£150m+ Transactions by Volume



£150m+ Transactions by Value



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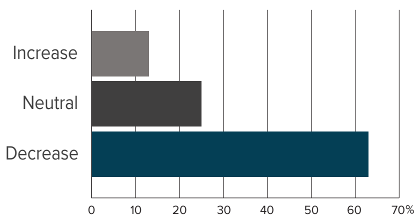
Q4 Q3 Q2 Q1

Data supplied by Thomson Reuters Eikon.

So what does our latest survey suggest?

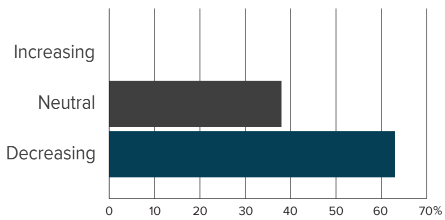
After picking up in last quarter's survey, sentiment among the market participants we've canvassed (across all deal sizes – larger and smaller) appears to have experienced something of a reversal.

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



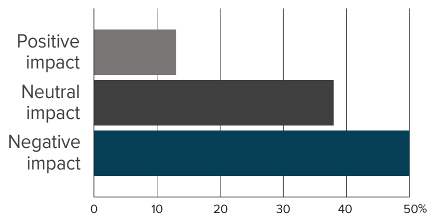
The proportion of respondents now predicting an increase in deal volumes over the next few months fell to 13%, down from a quarter. At the same time, the percentage forecasting fewer deals rose from 25% to 63%.

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



Concerns have grown about the availability of debt financing. Nearly two thirds of respondents said it was decreasing, up from 42% last time. Meanwhile, no one reported an increase in availability, compared with 17% the previous quarter.

3 **Has the current economic climate, including the rising cost of debt, had an impact on your portfolio companies overall?**



The current economic climate and the higher cost of debt are increasingly hurting portfolio companies, with the proportion of respondents reporting a negative impact rising since last quarter from a third to a half.

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Supply chains – the legal risks

Geopolitical changes are placing greater pressure on global supply chains, leading companies to reappraise their strategic contracts and consider contingency planning. This is a legal as well as an operational issue. Rhys Thomas of law firm Jones Day explains how a considered approach to supply chain risk can mitigate contract risk and should be seen as an essential element of effective board governance and compliance with directors' duties.

The unknown unknowns

Assessing supply chain risk in an uncertain world can be a daunting exercise. Significant geopolitical and other events can occur with little or no warning, making contingency planning difficult. Other events may be more predictable – such as price volatility and inflationary pressures, continued cost pressures from environmental, social and governance issues and the energy transition and a possible escalation in US-China tensions (more than 80% of the world's largest ships by tonnage pass through the Taiwan Strait).

The key is to identify the principal supply chains that are business critical. But it's also essential to understand which terms of any contract governing those supply chains might come into play if they are disrupted. These would include:

- The existence and extent of force majeure provisions
- Termination rights, whether for breach of contract or on giving a period of notice
- Price adjustment or indexation provisions that allow contract prices to be changed, particularly in back-to-back contract arrangements
- Provisions relating to the imposition of trade controls or international sanctions
- Provisions relating to access to or protection of key intellectual property

In addition to understanding the contractual terms in such a scenario, consideration should be given to how rights could be enforced in practice, even though enforcement might prove hard in some cases. For example, the war in Ukraine left many Western companies with little effective legal recourse in Russia, notwithstanding the terms of their contracts.

A good understanding of contractual – and commercial – terms can be used to map out the potential consequences of various scenarios. This is important because, while many businesses may not have the resources to undertake full disaster scenario planning, most companies will have a relatively small number of key relationships or contracts which are vital to business operations.

Directors' liability

Planning for supply chain disruption is increasingly seen as a requirement of effective board governance. Boards should consider recording the steps they have taken to assess the risk of supply chain failures, while being mindful that board records will not be legally privileged if a dispute arises.

For tax and operational reasons, groups often operate international business through regional subsidiaries. Particular care should be taken in these circumstances, especially where parents and subsidiaries have common directors. When wearing several hats, directors must exercise their fiduciary duties independently within each company, having regard to its individual circumstances and stakeholders. Where the different interests of group companies are not aligned, the board records should ideally reflect that. A lack of sufficient care and rigour in the exercise of directors' functions can give rise to collateral claims against controlling parties, undermining the limited liability of subsidiary corporate structures.

Something is better than nothing

While preparing for geopolitical events can seem overwhelming given the range of possibilities, early planning is important. Resources, and thus the degree of diligence expected from a company director, will vary from business to business. However, taking the first steps to map risk and plan for contingencies will both lessen any impact on the business and mitigate the risk for directors.

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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.

RATHBONES

The case for continued caution

A year ago, wealth manager Rathbones turned more cautious on markets, expecting a recession in the developed world over the following 12 months. Although that recession hasn't materialised yet, CIO Edward Smith explains why Rathbones maintains a cautious outlook.

With the benefit of hindsight, we underestimated the resilience of the global economy in 2023, and we could have advocated taking more risk. Yet global earnings have been falling since January, and equity markets have been largely driven by an improvement in sentiment. So where do we go from here?

To frame the way ahead, it's worth revisiting the checklist we have for turning more positive on the outlook for financial markets. In the past, new bull markets (sustained upward trends) have required at least two of these five conditions to be met:

1. **US rate increases peak** – This is the only one of our five conditions that has now probably been fulfilled, as the monthly gauge of services inflation that the US central bank focuses on has slowed to around pre-pandemic levels.
2. **Economic signals bottom out** – The peak impact of rising interest rates has typically been felt after nine to 18 months. US rates were still only 0.5% 18 months ago and 4% nine months ago, compared with 5.5% today. So forward-looking indicators of the economy have probably not yet reached their low point of this cycle. We've also had a major tightening of bank lending conditions after the bank failures earlier this year.
3. **Profit forecasts and economic outlook aligned** – Financial analysts still forecast strong earnings growth in 2024. Yet even mild recessions have typically been associated with double-digit declines in earnings. We expect downward revisions ahead.
4. **Historically cheap valuations** – This condition hasn't been fulfilled outside the UK. In the US, equity valuations are near the high end of their historical range. Investors aren't being paid for the extra risk of equities. The additional return from US equities compared with government bonds has declined to its lowest level since the dotcom era.
5. **Investors capitulate** – This is harder to measure than most of the other triggers, but investors certainly don't appear to have thrown in the towel. In fact, US retail investors' allocation to equities has increased recently and is far from low by past standards.

Some bright spots

While waiting for another one or two items on our list to be checked, we find plenty of bright spots to focus on. Our view on government bonds is more positive than at any point in the last decade. Yields on gilts are now higher than our estimates of their fair value, based on long-term trends in UK growth and inflation.

In Japan, the stock market has reached a 13-year high. It continues to be a beneficiary of improving corporate governance, and foreign investors have been flooding in (notably renowned investor Warren Buffet).

Where do we go from here?

Despite our caution, we don't think long-term investors should be selling their holdings and switching to cash, even with interest rates above 5%. Our analysis shows that, if you adopted such a strategy whenever interest rates peaked, you would normally have been better off staying invested in equities. Still, with plenty of reasons to remain wary, we're continuing to favour high-quality companies and areas of the market that should be more resilient in an economic downturn.

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Rathbones has been a provider of financial services since 1912, when the business was restructured to focus solely on wealth management. Today they are proud to operate out of 15 locations across the UK and Jersey, with £60.5bn of assets under management for their clients. Rathbones see it as their responsibility to invest for everyone's tomorrow. That means doing the right thing for their clients and for others too. Keeping the future in mind when we make decisions today.

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