Q4 2022

UK Private Company Director

Welcome to the January 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.

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

- Deal making remained subdued in the final quarter of 2022 after frantic activity in the first half and throughout 2021. But we are still finding plenty of cash-rich buyers looking for interesting businesses (pages 2 to 3).
- Earn-outs can be an attractive option in uncertain times, but they are complex. Sellers will need to pay very careful attention to the detail of the terms (page 4).
- Last year proved tricky for investors, as equities and bonds suffered and cryptocurrencies plummeted. Could real assets – such as property, commodities and infrastructure – provide an alternative source of returns (page 5)?

We wish you a happy, healthy and rewarding 2023!

Megan Peel

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Weathering the storm

The slower pace of deals in the third quarter of 2022 continued in the final three months of the year. Nevertheless, as Jim Keeling of corporate finance advisor Corbett Keeling notes, activity held steady in the smaller deals sector, and buyers remain poised to buy strong businesses.

Markets proverbially dislike uncertainty, and unfortunately there's plenty of it about at the moment. Last quarter, I wrote that we had already seen a lot of change both in the market environment and in the country at large.

That remains the case. Almost as soon as our last issue had been published, Liz Truss was replaced in Number 10 by Rishi Sunak, leaving us with not only a new monarch but also the second new prime minister in two months. The economic backdrop has also not been straightforward with GDP growth slowing in most major economies and inflation remaining high.

This year marks Corbett Keeling's thirtieth anniversary, and we have witnessed the market going through plenty of lean periods in that time; the market has never refused to rebound despite gloomy predictions and we have no reason to approach this period differently. Market participants will do what they always do: adapt and work hard to get deals done.

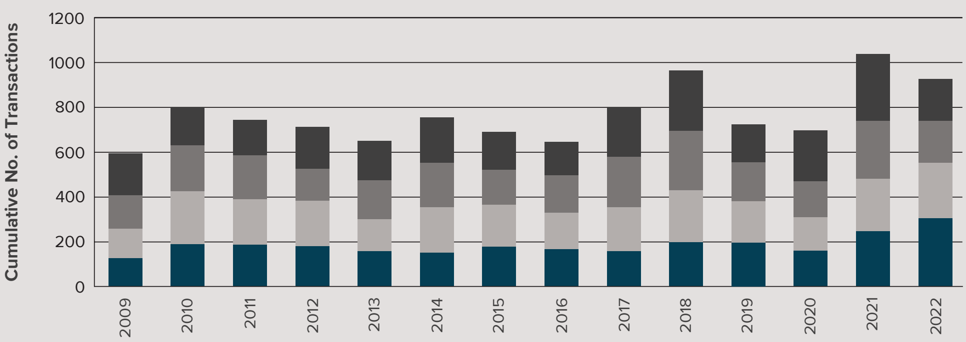
Moreover, even though the end of last year saw the pace of dealmaking slow in the larger segment of the market, volumes of transactions in the lower mid-market remained far more stable. This robustness helped to bring the total number of deals for 2022 in that segment to not far short of the record-breakingly busy 2021.

Directors who are looking to sell their company should not be discouraged. There are still plenty of market participants with cash to spend on the right opportunities. In particular, foreign buyers are being drawn in by what they see as attractive prices, given the continuing weakness in the pound.

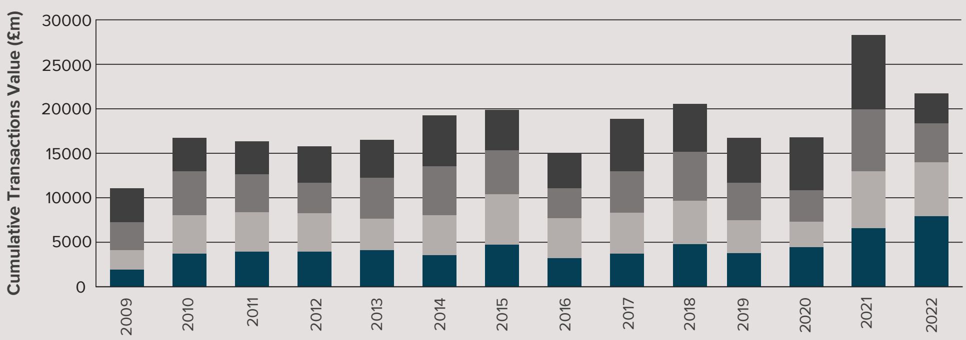
Assessing the deal data

Activity in the **smaller deals** sector (transactions with enterprise value of £150 million or less) held up well over the final quarter of 2022. The volume of deals exactly matched the previous quarter's 187, giving a total for the year which was not far below 2021's all-time high. The aggregate value of deals declined from £4.4 billion the previous quarter to £3.4 billion. Nevertheless, the value for the year as a whole was impressive, higher than any other recent years before 2021.

Sub £150m Transactions by Volume



Sub £150m Transactions by Value



Key:

Q4 Q3 Q2 Q1

Data supplied by Thomson Reuters Eikon.

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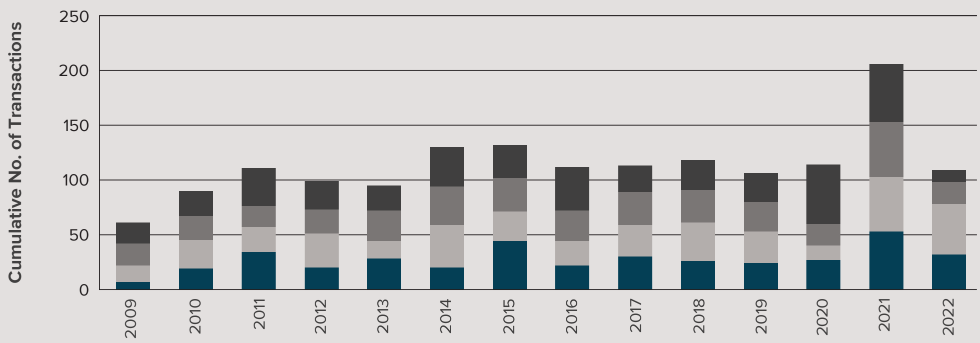
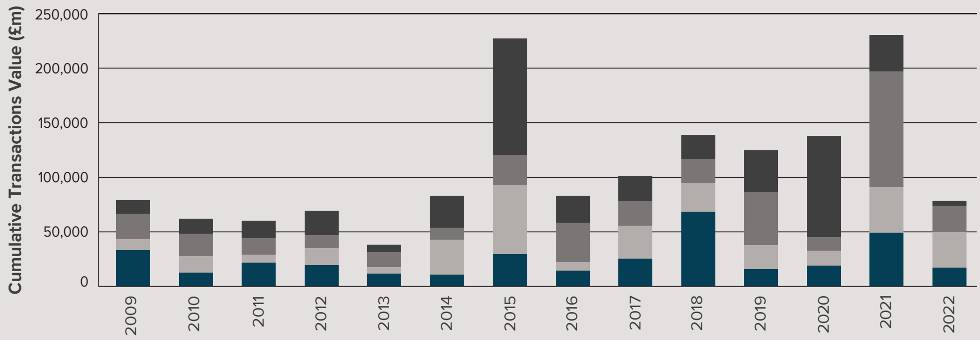
It was a more disappointing tale in the **larger deals** sector (enterprise value greater than £150 million). The number of transactions fell from 20 in the third quarter to 11 in the fourth, while their value plummeted from £24.3 billion to £4.4 billion, the lowest quarterly figure in our data series. For the year as a whole, both the volume and the value of deals were much lower than 2021's (admittedly record) levels.

£150m+ Transactions by Volume



£150m+ Transactions by Value



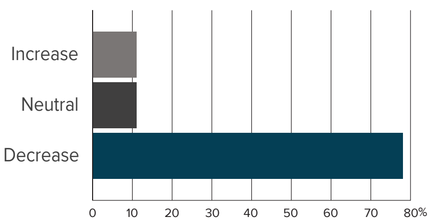
Key: Q4 Q3 Q2 Q1

Data supplied by Thomson Reuters Eikon.

So what does our latest survey suggest?

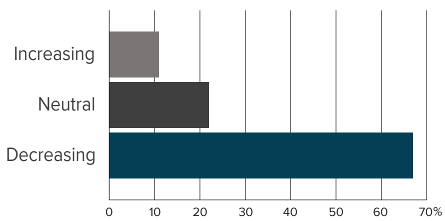
Against a backdrop of slowing growth, high inflation and more expensive debt funding, it's little surprise that the market participants who responded were more downbeat than normal.

1 Do you expect deal volumes to increase or decrease?



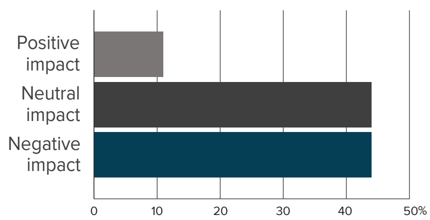
The number of respondents expecting deal volumes to increase over the next few months halved to 11%, while those forecasting a decrease rose from 56% to 78%.

2 Is debt availability increasing, decreasing or neutral?



Concerns about debt financing remained elevated, with two thirds of those surveyed still reporting decreasing availability.

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



Some 44% of respondents say the current economic climate is adversely affecting their portfolio companies, while only 11% report a positive impact. The remainder say they have seen little effect one way or the other.

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Bridging the valuation gap

Dealmakers faced significant challenges in 2022 as inflation and interest rates rose, economic growth weakened, energy prices soared, regulation was tightened and the M&A market corrected after frantic activity during the pandemic. Here, Dan Stafford and Alex Jobson of international law firm Sidley Austin outline some key issues to consider when structuring earn-outs in uncertain times.

As transaction activity weakened in the third quarter of 2022, the spotlight fell on valuations, particularly in the technology sector. Many buyers reassessed their M&A strategies, whether wishing to retain cash or concerned about the costs of raising acquisition finance as interest rates rose.

This year, however, we expect continued opportunities in certain sectors of the market. Likely buyers include private equity sponsors seeking to deploy their record amounts of dry powder, those executing buy and build strategies via bolt on acquisitions, and others looking for opportunistic, distressed investments.

Given the challenges already mentioned, buyers and sellers are more likely to disagree on the value of a target business. This problem is often addressed by deferred consideration mechanisms, where a portion of the purchase price is paid out in the years following completion. These mechanisms, such as earn-outs, can allow sellers to obtain the full value for what they consider a fundamentally robust business, though at the cost of a clean exit. Meanwhile, buyers can more accurately price targets, divest themselves of part of the risk of poor future performance and obtain the cash flow benefits from deferred consideration, particularly where an earn-out is funded using the target's retained profits.

However, earn-outs can be complex to negotiate and thus carry the risk of a future dispute. So, when structuring and negotiating earn-outs, sellers should carefully consider several factors:

- **Financial metrics** – Earn-outs are often based on the target business's future revenue or profits. Whichever metrics are used, the relevant provisions should be clear, objective and measurable, with input from both parties' financial advisors.

- **Earn-out period** – This is typically one to three years, with sellers usually pushing for shorter periods. The final length will depend on the relative bargaining power of the parties and the financial strength of the target.

- **Payment timing** – The frequency of any earn-out payments needs to be unambiguous, and the parties should agree on the means of payment (often based on tax considerations) and whether they are secured.

- **Earn-out protections** – The buyer will control the business after completion, so the seller will want to ensure that the buyer not only continues to run it largely as it was previously operated but also does nothing to reduce the value of any earn-out payments due. These terms will be heavily negotiated, as the buyer will want the flexibility to run the business in line with its own business plan.

- **Payment mechanics and dispute resolution** – The buyer and seller should consider the detailed mechanics for calculating the earn-out payments (often by reference to the target's annual audited accounts) and the means for resolving any dispute (usually by a suitably qualified firm of accountants).

Earn-outs can be an attractive way to structure a deal, particularly in uncertain market conditions. However, they are complex, and thinking the terms through carefully in advance – with help from professional legal and accounting advisors – can help to mitigate the risk of future disputes.

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Keeping it real

Last year proved challenging for investors as the inflationary aftermath of the pandemic and the war in Ukraine left them very few places to hide. Fahad Kamal, Chief Investment Officer, Kleinwort Hambros suggests real assets could be one attractive option for the year ahead.

In 2022, traditional balanced portfolios – consisting of 60% stocks and 40% bonds – suffered a disastrous double whammy. Equity markets were hit by lingering supply chain issues, shifting demand and tightening financial conditions, while bonds struggled with the reversal of the ultra loose monetary policy that had lasted more than a decade.

Among other assets, gold rallied during the initial stages of the war but then fell, given the increased attractions of interest-bearing assets. Meanwhile, cryptocurrencies plummeted, with many losing 50% or more of their value.

In an environment of rising inflation and declining markets, investors needed prudent positioning and maximum diversification. One possible solution: real assets, such as property, commodities and infrastructure.

Unlike most financial assets, their value is largely defined by their inherent physical worth. The most basic example is property: a building which generates a steady cash flow from the rent charged to its occupier.

These days, however, investors can take a much more nuanced approach to real assets. Within property, they can invest specifically in hospitals, schools, prisons, affordable housing or care homes. They can also take advantage of attractive opportunities in infrastructure, such as toll roads and bridges, trainlines, smart grids, waste-to-energy plants and digital infrastructure. Many of these assets derive their value from their intrinsic worth to society: they are fundamental to all aspects of modern life.

While the value of real assets is not decoupled from financial market movements, their risk profiles tend to be markedly different from those of other risk assets, such as equities. This gives them the diversification benefits investors desperately need when equities and bonds are falling in tandem.

Crucially, cash flows for real assets are often based on long-lasting contracts, and hence are less sensitive to short-term economic factors than equities. This dependability of cash flows also allows their managers to pay out a large proportion of revenues to investors with regularity once projects are up and running.

This greatly reduces swings in the capital value of the investment. For example, over the past three years (which includes the pandemic), the simulated volatility of a diversified portfolio of infrastructure and specialist property assets averaged 10.8% (measured by its annualised standard deviation of returns), well below the 18.5% for the MSCI All Country World Equity Index.*

Real assets can also provide an element of inflation protection. That is because contracts for the usage of real assets often include clauses that periodically adjust cash flows to account for inflation.

Naturally, investing in real assets comes with its own challenges, notably liquidity. Even the more liquid vehicles, such as open-ended REITS, traditionally employ gates to prevent large outflows at times of market distress when managers would not be able to liquidate holdings fast enough to meet redemptions.

However, during this time of uncertainty and slower global economic growth, we believe real assets are a valuable diversifying investment for the same reasons that we rely on them in real life. They are dependable pillars of society whose value is less affected by short-term economic issues.

*Bloomberg – September 2022.

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