

Q4 2020

UK Private Company Director

Welcome to the January 2021 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.

The current issue addresses some of the topics which we believe will be of interest to directors:

- Despite the COVID crisis and the prolonged uncertainty over the Brexit terms, deal volumes among privately owned companies held up well in 2020, with generally strong valuations achieved at sale (pages 2 to 4).
- A sale to a private equity fund will usually entail new incentive arrangements for managers. We examine the ins and outs of these arrangements, which can be complex (page 5).
- After a volatile year for financial markets, the advent of COVID-19 vaccines has brought renewed hope, and there appears to be a good case for taking more investment risk within portfolios (page 6).

We wish you a happy, healthy and prosperous 2021!



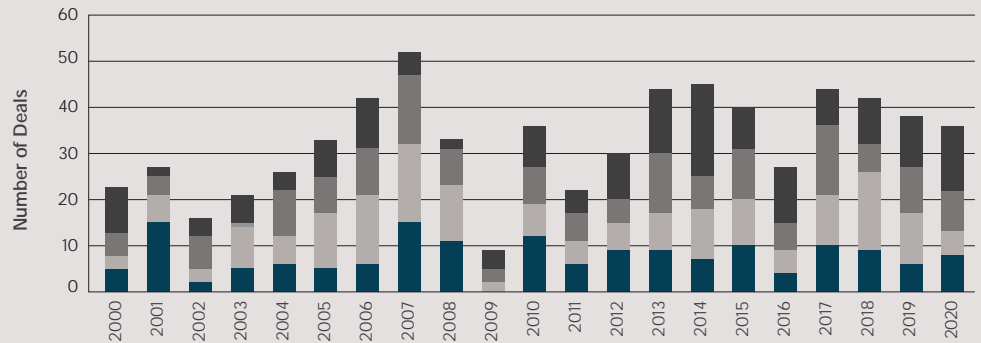
Megan Peel, Editor

meganpeel@ukprivatecompanydirector.com

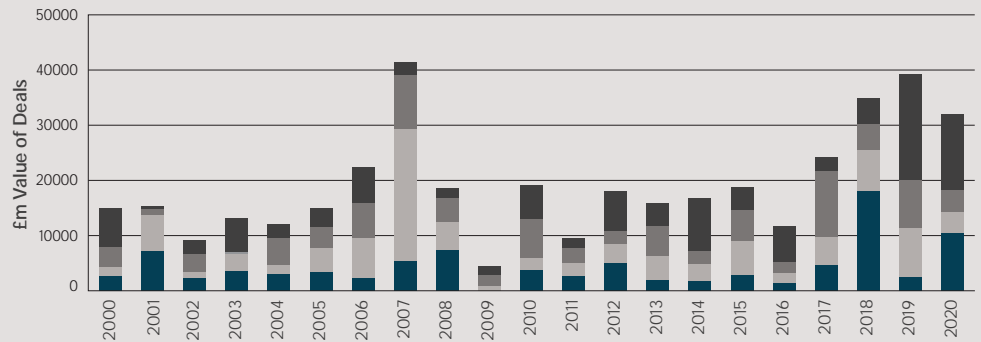
It was a similar story in the **larger buy-outs** sector (enterprise value of £150 million or above) with both the volume and the value of deals marking their strongest quarter of the year. The volume rose from nine to 14, the highest for two and a half years, and the value rose from just under £4 billion to £13.7 billion, the fourth highest quarterly total in our series. For the year as a whole, volumes were around average for the period since the global financial crisis, while values were very strong, if not matching 2019's record figure.

Key:
 ■ Q4
 ■ Q3
 ■ Q2
 ■ Q1

£150m+ Buyouts by Volume



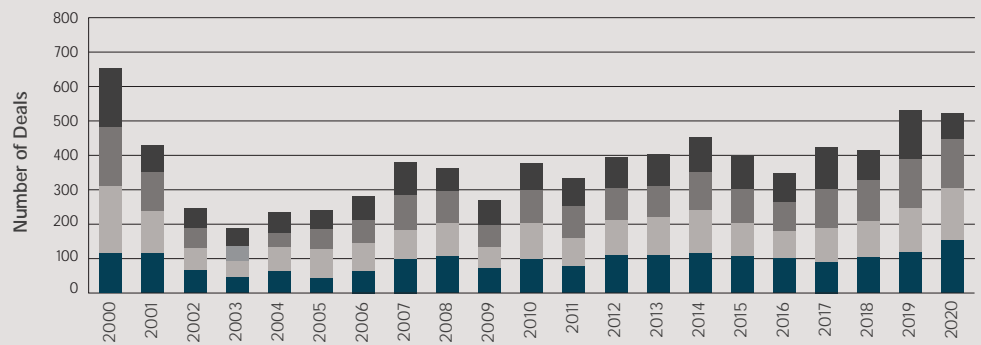
£150m+ Buyouts by Value



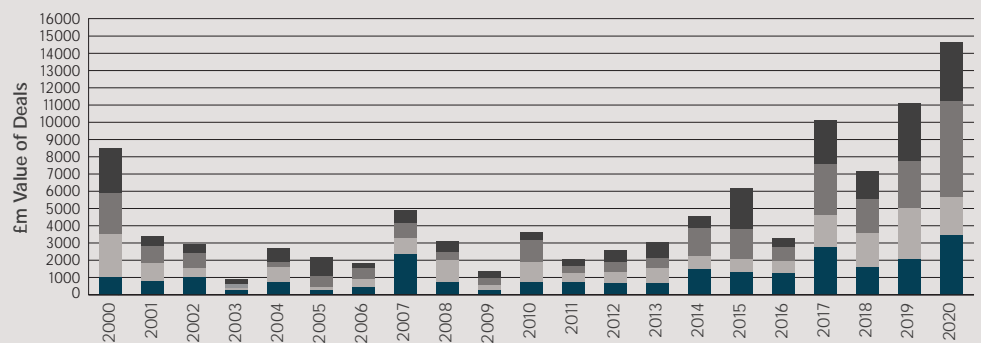
The quarterly picture was more mixed for **early-stage and expansion capital deals**. The number of transactions fell steeply from 140 to 77. However, the average value of these deals was strong, with the total holding up nicely at £3.4 billion. Although well down on the third quarter's £5.6 billion, that had been far the highest number since our series began, and the annual total easily beat last year's record figure.

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Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals

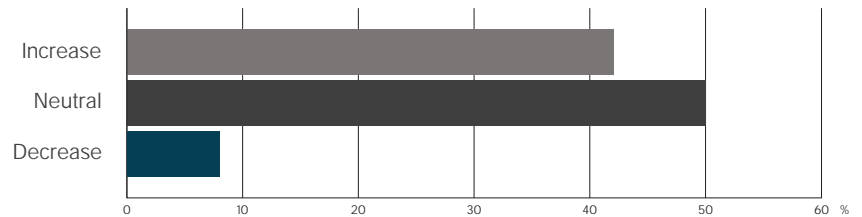


So what does our latest survey suggest?

As we enter the new year, with fresh COVID restrictions being introduced even as the economy seeks to recover from the worst recession in living memory, the market's mood was never going to be exactly sunny. However, I remain impressed by just how confident sentiment is, particularly with regard to future deal activity.

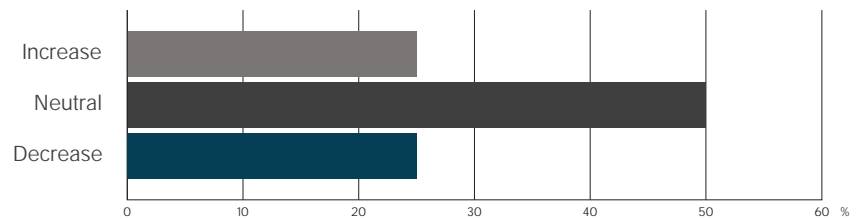
1 Do you expect deal volumes <£150m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months increased from 33% to 42%, with only 8% expecting a decline. The remainder are forecasting activity to stay around the current level.



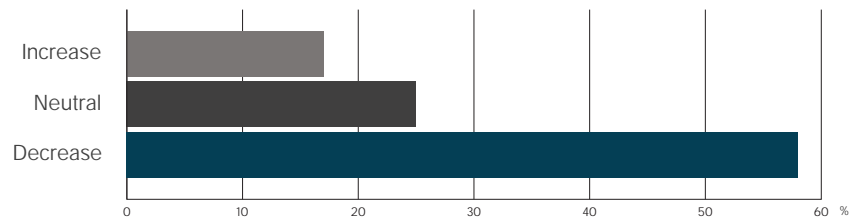
2 Do you expect deal volumes >£150m to increase or decrease?

For the larger value segment, sentiment is fairly evenly balanced. Half of the respondents expect little change in activity, while the rest are evenly split between the optimists and the pessimists.



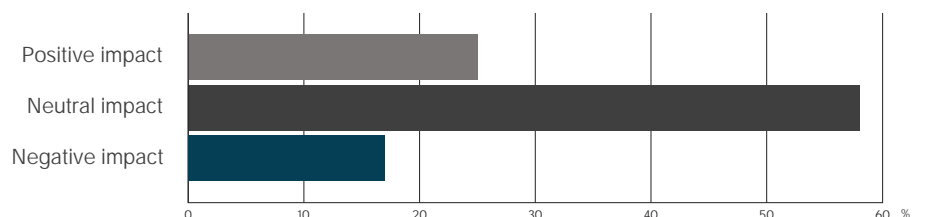
3 Is debt availability increasing, decreasing or neutral?

Last quarter, our survey flagged a growing concern about debt availability. That concern has persisted this quarter, as the proportion of respondents saying that debt is becoming less available rose from 33% to 58%, in stark contrast with the 0% figure at the start of the year.



4 On balance, how has the impact of COVID-19 affected your portfolio companies?

When asked how COVID-19 has affected portfolio companies, nearly 60% reported a neutral effect. Only 17% had observed a negative impact, while a quarter said the effect had actually been positive.



Contact us

Jim.Keeling@corbettkeeling.com

Aligning management incentives post-sale

For a sale to a private equity fund, an alignment of interests between the management team of the target company and the PE fund can be the key to future success. At the time of the acquisition, managers are often issued with equity to let them share in the value created by the subsequent growth of the company. Here, Alex Pritchard of Dechert LLP explains some of the incentive arrangements for PE-backed deals in the UK.

Sweet and strip

In the UK, managers are often issued with low-cost ordinary shares, sometimes called sweet equity. The sweet equity sits alongside the PE fund's interests, known as the institutional strip. This consists of a combination of equity and debt, usually a small amount of ordinary shares and a larger proportion of shareholder loans.

The sweet equity often contains some performance-related element and usually has little or no value when issued. Managers receive a meaningful return on their sweet equity only if the company performs well enough after the acquisition for the PE fund to achieve a certain return from its own investment on exit. In this way, the sweet equity works as an incentive for managers to drive the performance of the company, in line with the PE fund's expectations.

Roll-over

In a transaction where managers hold existing shares in the company, they may receive a substantial windfall as a result of the PE fund's investment. To ensure continued incentives for management in such circumstances, PE funds often require managers to roll over a substantial amount (which can be 40% to 60%) of this windfall by re-investing these proceeds in the company's shares.

This scale of re-investment puts managers on a more equal footing with the PE fund. Although the managers do not receive the full amount of their windfall on day 1, this re-investment creates further alignment of interests towards growing the company and creating more value. If the managers succeed in doing that, they will receive an enhanced upside later on when the PE fund ultimately sells the company.

Leaver provisions

If a manager ceases to be employed by the company, the usual default position is that the manager will not be allowed to retain their stake in the company.

Managers' equity will generally be subject to leaver provisions, which give the PE fund the right to repurchase these shares when a manager departs. The price the manager receives for the sweet equity depends upon the circumstances of their departure.

Although always open to negotiation, a manager will typically be a so-called good leaver if the reason for going is death, permanent incapacity or proven unfair dismissal. A good leaver is typically entitled to receive fair market value for the equity in these circumstances.

However, a manager is normally considered a bad leaver if the departure is for what the PE fund might consider a negative reason, such as resignation or summary dismissal. In such cases, the leaver may only receive the nominal value of their equity (which can be mere pennies per share).

Summary

Equity arrangements for managers are an important part of many sales of private companies to PE funds. These arrangements can be complex, so appropriate advice should be sought on them at the relevant time.



Contact us

Robert.Darwin@dechert.com

More positive – on balance

Financial markets had a seesaw 2020, with equities falling abruptly in spring before rallying strongly over the rest of the year as governments and central banks intervened to support businesses and households. Here, Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, assesses the outlook as we enter 2021 and outlines the implications for portfolio positioning.

Despite the market's optimism about the roll-out of COVID vaccine programmes, we are not out of the woods yet – a dark winter looms before vaccinations will begin to bear fruit. And investors find themselves facing stark contradictions in economic and market signals.

On one hand, we are in the tightest grip thus far of the coronavirus pandemic, with thousands of deaths each day and major economies in various states of lockdown. On the other, human ingenuity and modern technology have never shone brighter, with the fastest development of vaccines and the largest mass inoculations ever.

On one hand, last year's economic slump is being followed by a subdued recovery. Activity in manufacturing has improved markedly, but the more important services sector remains tepid. On the other, global markets – with equities at all-time highs and rates close to record lows – have chosen to look through the darkness and focus on the vaccine-led return to normality.

On one hand, populism remains rife, as the mob storming of the US Capitol in early January made clear. On the other, major geopolitical tensions seem to be on the wane – the Biden presidency should bring more predictable policies on trade, and the long-standing issue of Brexit is now in the rear-view mirror.

Given these contradictions, we believe it is especially critical to rely on the inputs we trust to guide us in matters of asset allocation.

The macro cycle – In the short term, much depends on the vagaries of virus-induced lockdowns. As the year progresses, the recovery should be less reliant on wide-ranging fiscal support and more driven by the post-vaccine return to normal for both businesses (hiring and capital expenditure) and households (consumption and travel).

Valuation – Here the picture is nuanced. Valuations for equities are expensive across most major regions, particularly the US. Even regions which had been cheaper – for example, the euro zone and the UK – have been re-rated since the vaccine

announcements. However, key interest rates are at historical lows, which would generally indicate higher valuations, and central banks across the world have been very clear about their intention to keep interest rates low for the foreseeable future.

Momentum – Risk assets remain in a powerful upward trend, which is positive.

Sentiment – Investors seem to be getting less risk-averse, judging by indicators such as the trade-weighted dollar, which fell precipitously over the fourth quarter. Indeed, there is some evidence of overexuberance – witness the huge recent increase in the value of bitcoin. However, bond yields remain close to historic lows, and investors are still seeking safe havens like gold.

On balance, we believe risk assets – particularly equities – remain attractive, supported by strong momentum and a recovering economy. Valuations are challenging but tolerable, given low interest rates and the extreme overvaluation in fixed income markets. As always, risks remain – sentiment is bubbly in certain assets, and we cannot rule out the emergence of vaccine-resistant coronavirus mutations. Nevertheless, we see strong grounds for taking increased risk in portfolios, though with plenty of safe-haven assets to mitigate any downside.



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

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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

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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

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