Q1 2019

UK Private Company Director

Welcome to the April 2019 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.

EOTs are becoming increasingly popular exit routes for shareholders looking to retire and so we work closely with RM2, employee ownership advisers, to provide this option for our clients. We have invited them to contribute to this quarter's edition.

This issue highlights:

- Private company deal making held up well in the first quarter, with an acceleration in the lower value segments of the market offsetting lower activity at the higher value end (pages 2 to 4).
- This could be a breakthrough year for Employee Ownership Trusts, which confer important tax benefits both to shareholders who are selling and to their employees (page 5).
- Geopolitical uncertainty, such as the current concerns over Brexit, tends to have little impact on long-term returns from stock markets, and UK equities currently appear to offer good value (page 6).
- A recent court case highlights some important considerations for any shareholders thinking about launching an unfair prejudice action against the management of the company (page 7).

We hope you enjoy this edition of UK Private Company Director. If you have any questions, please do not hesitate to get in touch.

Best wishes,

Megan Peel

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Corbett Keeling Corporate Finance

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Off to a solid start

As Brexit uncertainty continues, we are watching the data closely for any signs of an adverse impact on transactions for private companies in the UK. So far, however, as Jim Keeling of corporate finance advisor Corbett Keeling notes, there is little sign of a slowdown in activity. In fact, the smaller value segment enjoyed a robust first quarter.

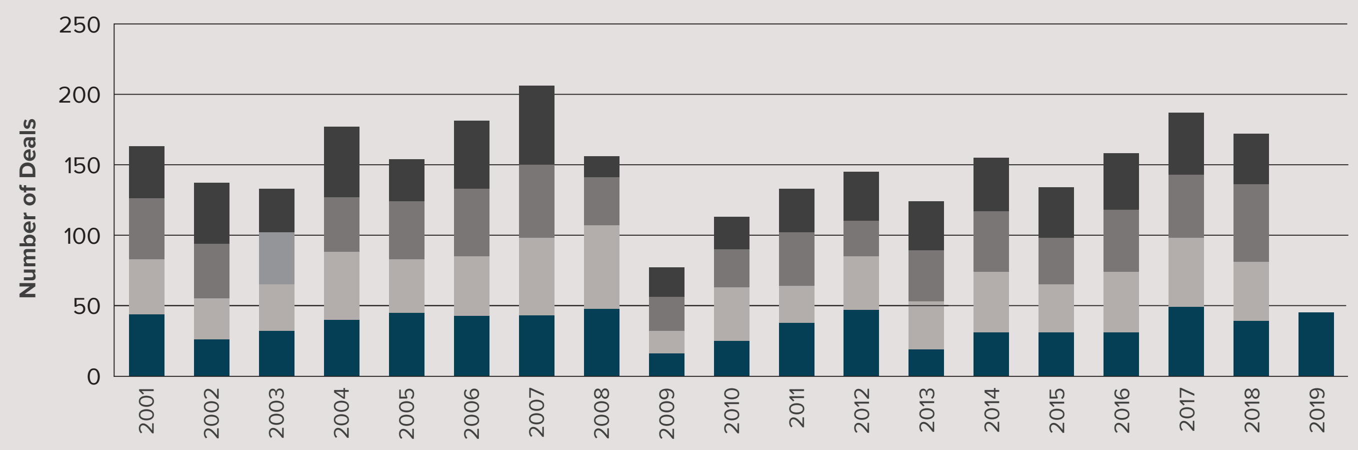
With the final figures in for 2018, it is clear that it was a very strong year for private company deal making. After the bumper vintage of 2017, it was the second best year for values since the global financial crisis. The question – as always – is whether that strong momentum can be continued in 2019. And the evidence of the first quarter as well as our market survey suggests that activity remains at solid levels, with the smaller value segment actually accelerating while the larger value segment, which tends to be volatile, weakened.

Of course, the Brexit story rumbles on, and we appear to be little clearer on the way forward than we were after the referendum in June 2016. But it is hard to know precisely what impact this is having on current activity levels. Certainly, the respondents to our market survey do not seem too concerned about the Brexit effect. And, if it is weighing on the market, then would it be fair to assume that any resolution of the Brexit conundrum could lead to a higher level of future activity?

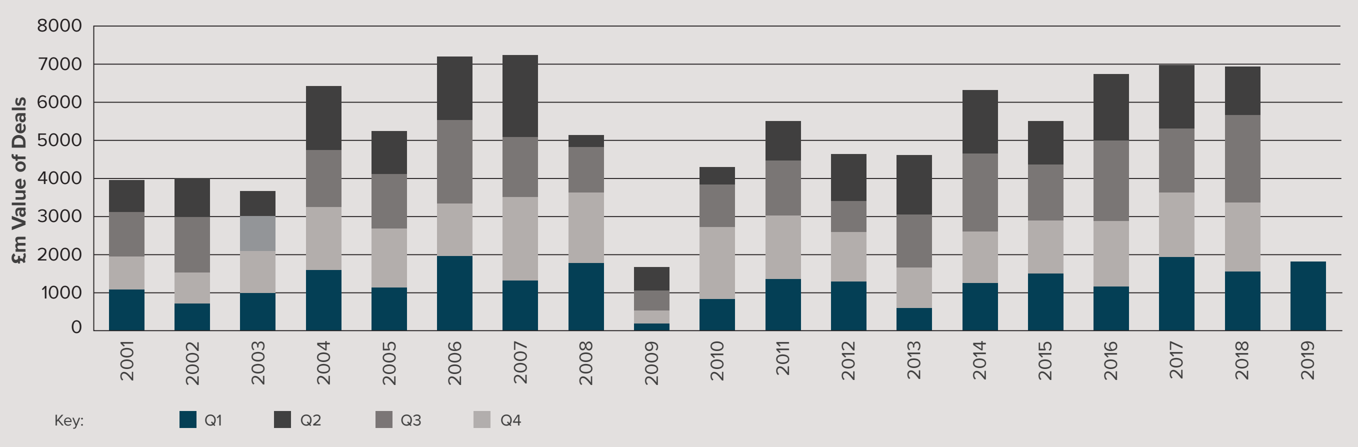
Assessing the deal data

Activity in the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) dipped slightly in the final quarter of 2018. But we are pleased to report that the pace and value of deals picked up again in the first three months of this year. The volume of deals rose from 37 to 45, while the value was up from £1.3 billion to £1.8 billion. That made it one of the strongest starts to any year since our data series began in 2000.

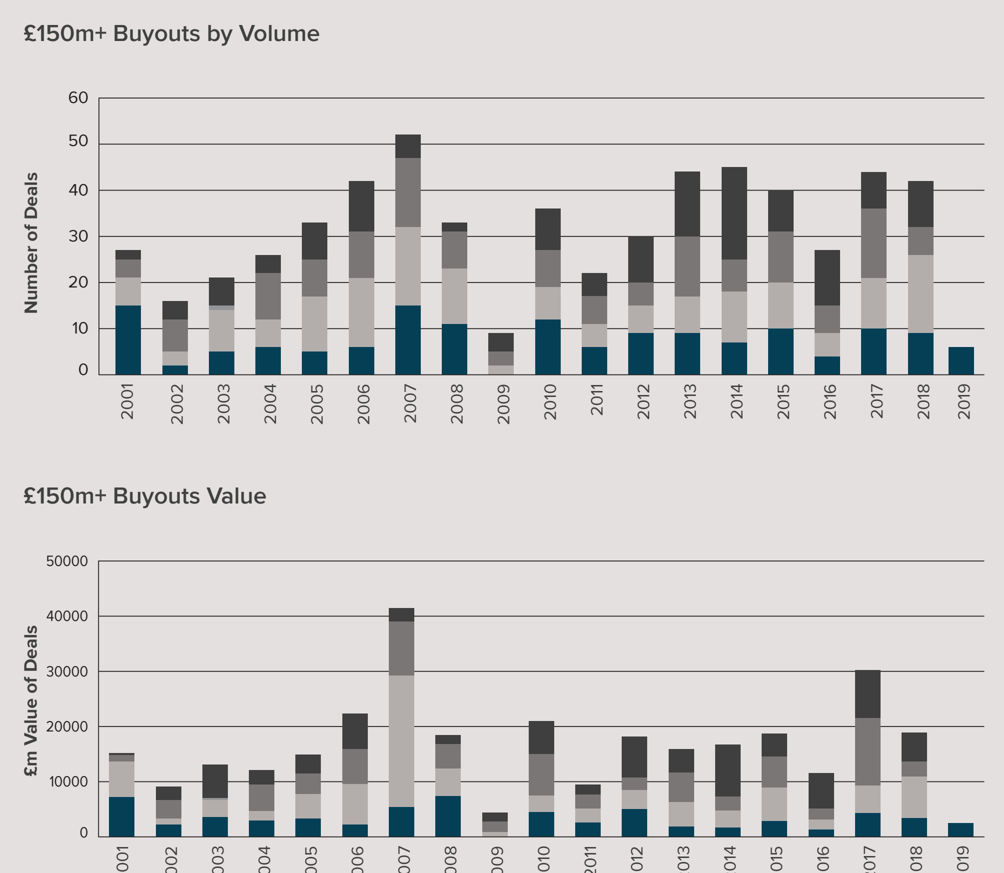
Sub-£150m Buyouts Volume



Sub-£150m Buyouts Value



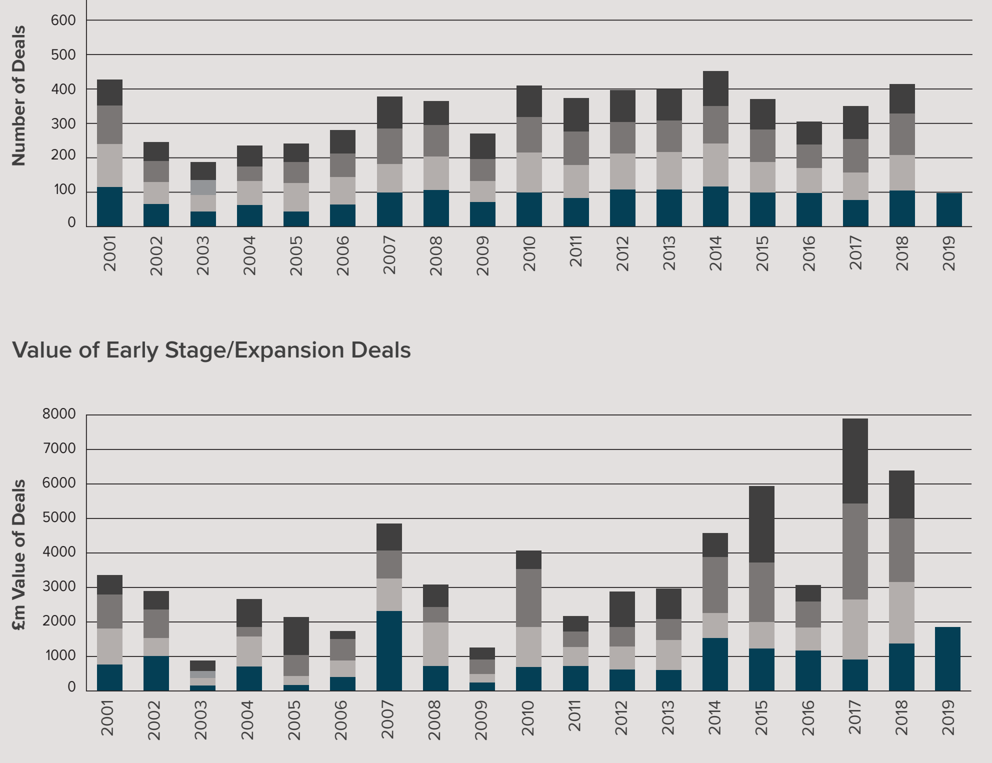
It was a different picture for the **larger buy-outs** sector (enterprise value of £150 million or above). The volume of deals fell from nine to six, while the value was down from £4.8 billion to £2.5 billion. Though well above recessionary levels, these were the lowest figures since the third quarter of 2016.



Key:

- Q1
- Q2
- Q3
- Q4

Early stage and expansion capital deals picked up a little momentum for the new year. The number of transactions could not quite match the heady pace of the first three quarters of 2018 but still registered a strong total of 97, up from 88 in the previous three months. The value of transactions also rose, from £1.5 billion to £1.9 billion, the highest figure since the last quarter of 2017.



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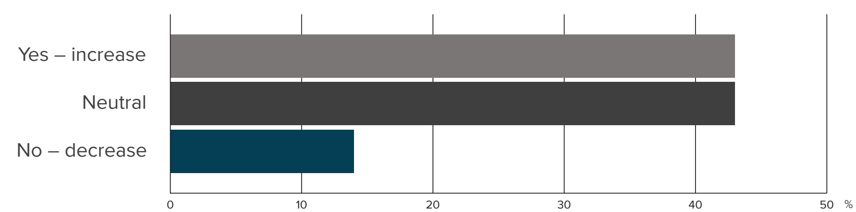
So what does our latest survey suggest?

In the last quarter, debt remained freely available and cheap, so it was little wonder that all equity buy-outs remain in the doldrums. Only two such deals were recorded in the last three months, which was a little bit below the already weak trend rate.

To see if we should have any reasons to be fearful for the rest of 2019, we turn to the latest evidence from our survey of market participants. Despite the continued uncertainty over Brexit and the signs of an economic slowdown on the Continent, their responses suggest that sentiment remains broadly sanguine.

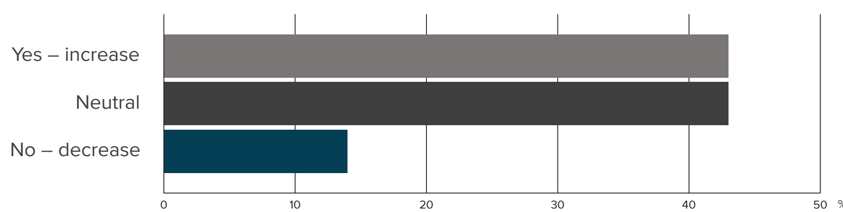
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the vast majority of respondents expected activity to increase or remain at current levels. Only 14% expected a fall over the next six months.



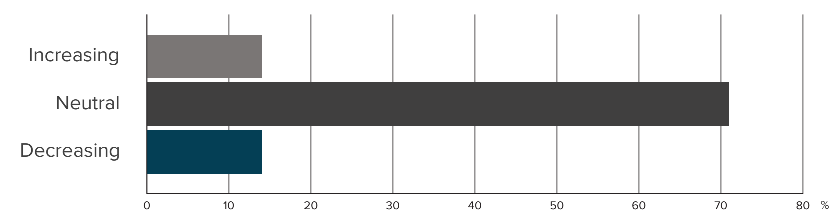
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment of the market, the vast majority of respondents expected activity to increase or remain at current levels. Only 14% expected a fall over the next six months.



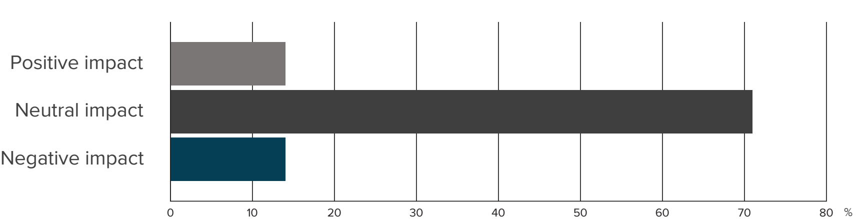
3 Is debt availability increasing, decreasing or neutral?

As we noted above, debt is still plentiful and cheap. However, the outlook may perhaps be becoming more balanced, with equal percentages forecasting an increase and a decrease in debt availability, while the vast majority predicts that the supply and cost of debt will remain broadly at current levels.



4 Has uncertainty over the Brexit negotiations affected investment decisions?

The media have talked about little else but Brexit over the past three months, and you'd be forgiven for assuming that the entire economy was going to hell in a hand-basket. Fortunately, those in the market appear to be getting on with business. Just over 70% of respondents said that the Brexit negotiations had not affected their investment decisions. The remainder were evenly split between positive and negative responses.



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Selling tax free to an Employee Ownership Trust

As some well known companies embrace the Employee Ownership Trust (EOT) as an exit route for founders, 2019 looks set to be a breakthrough year for this elegant structure. Richard Cowley, director of employee ownership advisers RM2, explains how it all works.

In 2014 a little-noticed tax relief was passed into law. It was inspired by the US Employee Share Ownership Plan, which for forty years has been a popular exit route for shareholders in private companies on the other side of the Atlantic. The UK version offered similar tax incentives to selling shareholders – provided they sell a controlling interest in their business to an Employee Ownership Trust, vendors can claim full exemption from Capital Gains Tax (CGT) – and to employees, who can receive bonuses of up to £3,600 per annum free of Income Tax.

The EOT has struck a chord with company owners who can't or don't want to arrange a trade sale. For example, trade buyers might be deterred if the company has a dependency on a key contract or key personnel or relies on unprotected intellectual property. And, even if a company can be sold, many founders would prefer to sell their business to the loyal employees who helped to build it.

Aardman Animations, the creators of Wallace and Gromit, falls into this category. Over the years, it spurned numerous offers from Hollywood studios before eventually agreeing a 75% sale last year to an EOT, driven strongly by the founders' desire to secure the company's future in Bristol.

Banks like lending to EOTs because founders still have a financial exposure to the company in the form of subordinated debt (representing the balance of the agreed purchase price that the EOT has not paid up front) and usually stage their withdrawal over several years. All of which makes the transaction less risky from the bank's viewpoint.

Employee Ownership Trusts in brief

- EOTs allow owners to sell a controlling stake in their businesses to a trust where all employees are the beneficiaries and the transaction can be completed without a CGT liability.
- Introduced in the Finance Act 2014, EOTs can be established by any trading company, with no restrictions on the type of trade.
- The EOT is controlled by trustees appointed by the vendors.
- The trustees and the vendors agree a "fair market value" for the company.
- Shareholders selling more than 50% to an EOT qualify for full CGT relief, provided the EOT remains a controlling shareholder for at least one full tax year.
- EOTs pay for the shares using surplus cash on the company's balance sheet (which might otherwise have to be paid out as a taxable dividend), borrowings and future profits.
- Employees of a company that is EOT-controlled qualify for Income Tax free bonuses up to £3,600 per annum.
- Key employees can be offered shares alongside the EOT up to 49%, creating the classic MBO incentive structure.
- HMRC clearance is available.

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Brexhausted

After almost three years of wearying Parliamentary debate, many investors are nervous about the outcome of Brexit. Here, Mouhammed Choukeir, Chief Investment Officer of Kleinwort Hambros, argues that even lasting political transformations have rarely had an adverse impact on long-term returns from equity markets.

At the time of writing, we still don't know what form – if any – Brexit will take. Despite this uncertainty, the FTSE 100 Index has delivered a total return (including dividends) of 9.5% since the referendum (as at the end of March). Some argue that the many multi-nationals in the index obtain much of their earnings from overseas, and they have been boosted by the weaker pound. Yet the FTSE 250 – whose earnings are more tied to the domestic UK economy – is up an almost identical 9.8% over the same period.

Short-term geopolitics

At times of stress, it's tempting to be cautious in your asset positioning. But financial history teaches us that geopolitics rarely has a lasting adverse impact on returns from equity markets.

In October 1962, the Cuban missile crisis brought the world to the brink of nuclear Armageddon. Yet an investor in the US S&P 500 Index would have been up 7% in the following month and 34% a year later. More recently, the Russian annexation of the Ukraine, the Brexit vote and the election of Donald Trump were all followed by strong rallies: the S&P rose 17.3%, 15.0% and 14.8% respectively in the following 12 months.

Long-term transformation

But what about the impact of enduring geopolitical changes? Again, context is crucial. While Brexit poses new questions for the UK, so did World War II, the loss of the British Empire, and the dizzying social, demographic and technological changes over the last 100 years. None of them caused UK equities to lose their long-run return potential.

Since the turn of the last century, UK equities have returned 6.7% per year on average after inflation. Of course, equity markets tend to be volatile and can lose value dramatically – UK equities were down 57% in 1974, its worst year ever. Yet, over any period of ten years, they generally outperform cash and bonds comfortably. In fact, ten-year forward returns from equities have been negative in only three periods.

The first was from 1905 to 1913. The investment losses were largely due to high inflation – between 1915 and 1920, the inflation rate averaged 17%* – and the post-war economic collapse from 1919 to 1921.

The second period was in the late 1960s and early 1970s. This was another period of high inflation as oil prices rocketed after the Arab oil embargo and, perhaps more significantly, the collapse of the Bretton Woods gold-backed system of exchange rates.

The third lasted just two years, 1998 and 1999. In the dot-com era, new companies promised to change the world by harnessing the power of the internet, tempting many investors to pay mind-bending valuations for potential that remained largely unfulfilled.

Conclusion

The evidence suggests that, for equity investors, geopolitics should be less of a concern than double-digit inflation or excessive valuation. Currently, neither is a significant worry for the UK. Inflation is at its lowest in two years (1.9%) and seems unlikely to rise significantly, given feeble demographics, frail productivity and the tools at policymakers' disposal. Meanwhile, valuations for UK equities appear cheap, with the FTSE 100 offering a dividend yield near 5%. We therefore continue to favour equities over cash and bonds.

*Kleinwort Hambros, Barclays Equity Gilt Study 2018. Data as at 31/12/2018.

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Unfair prejudice: Lessons for directors and shareholders

When aggrieved with the management of a company, shareholders may consider seeking redress through an unfair prejudice petition if they can show that the conduct in question relates to the company's affairs, prejudices their interests as a shareholder and is unfair. Joshua Smith of law firm Dechert LLP looks at a recent case which has some important takeaways for anyone considering an unfair prejudice action.

The recent case of **Waldron and others*** concerned a family business in the construction and civil engineering industry and a fall-out between the four siblings who had inherited the business from their parents. The court considered whether the behaviour of the first sibling, the majority shareholder and managing director (MD), was prejudicial to the other shareholders, particularly the three other siblings, of whom one was a director and another the company secretary. There was one further corporate shareholder, called SIG.

In 2014, the MD incorporated a new entity (of which he was the sole shareholder) to acquire the assets of a group of companies that had gone into administration. The other siblings alleged that the MD acted in breach of his fiduciary duties by hiring the assets and leasing some real estate to the company at what they considered excessive rates. In their view, this was a means of extracting value (even though the arrangements also appeared to benefit the family company).

When the MD subsequently approached SIG to acquire its shares in the family business, the relationship between the siblings became particularly fraught. As the conflict unfolded, the MD restricted the other siblings' access to company email and, when the other siblings offered cash to the company's IT consultant to restore their access, the MD dismissed them. The aggrieved siblings eventually brought an action for unfair prejudice.

The MD had pushed through the asset acquisition and set up the rental arrangements without properly consulting and obtaining approval from the company and its board. Not surprisingly, the court confirmed that, where directors put themselves in a position of conflict without the company's permission, this breach of duty will often amount to unfair prejudice. Crucially, though, the siblings had discovered the arrangements in question shortly after they had been put in place but had not taken any action until they were dismissed. The court ruled that, by acquiescing in the conduct for over two years, they had lost their remedy.

Food for thought

Whilst directors should always be mindful of potential conflicts of interest and how the running of the company's business may impact its shareholders, this case underlines that shareholders must act without delay if they think they have been unfairly prejudiced.

What about the siblings' dismissals? Interestingly, the court held that the restriction by the MD of the other siblings' email access did not constitute unfair prejudice. Although directors are generally entitled to access information about a company's affairs, the right is not automatic and unrestricted and will depend on the particular situation and justifications. The dismissals themselves were also not deemed unfairly prejudicial. The siblings' attempts to pay the company's IT consultant for access constituted "manifestly improper conduct" which, the court also found, the siblings had sought to cover up with false evidence. An action for unfair prejudice will likely be undermined if a petitioning shareholder's integrity is called into question in this way.

*Waldron & Others v Waldron & Another [2019] EWHC 115 (Ch).

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