Q2 2018

UK Private Company Director

The newsletter for directors of owner-managed, family and private equity backed businesses

Corbett Keeling Corporate Finance

Hogan Lovells

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Dear Reader

Welcome to the August 2018 issue of UK Private Company Director, the quarterly newsletter for directors of owner-managed, family and private equity backed businesses. UK Private Company Director covers financial, legal, tax, wealth management and similar issues that are crucial to both building and realising the value of your business. It also incorporates Corbett Keeling's report on deal activity in the private equity markets – a clear indicator of financial investor appetite for privately owned businesses.

Commentators always love a reason to be nervous. And, with Donald Trump in the White House, headline writers are never short of ammunition. Their latest target is the US's unilateral action on Iran. Over here, as the Article 50 deadline nears, the EU-philes are focused on what could go wrong with Brexit. And, of more immediate concern to our readership, the Financial Times recently noted a steep drop in deals where private equity houses sold businesses.

As always, there is another side to the coin. For example, whatever you may think of Trump personally, his approach has shaken up the diplomatic consensus, forcing people to consider a fresh perspective on many of the world's abiding geopolitical problems. And investors have taken it all in their stride, with most stock markets close to historic highs. In our own sector, the data suggests – and our own experience confirms – that overall deal making activity remains strong, supported by a wider boom in global M&A. For us, the absence of any evidence of over-optimism is a positive sign that market sentiment has not become divorced from reality, suggesting that the current benign conditions for sellers of businesses are likely to persist for some time yet.

In this issue, we examine some of the topics which are currently front of mind for directors of privately held companies.

- While the market's mood seems only moderately positive, **the pace of deal making activity picked up once more in the second quarter, leading to the strongest first six months of any year since 2008** (pages 2 to 5).
- For sellers of businesses, **an early, pro-active approach to legal due diligence can help to avoid nasty surprises later on and thus keep a transaction on track.** We look at some of the potential pitfalls with sale and purchase agreements (pages 6 to 7).
- According to theory, **the recent behaviour of US government bond yields may be signalling a coming recession.** While acknowledging the risks, we find that the theory doesn't always work in practice and in any case is an unreliable predictor of stock market returns (pages 8 to 9).

Best wishes

Megan Peel

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A second wind

The second half of 2017 produced the strongest six months for deal making activity since the global financial crisis, and it was always going to be hard to sustain that momentum. However, after a brief pause for breath in this year's first quarter, the market re-accelerated between April and June. Jim Keeling of corporate finance advisor Corbett Keeling examines the data and explains why conditions remain favourable for potential sellers – for now, at least.

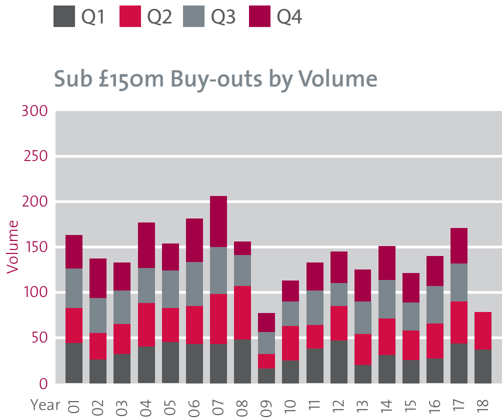
In April's issue of this newsletter, we warned that, while deal making activity remained robust, the market backdrop wouldn't always be similarly benign. Quite apart from all the headlines about the perils of Brexit and possible Trump trade wars, rising inflation had brought the risk of rising interest rates from the Bank of England, as well as actual rate increases from the US Federal Reserve. The end of the economic cycle was drawing nearer, and the threat loomed of a new, less business-friendly government in the UK at some point.

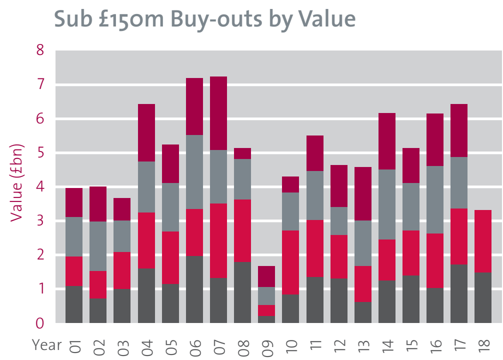
In terms of values, the market recorded its strongest first six months of the year since 2008

None of those concerns have gone away. But it seems as if the market has either shrugged them off or collectively decided to make the most of things. Certainly, the transaction numbers for the second quarter of the year showed a marked pick-up in activity from the previous three months. In fact, in terms of values, the market recorded its strongest first six months of the year since 2008.

Let's look at the deal data for the different segments of the market.

- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) had a solid three months. The volume of deals rose to 41, up from 37 in the first quarter, while the value rose from £1.5 billion to over £1.8 billion. In fact, the value of transactions in the first half of the year matched the total for the same period last year, which was the highest since 2008.

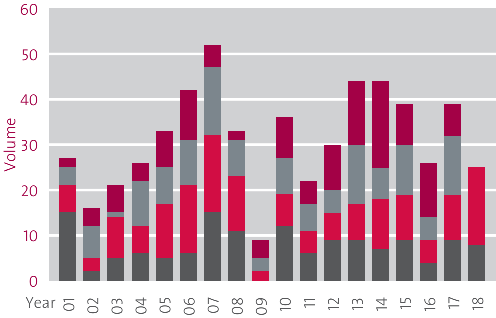




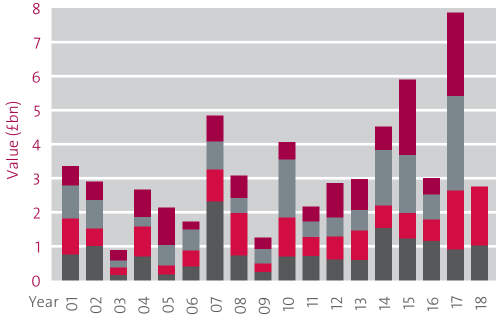
The larger buy-outs sector deals rose from 8 in the first quarter to 17, the highest for nearly four years, and their value soared from £3.0 to £7.5 billion

- Activity increased sharply in the **larger buy-outs** sector (enterprise value of £150 million or above). The volume of deals rose from 8 in the first quarter to 17, the highest for nearly four years, and their value soared from £3.0 billion to £7.5 billion. While that was not quite up to the heady pace in the last two quarters of 2017, it still added up to comfortably the strongest first half of the year since 2008.

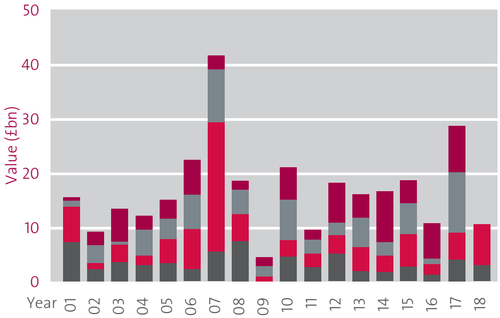
£150m+ Buy-outs by Volume



Early-Stage/Expansion Deals by Value

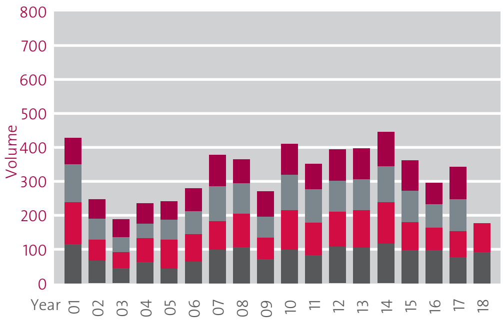


£150m+ Buy-outs by Value



Early stage and expansion capital deals climbed to £1.7 billion. The total value for the first six months of 2018 was the second-highest level for 11 years

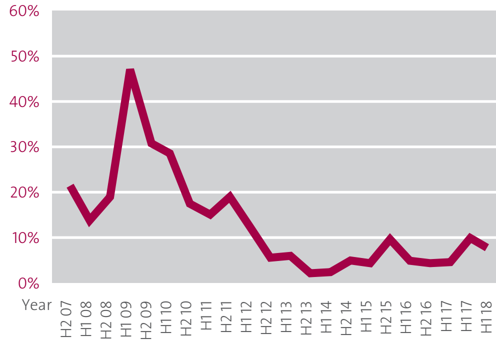
Early-Stage/Expansion Deals by Volume



- **Early stage and expansion capital deals** joined in the general re-acceleration. While the volume of deals so far reported was slightly down on the first quarter (84, versus 92), the value climbed substantially to £1.7 billion, from £1.0 billion. That took the total value for the first six months of 2018 to the second-highest level for 11 years.

All equity buy-outs remain a comparative rarity in the current market. Only five were recorded in the second quarter, representing less than 9% of buy-outs.

All Equity Funded Buy-outs to All Buy-outs



We are by nature optimists, but even we were a little surprised by the strength of the transaction data in the second quarter. What of the outlook for the rest of the year? If the results of our latest survey are any indication, we see little reason to expect any imminent slowdown in the pace of deal making activity.

- Half of our respondents think deal volumes will increase for the smaller value segment, while a third predict little change either way. Only 17% suggested that volumes could actually decrease.
- For the larger value segment, it is perhaps no surprise, given the abnormally high number of deals recorded in the second quarter, that the proportion forecasting a rise in volumes falls to 33%, with half expecting little change.

Our respondents remain confident about the availability of debt for funding transactions

- Our respondents remain confident about the availability of debt for funding transactions. While the percentage predicting an increase in availability fell once more (from 29% to 17%), the remainder expected it to remain broadly at current levels. None forecast that funding would become any less readily obtainable.
- Asked how a global trade war might affect the M&A market, our respondents were relatively sanguine. Not surprisingly, none expected it to bolster activity. However, while half of the respondents predicted a negative impact, the other half thought it would not have any effect. Let's hope a trade war is avoided and we never find out whether the second half's confidence is misplaced.

Should we be worried about over-heating in the market, given the current pace of activity? Are participants showing signs of complacency? We don't think so.

It's only sensible to have a sanity check when the market reaches levels last seen before the previous downturn.

But the current market backdrop is very different from how it was back in 2008, and we see no signs of excessive optimism. Far from it. As both our survey and our every-day dealings in the market suggest, the mood is more one of business as usual, with market participants expecting neither a deal bonanza nor an imminent slowdown.

Business owners contemplating an eventual exit would do well to explore their options while it remains a sellers' market

Nevertheless, we stand by our comment in April that buyers will not always have this much cash at their disposal or this much debt available. Business owners contemplating an eventual exit would do well to explore their options while it remains a sellers' market.

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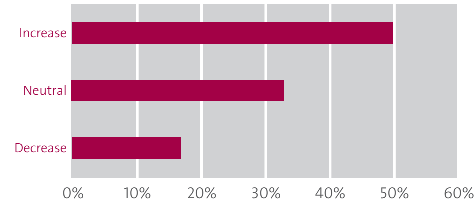
Source: Transaction statistics supplied by unquote

Survey of market expectations

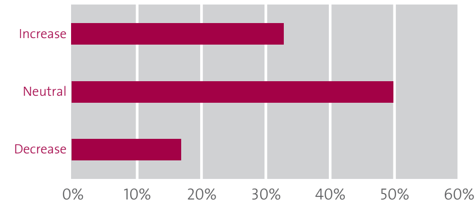
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q2 2018 predictions

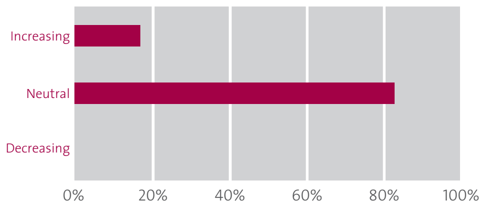
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next six months?



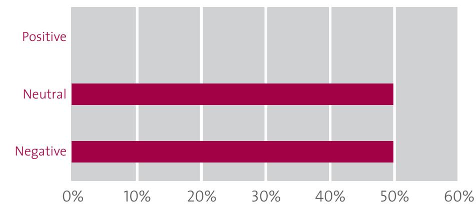
2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next six months?

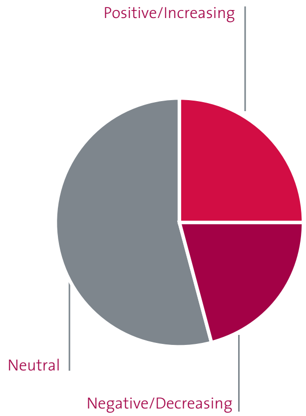


3 Is debt availability increasing, decreasing or neutral over the next six months?



4 How would a global trade war affect the M&A market?





Average of 1, 2, 3 and 4 questions surveyed.

Preparing for sale: SPA treatment

Once you have embarked in earnest on the sale process, the first step is to ensure you have the right financial and business information to support your financial adviser's valuation and to produce marketing materials. Then it's time to consider the legal aspects of the transaction. Robert Darwin of law firm Hogan Lovells notes that taking a pro-active approach to legal due diligence and disclosure can help to avoid any subsequent surprises which could derail the transaction. Special attention should be paid to the sale and purchase agreement (SPA) and how legal due diligence and disclosure relate to the warranties.

Caveat emptor, warranties and disclosure

Under English law, the general principle that applies to the sale of a company is *caveat emptor* – let the buyer beware. The onus is on the buyer to investigate the target company, not on the seller to point out any shortcomings. For this reason, the SPA will contain warranties by the seller confirming the status of the target company's financial performance, operations, assets and liabilities, so that the seller has protection as to the condition of the company.

If the warranties in the SPA are inaccurate, the buyer may have a right to recover damages for breach of warranty. The seller should therefore write a formal disclosure letter outlining the extent to which the warranties are not accurate. If the disclosure letter has explained the inaccuracy of the warranty and it has been contractually agreed that this disclosure will limit the scope of the warranties, the buyer is very unlikely to have a claim against the seller.

The negotiation of the scope of the warranties and the disclosure of information against them comprises a significant part of the negotiation of the SPA. To retain the initiative in the transaction, the seller should be well prepared for the warranty and disclosure exercise and should engage with the legal due diligence process as early as possible.

Legal due diligence

At the start of a transaction, the buyer usually sends the seller a due diligence questionnaire. This generally covers all legal aspects of the target's operations, including ownership and corporate structure, material contracts, financing arrangements, assets, intellectual property, employees, litigation, real estate, compliance with laws and taxation. The seller typically responds by providing replies and copies of all relevant documents, usually, now, to an on-line virtual data room.

However, the seller may want to accelerate the process, particularly where the financial adviser has organised an auction. In that case, the seller may produce its own data room which can be made available to potential buyers. In an auction, the financial adviser may recommend that the seller's lawyers go further and produce a legal due diligence report about the company. This should allow the buyers to confirm their offers for the target earlier in the process, with fewer caveats to the offer price.

In English law transactions, a general disclosure is often accepted. But some buyers may not accept it, particularly if they are from the US

SPA provisions relating to diligence

Scope of disclosure

Negotiating the scope of the warranties, and any disclosure against them, is a significant part of the SPA process. Buyer and seller may debate whether the data room is disclosed in its entirety (general disclosure) or only by reference to specific warranties given (specific disclosure). In English law transactions, a general disclosure is often accepted. But some buyers may not accept it, particularly if they are from the US, where a general disclosure is uncommon.

Quality of disclosure

The SPA will also usually define what quality of disclosure will be effective to limit the application of the warranties. For example, disclosure may be agreed to be effective if a fact is "fairly disclosed" in the disclosure letter. "Fair disclosure" is a concept which has become quite well established. Alternatively, information disclosed may only be effective if it is disclosed "with sufficient details to identify the nature and scope of the matter disclosed". The decision of the Court of Appeal in the leading case of Infiniteland v. Artisan Contracting Limited indicates that, in deciding whether a disclosure is sufficiently clear to be effective, the court will consider the standard of disclosure required by the relevant SPA. Where no particular test is set out in the SPA, the Infiniteland case suggests that the court is likely to apply an objective fairness test. This will take into account what the buyer – and its advisers, if the disclosure letter contemplates the possibility of effective disclosure being made to an adviser – could fairly be expected to have understood from the disclosure.

In order to reduce the possibility of a court deciding that general disclosure is not sufficiently clear to be effective, sellers are advised to provide specific disclosures against particular warranties, cross-referencing any relevant information in the disclosure letter, even where general disclosure of the data room is accepted.

A buyer who is aware of a matter which has not been disclosed in the disclosure letter would be well advised to tackle the issue in commercial negotiations

Buyer's knowledge

SPAs often include a provision that no matters of which the buyer is aware, except those contained in the disclosure letter, will reduce the buyer's ability to claim under the warranties. However, a seller cannot safely assume that such a provision will be effective. The Court of Appeal in Eurocopy v. Teesdale decided that knowledge of a matter not included in the disclosure letter would preclude a claim for breach of warranty by the buyer in respect of that matter.

However, that decision has since been called into question. The judge at the High Court hearing in the Infiniteland case commented that there was no general proposition under English law that, if a buyer knows about something but still goes ahead with a contract, it cannot later say there was a breach of warranty, whatever the detailed terms of the contract may provide. So a buyer who is aware of a matter which has not been disclosed in the disclosure letter would be well advised to tackle the issue in commercial negotiations, rather than assuming that an issue not disclosed in the disclosure letter will still enable a claim to be made

A dishonest seller is unlikely to be able to rely on contractual protections to limit claims against it

Fraud

An SPA will usually contain what is known as an "entire agreement" clause. This states that the buyer has not relied on any statement or representations other than those in the SPA. However, a clause which seeks to exclude fraud is likely to be ineffective, and a carve-out for fraud from an entire agreement clause is usually included. Further, under section 89 of the Financial Services Act 2012, it is a criminal offence to make a statement knowing it to be false or misleading (or being reckless whether it is) or to dishonestly conceal material facts in order to induce (or being reckless whether the statement or concealment may induce) another person to enter into a relevant agreement, including an SPA. So a dishonest seller is unlikely to be able to rely on contractual protections to limit claims against it.

Early diligence and disclosure pays off

In summary, ensuring a thorough legal due diligence exercise early in the transaction will enable a seller to handle the warranty and disclosure process efficiently and provide a higher quality of disclosure. That should reduce the risk of later claims by the buyer while decreasing reliance on contractual provisions regarding fair disclosure and buyer's knowledge. It should also help to flush out any problems early in the process.

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Curve ball

As the US central bank raises interest rates, markets are starting to get nervous about the shape of the US yield curve. But are they right to be worried? Mouhammed Choukeir, Chief Investment Officer of Kleinwort Hambros, explains what an inverted yield curve is and investigates what it could mean for the global economy and stock markets.

"In theory, there is no difference between theory and practice. In practice, there is."

When it comes to investment opportunities and risks, theories abound. Currently, markets are concerned about the flattening of the US yield curve. The theory is that, if the short end of the curve rises above the long end ("inverts", in technical parlance), a recession may be imminent. Theory also suggests that recessions are bad for equity markets, so an inverted yield curve would be a strong signal to reduce risk in portfolios.

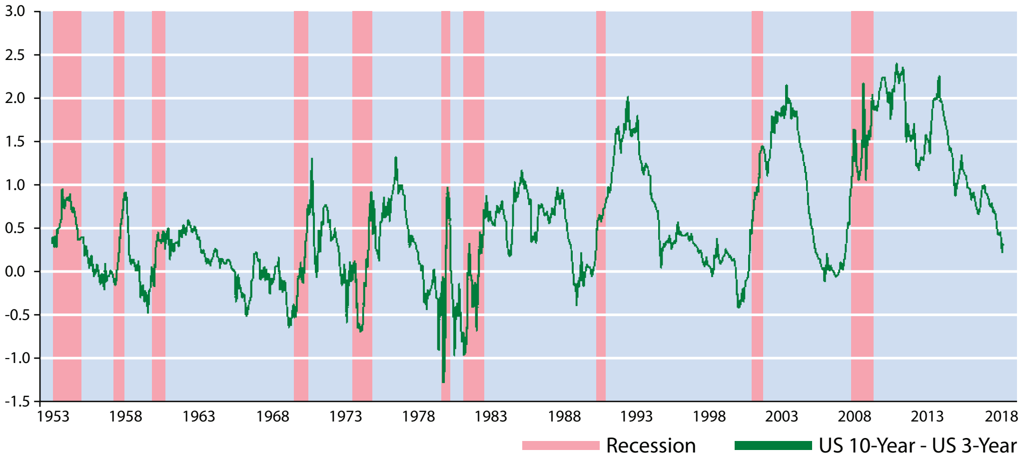
What does this all mean? The US Treasury yield curve is a graph of the interest rates (at any given point) on US government debt of different maturities. The line of the graph generally curves up towards the right because, in normal circumstances, rates are higher on longer-dated debt. In essence, investors typically require higher interest in return for lending their money for a longer period.

Recently, the curve has been flattening as the Federal Reserve has been gradually raising interest rates. While that has driven up rates on short-term government debt, rates for longer-dated debt have stayed relatively stable, reflecting investors' expectations that growth and inflation will be subdued in the long term. This has taken us close to the point of curve inversion – where short-term rates are higher than long-term rates – which is widely regarded as an indicator of a coming recession.

Over the last seven decades, an inverted yield curve has preceded every US recession. *Figure 1* shows the US Treasury yield spread, the difference in the yields on the 10-year and the 3-year Treasury, which has turned negative (meaning the curve has inverted) before each of the 10 shaded areas representing recessions*.

At first glance, that appears to support the theory. In practice, however, the story is much more nuanced.

Figure 1: US Treasury 10-year versus 3-year yield spread, 1953 - 2018



**Conventionally, the slope of the yield curve is calculated by subtracting the 2-year US Treasury yield from the 10-year yield. We have used the 3-year yield instead of the 2-year, as we have data going back further and the difference is marginal. We also apply some judgement in determining when the curve is really negative, not just skirting the border.*

Figure 2: Market returns after yield curve inversions

Negative Yield Curve	Months to Recession	Forward Returns				
Begins		1M Return	3M Return	6M Return	12M Return	24M Return
April 1956	17	−3.1%	1.5%	−3.8%	−6.2%	−11.9%
June 1959	11	4.0%	−0.7%	2.8%	−0.3%	14.2%
November 1965	50	−0.5%	0.6%	−5.8%	−12.1%	0.6%
February 1973	11	−1.6%	−6.1%	−9.1%	−18.2%	−29.9%
October 1978	16	−5.9%	−0.9%	1.5%	3.9%	29.4%
September 1980	11	2.9%	5.5%	5.3%	−6.5%	−3.2%
December 1988	20	3.2%	5.9%	17.1%	26.1%	18.9%
June 1998	34	4.3%	−7.9%	7.4%	19.3%	31.9%
February 2000	14	3.8%	2.1%	7.0%	−6.0%	−20.8%
February 2006	23	1.3%	1.0%	0.8%	13.2%	6.1%
Average	21	0.9%	0.1%	2.3%	1.3%	3.5%
Median	16.5	2.1%	0.8%	2.1%	−3.2%	3.3%
Lowest	11	−5.9%	−7.9%	−9.1%	−18.2%	−29.9%
Highest	50	4.3%	5.9%	17.1%	26.1%	31.9%
% of observations negative		40%	40%	30%	60%	40%

Pink shaded areas show a recession occurring within 12 months from the observation of a negative yield curve.
Yellow shaded areas show a recession occurring within 18 months from the observation of a negative yield curve.

Ahead of the curve

First, an inverted yield curve doesn't necessarily mean that a recession is imminent. While an inverted yield curve does occur before recessions, there has to be some time parameter if this is to be a useful signal. A 12-month period is a sensible starting point. Looking at *Figure 2*, an inverted yield curve heralded a recession within the next 12 months just three times out of ten. Even if we extend our parameter to 18 months, a recession would still have occurred only six times.

Second, an inverted yield curve sometimes doesn't signal a recession at all. No recession occurred for 50 months after November 1965 or for 34 months after June 1998, long enough to say the signal failed in practice.

Third, for investors, the crucial question is what an inverted yield curve can tell them about the future performance of equity markets. Here, too, the signal appears of limited use. In any given year, gross domestic product may fall at the same time as markets rise, and vice versa. After the yield curve turned negative, equity markets were down over the next year six times out of ten. However, the average return is still positive. And double-digit gains (in 1988, 1998 and 2006) were more frequent than double-digit losses (in 1965 and 1963).

Clearly, an inverted yield curve is far from a perfect signal for either recessions or equity sell-offs. Nevertheless, it does tell us a lot about market-wide perceptions of risk and expectations for monetary policy, economic growth and inflation. While these have little bearing on the near-term performance of markets, equities are highly correlated with economies over the longer term. That is why we include the shape of the US yield curve in our Macro-Cycle Indicator, but it is just one of nine signals that, when combined, can more accurately predict a favourable economic environment for taking equity risk than any single factor alone.

Moreover, predicting the economic climate on its own is of limited usefulness for investors. The most effective method for making investment decisions combines an objective assessment of the economic climate with a consistent focus on market valuation, momentum and sentiment.

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