Q2 2020

UK Private Company Director

Welcome to the July 2020 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 at the forefront of directors' minds:

- Despite weakness in some segments, private company deal making activity overall proved pretty resilient, and many sellers are still managing to obtain good valuations (pages 2 to 4).
- The new Insolvency Act contains useful measures – some temporary, others permanent – which should help businesses struggling to stay afloat as a result of the crisis (page 5).
- The steepest decline in economic growth since World War II has taken a toll on stock markets, but should investors now be positioning themselves for a rebound (page 6)?

Best wishes,

Megan Peel

Megan Peel, Editor
meganpeel@ukprivatecompanydirector.com

Past the worst?

The COVID-19 lockdown has clearly taken a severe toll on economies and businesses around the world. But what has it meant in terms of deal activity for private companies in the UK? Jim Keeling of corporate finance advisor Corbett Keeling analyses the data from the second quarter and finds a perhaps surprisingly upbeat outlook for any business owners looking to sell.

Even as the lockdown eases, the situation remains precarious for many businesses and the path ahead appears uncertain. Yet I don't share the gloomy outlook of many commentators in the media. In fact, I have been hugely impressed with the resilience shown by business owners as they have adapted to their new circumstances. Over the last few weeks we have spoken to many private equity firms, and it feels as if the impact of Covid has been split equally across their portfolios; a third have been negatively impacted, a third report a neutral impact, a third have found Covid had a positive impact on their businesses. The Governor of the Bank of England appears to agree, having recently expressed his confidence that the recovery may be stronger than previously expected.

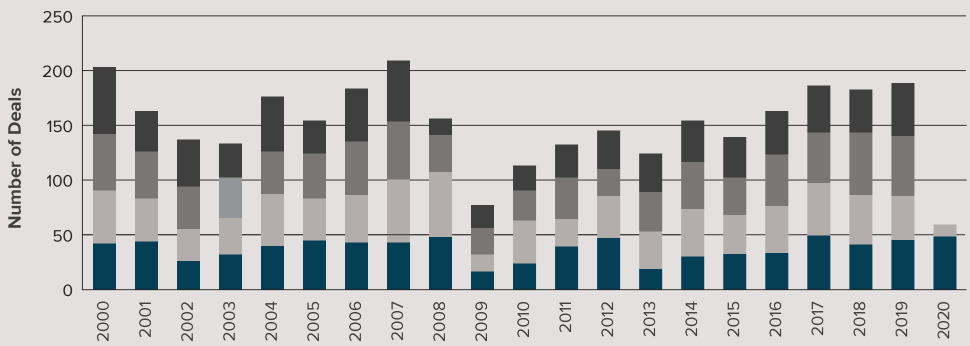
Of course, a drop in activity in the private company transactions market was only to be expected, and some segments have been hit hard since March. That said, the overall figures for the second quarter of the year are well above the levels seen during the global financial crisis, as I explain in more detail below. And it could well be that we are already past the worst.

The good news is that we continue to see lots of activity in the market. In particular, private equity firms have plenty of funds available, and they are actively looking for opportunities to put that money to work. This means that many sellers are still managing to achieve full valuations for their businesses even where earnings have taken a temporary knock as a result of the lockdown. Our latest survey responses confirm that market participants are in a realistic but determined mood, working hard and getting deals done.

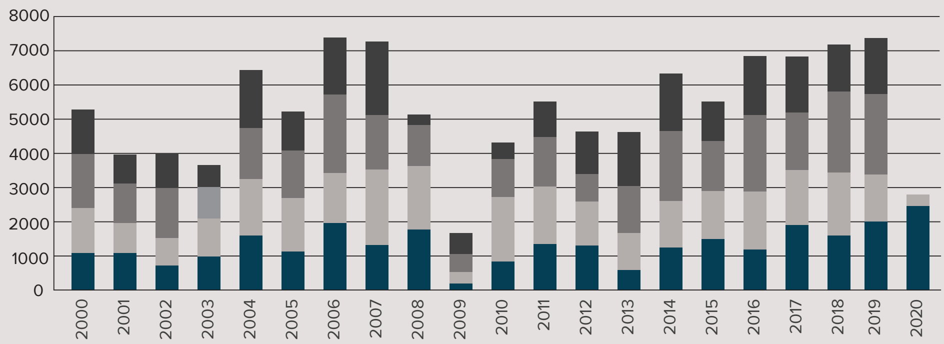
Assessing the deal data

After a record strong start to the year, the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) took the hardest hit in the second quarter. The volume of deals fell from 48 to just 11, while their value was down from £2.5 billion to £338 million, the third lowest quarterly figure since 2000.

Sub-£150m Buyouts by Volume



Sub-£150m Buyouts by Value



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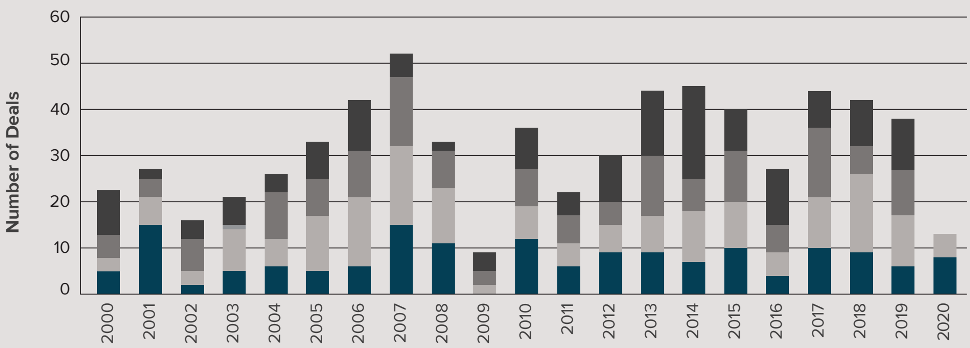
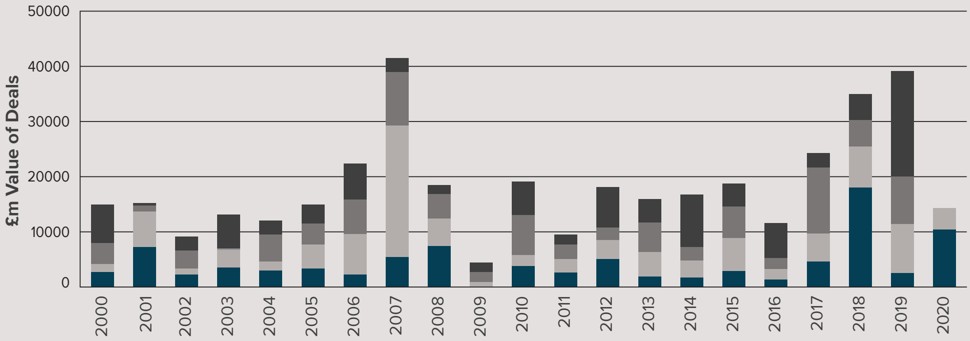
- Q4
- Q3
- Q2
- Q1

The declines were not as steep in the **larger buy-outs** sector (enterprise value of £150 million or above). The number of deals was down from eight to five, and the value of transactions also fell, from £10.4 billion to £3.9 billion. Still, that is a respectable quarterly figure, and the total values for the first six months of the year are very similar to the same period last year.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value



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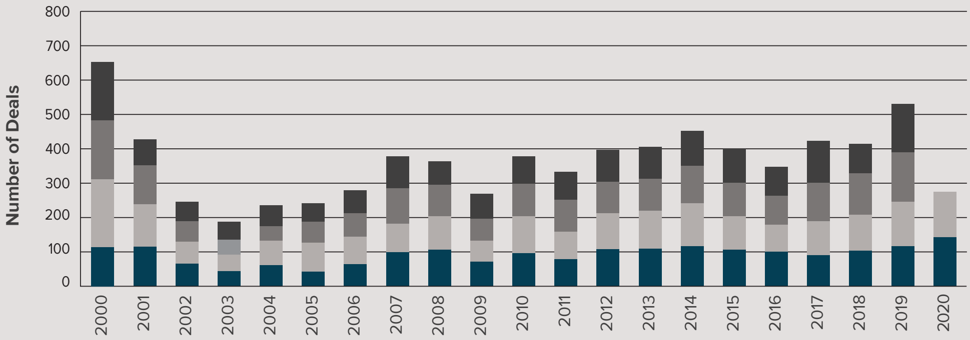
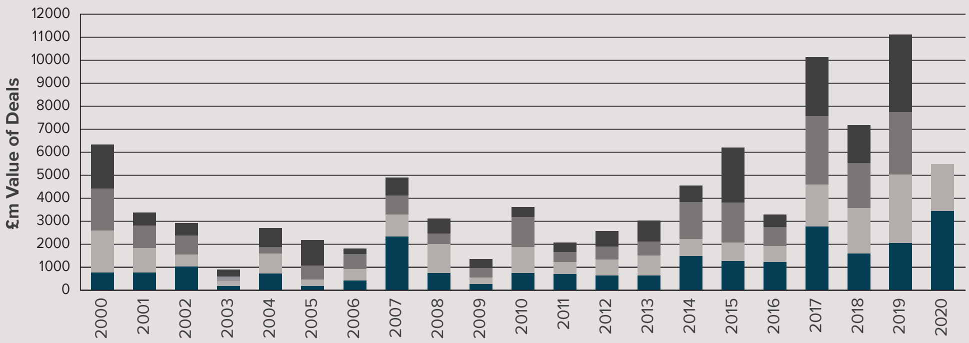
Early-stage and expansion capital deals were easily the most resilient segment of the market. The number of transactions held remarkably firm, edging down from 143 the previous quarter to 131. The value of these deals declined rather more significantly, from £3.4 billion to a still very acceptable £2.0 billion. That enabled the segment to set a new record values total for the first half of any year.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



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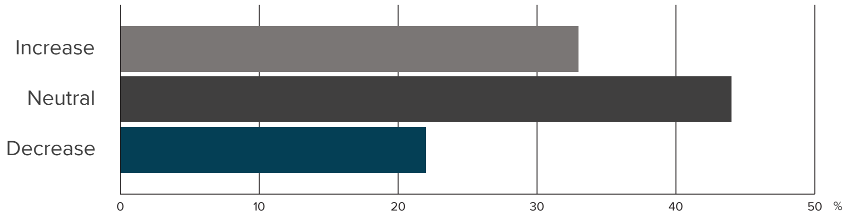
Corbett Keeling Corporate Finance

So what does our latest survey suggest?

With the lockdown restrictions only just beginning to ease and the shape of the recovery still uncertain, it's little surprise that sentiment remains subdued. However, I find it encouraging that we received more positive than negative responses to our survey of market participants.

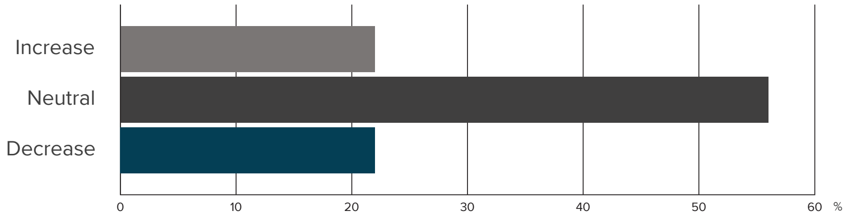
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months has fallen from 55% to 32%. However, that outweighs the 22% forecasting a drop in activity, which is little changed from last quarter's 18%. The remainder (45%) expect activity to stay around current levels.



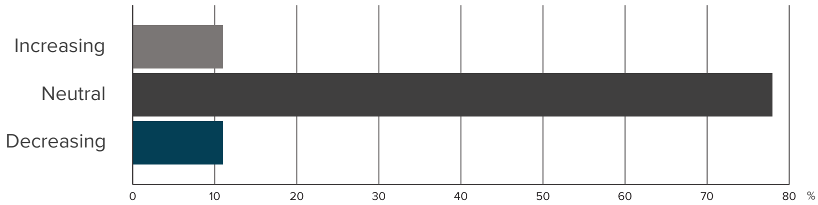
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment, most respondents expect little change. Of the rest, 22% predict a rise in activity, the same proportion as those forecasting a decline.



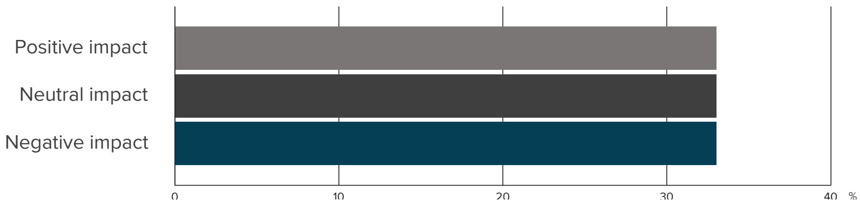
3 Is debt availability increasing, decreasing or neutral?

With the Bank of England in full supportive mode, debt availability is not seen as a problem. Over three quarters of respondents said they expect debt availability to remain around current levels, and only 11% thought it was decreasing.



4 How have the restrictions imposed to stop the spread of Covid-19 affected your portfolio companies?

When asked how the restrictions related to COVID-19 have affected portfolio companies, our respondents were evenly split between those reporting a positive, negative and neutral impact.



Contact us

Jim.Keeling@corbettkeeling.com

Dechert LLP

New Insolvency Act: Some breathing space

The COVID-19 pandemic has brought forward the government's plans for major reform of the UK's insolvency framework. The Corporate Insolvency and Governance Act 2020, which came into force this June, introduced some permanent landmark changes as well as temporary measures to help businesses cope with the crisis. Anthony Frost of Dechert LLP highlights those of particular relevance to company directors.

COVID-19 temporary measures

- **Suspension of winding-up petitions and statutory demands**

  From 27th April, statutory demands served on companies between 1st March 2020 and 30th September 2020 can't be used as the basis for presenting a winding-up petition. During the same period, creditors can't present a winding-up petition unless they have reasonable grounds to believe that COVID-19 hasn't had a financial effect on the company, or that the company would still be unable to pay its debts even if COVID-19 had not had a financial effect on the company. The courts will probably find this a difficult question to determine.

  These changes should help to reduce the use of statutory demands and winding-up petitions as an aggressive form of debt collection (a winding-up petition can be presented if no payment is made within 21 days of a statutory demand). In particular, these provisions seek to prevent landlords using statutory demands to get around the moratorium on forfeiture introduced in previous coronavirus related legislation.

- **Suspension of wrongful trading rules**

  Under the wrongful trading rules, directors can be personally liable if the company enters into liquidation or insolvency administration and the director knew (or should have concluded) that there was no reasonable prospect of avoiding such proceedings. The New Insolvency Act temporarily suspends directors' personal liability for any worsening of a company's financial position during the period. This should help directors of companies affected by the pandemic to make decisions without fear of personal liability arising from the application of the wrongful trading rules.

  However, directors will still be subject to their usual duties – such as promoting the success of the company and considering creditors' interests in certain circumstances – and may still incur liability for fraudulent trading. It remains important for directors to take legal advice. Furthermore, the temporary suspension doesn't apply to certain excluded companies, such as those financed by rated or listed bonds.

Permanent insolvency law reforms

- **New statutory moratorium mechanism**

  Companies in distress may be given more breathing space to negotiate with creditors if they take advantage of a new statutory moratorium mechanism. This stops creditors taking enforcement action, restricts insolvency filings and provides a payment holiday for certain types of pre-moratorium debts as well as post-moratorium debts. The moratorium must be proposed by the company's directors and lasts for a fixed period. As with wrongful trading, some companies are excluded from using the mechanism.

- **Restructuring plan**

  A company in financial difficulty will be able to propose a compromise or arrangement between its creditors or shareholders, subject to the approval of the court and 75% of each class of creditors. In certain circumstances, the court may sanction the plan even where one or more classes don't vote for the plan. The first plans presented to the English courts will be closely watched to see the scope of these provisions.

- **Other provisions**

  The Act prevents suppliers from relying on contractual clauses that allow termination because a counterparty enters an insolvency or restructuring process. It also includes COVID-19 related measures for company meetings and filings.

Contact us

Robert.Darwin@dechert.com

KLEINWORT HAMBROS

SOCIETE GENERALE GROUP

Getting warmer

After steep declines at the onset of the COVID-19 crisis, stock markets have bounced back. However, they remain below pre-crisis levels and are still highly volatile. So where do they go from here? Fahad Kamal, Chief Market Strategist of Kleinwort Hambros, explains what the four main factors he watches are suggesting about the path ahead.

- **Economic regime**

  Despite surprisingly positive economic data recently, the global economy is on track this year to suffer its deepest recession since World War II. The World Bank's latest forecast (on 8th June) was for global output to contract by 5.2%, with per capita income falling in the largest proportion of countries since 1870. Although their lockdowns are easing, advanced economies are still expected to shrink by 7% this year. In perfect conditions, a rebound may begin as soon as the third quarter. Our inhouse macro-economic indicator has just switched from a regime of contraction into one of recovery, suggesting a favourable environment for risk-taking. However, this is a highly unusual situation, so we are awaiting further confirmation of economic stabilisation over the coming months.

- **Valuations**

  Valuations for equities – the largest source of risk and return in most portfolios – remain challenging in absolute terms. The US equity market, which represents nearly 60% of the global total, is currently trading at a forward price-to-earnings multiple of 22, the highest since 2002. That is expensive. However, with interest rates close to 0%, there is a good case for a higher than usual tolerance for valuations, particularly for large-cap companies which appear to be immune to the business cycle (often called secular growth stocks). Moreover, when compared with cash or government bonds, equities still have a clear advantage in terms of long-term expected returns. So, while equities are expensive, there are few attractive alternatives amongst the core asset classes.

- **Momentum**

  The second-quarter surge in equity markets illustrates why momentum is a critical factor in our asset allocation process. Markets don't have to follow expectations or even logic, and trends can prove to be self-fulfilling. We take a longer-term view of momentum and only assess it at month end. This helps us to avoid being caught in short-term market cross currents, guiding us to take advantage of those trends that have sufficient strength. As of the end of June, the global equity market had just tipped back into positive territory on the ten-month moving average metric that we favour. Should this be sustained, we will view it as positive for risk-taking.

- **Sentiment**

  Sentiment for risk assets, such as equities, has oscillated wildly over the last few months. Of the indicators we follow, some – for example, the S&P 500 Index net speculative positions – imply a certain bullishness. Others – such as the ten-year US Treasury net speculative positions – imply more bearishness. Overall, we are in neutral territory.

The bottom line

Taking all the above into account, we remain cautiously positioned in our portfolios. Risk assets remain volatile – for example, the most closely watched index of volatility is near 30, well above its long-term average – and thus more unpredictable than usual; they also appear expensive on most measures. Nevertheless, the signals we follow for the economic regime and momentum have shifted towards increasing risk in portfolios. Should these signals remain supportive, we may seek to take more risk in the months ahead.

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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dechert.com

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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