Q3 2017

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 October 2017 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.

Even many keen Brexiteers are surprised at how well the economy has held up so far, despite an apparently unending succession of negative headlines. Of course, nothing has actually changed in the rules governing our trading relationship with the EU. Yet the atmosphere has undoubtedly been soured by the claims and counter-claims over the difficulty or ease of pursuing one or other form of Brexit – or even reversing the decision altogether.

This is all very good sport for politicians on both sides of the Channel, as it is for headline writers in the media. Fortunately, some of us have more constructive things on our minds. While they have been fiddling, business people in the United Kingdom and beyond have been getting on with their jobs, and we are pleased to report that owners of private companies looking to sell their businesses will find that the market currently appears in a receptive mood.

Here, we outline some topics we believe should currently be of interest to private company directors, especially those looking to sell their businesses.

- Last quarter, we questioned whether the momentum in deal making activity could continue, given the blow to sentiment after the General Election. But the market answered with a resounding yes, as **the value of deals remained on course for a bumper year** (pages 2 to 5).
- While the Braganza Duty and the Watchfinder case perhaps sound like titles from the Jason Bourne series, **they may be of vital practical relevance for boards deciding whether to exercise a consent or veto right in an options contract** (pages 6 to 7).
- Though some investors are starting to get nervous about valuations in the stock market, the **economic backdrop and solid momentum could propel this bull market to further highs** (pages 8 to 9).

Best wishes

Megan Peel

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Heading for a vintage year?

At the half-way mark of the year, some market participants appeared doubtful whether the strong momentum of deal making activity in the first six months would prove sustainable. Jim Keeling of corporate finance advisor Corbett Keeling finds that in fact activity accelerated in the third quarter, putting us on course for the strongest year for values since 2010 or perhaps even 2007.

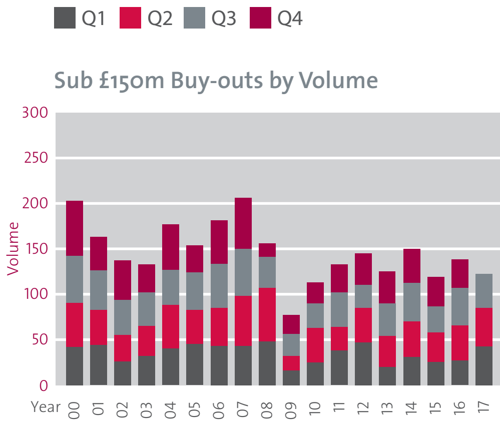
Three months ago, we argued that the adverse impact of the General Election on market sentiment was likely to prove temporary. Certainly, our firm was very busy and we saw clear signs of deal making all around us in the marketplace. Even so, we have been slightly surprised by the strength of activity across the market as a whole during the third quarter of the year.

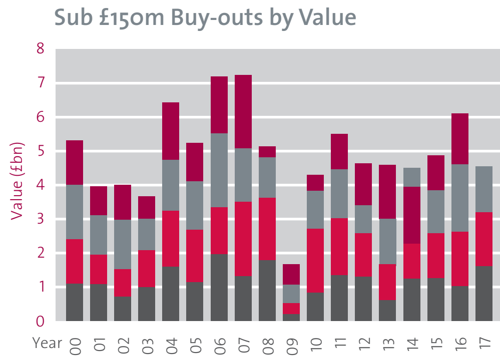
The pound's weakness since the Brexit vote continues to present some attractive opportunities to overseas buyers who are prepared to look through the short-term uncertainty

Several factors may be at play here. There may be an element of catching up, as decisions delayed by uncertainty over the Brexit referendum finally come to fruition. Last year's subdued activity in some segments would appear to support this notion. And, with the Bank of England signalling its wish to bring the era of ultra low interest rates to a close, some participants may be wanting to push through deals in case debt funding becomes costlier or less readily available. In addition, the global economy appears to be in fairly healthy shape, even if growth in the UK has slowed slightly. Lastly, the pound's weakness since the Brexit vote continues to present some attractive opportunities to overseas buyers who are prepared to look through the short-term uncertainty.

So just how strong was deal making activity in the third quarter of the year?

- The **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) maintained its solid momentum from the first half of the year. The volume of deals was down only marginally, from 42 to 37, and it was a similar story for the total value, which dipped to £1.3 billion from £1.6 billion. Both the volume and the value appear set to match or even beat last year's strong showing.



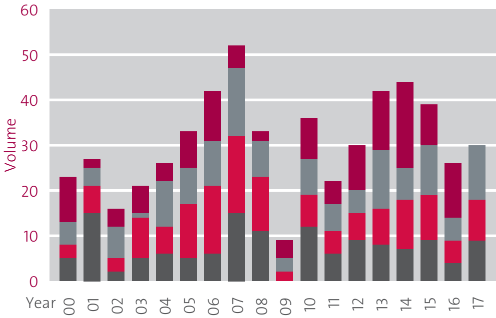


The larger buy-outs sector had an exceptionally busy August, with seven deals worth a combined total of over £7.5 billion

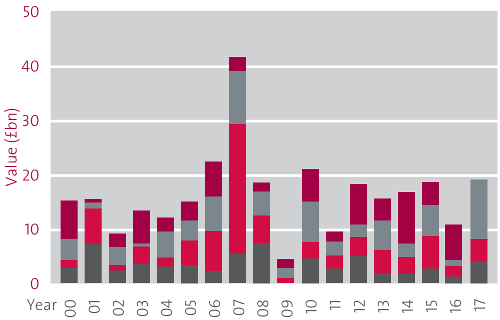
- The **larger buy-outs** sector (enterprise value of £150 million or above) had a bumper quarter, with the number of transactions up from nine to 12 and their total value soaring from £4 billion to £10.9

billion. That marks the strongest three months for over ten years. The figure was buoyed by an exceptionally busy August, with seven deals worth a combined total of over £7.5 billion, but July and September were also very strong months.

£150m+ Buy-outs by Volume



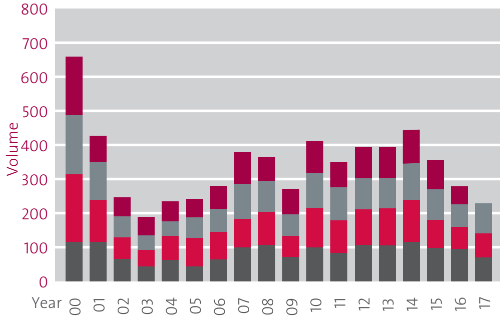
£150m+ Buy-outs by Value



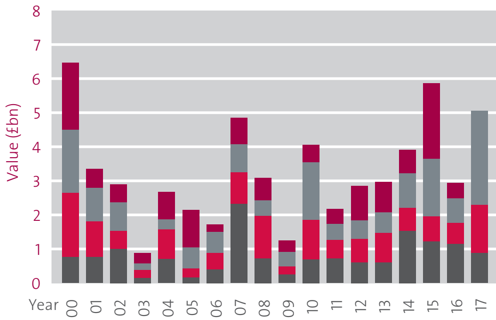
The number of early stage and expansion capital deals was up from 69 in the second quarter to 88, the highest for 18 months

- **Early stage and expansion capital deals** also enjoyed a strong quarter – in fact, the best in terms of value since this data series began in 2000. The number of deals was up from 69 in the second quarter to 88, the highest for 18 months, while their value leapt from £1.4 billion to £2.8 billion. That takes the value for the first nine months to a record high.

Early-Stage/Expansion Deals by Volume



Early-Stage/Expansion Deals by Value

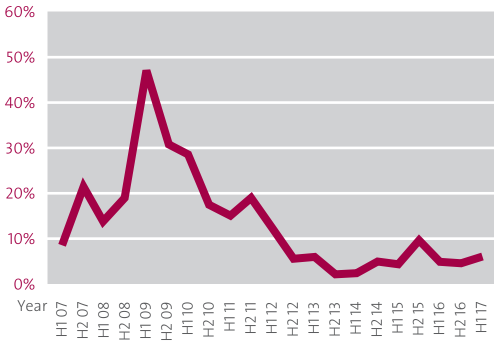


All equity buy-outs appear to be undergoing something of a renaissance, with six completed during the quarter. While this was the equal highest quarterly total since the start of 2012, it is still a modest number and it remains to be seen whether this marks the start of a genuine upward trend.

Overall the survey appears very upbeat and a marked contrast from last quarter's, held in the immediate aftermath of the General Election

So the deal totals for the third quarter clearly look very robust. But what does our most recent survey tell us of the prevailing mood in the market? Overall, it appears very upbeat and a marked contrast from last quarter's survey, which was held in the immediate aftermath of the General Election.

All Equity Funded Buy-outs to All Buy-outs



- For both the lower and the higher value segment of the market, the survey showed an overwhelmingly positive tone. Not one respondent expected a decrease in deal volumes over the coming months, even from the current high level.
- While half predicted no change in deal volumes for the lower value segment and nearly two thirds for the higher value segment, the rest forecast that deal volumes would actually rise from here.
- We still see little concern about the availability of debt. Over 60% of respondents said it was currently increasing; the remainder thought it was staying the same.
- However, there is a clear expectation that interest rates will be on the rise. Two thirds said they expected the environment of low rates to last less than a year, and none foresaw it lasting for longer than two years.

Nevertheless, the market has forged ahead despite the uncertainty created by political instability and the Brexit negotiations

Having argued last quarter that negative sentiment can quickly turn more positive, we are not going to read too much into the upbeat tone of our latest survey. Nevertheless, the market has forged ahead despite the uncertainty created by political instability and the Brexit negotiations. That gives us considerable confidence that, barring any unforeseen shocks, the current strength should prove sustainable.

Potential buyers seem to have a strong appetite for private companies coming to market

As I said earlier, we have seen plenty of evidence of continued activity in the marketplace since the Brexit vote, and it is good to see the results showing up strongly in the data for deal activity so far this year. Certainly, potential buyers seem to have a strong appetite for private companies coming to market, and that trend shows no sign of abating at present.

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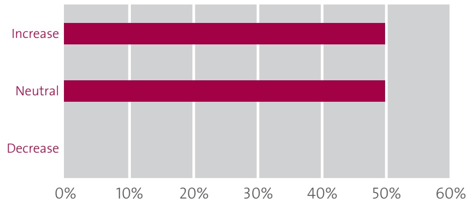
Source: Transaction statistics supplied by unquote

Survey of market expectations

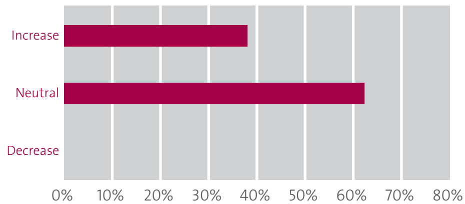
In order to produce these statistics, key players in the UK private equity and venture capital markets were surveyed.

Q3 2017 predictions

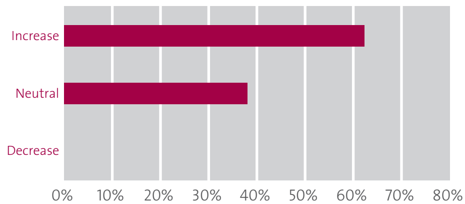
1 Do you expect deal volumes (less than £100m) to increase or decrease over the next six months?

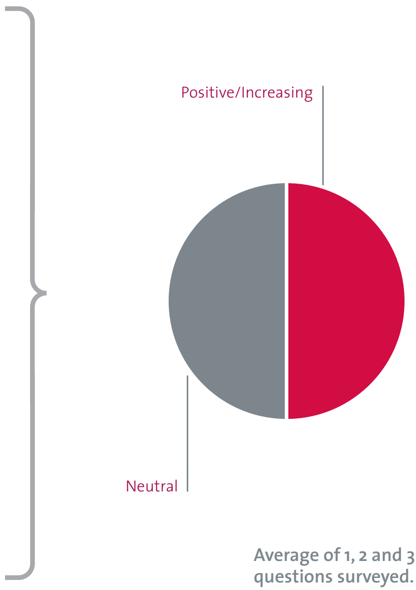


2 Do you expect deal volumes (greater than £100m) to increase or decrease over the next six months?



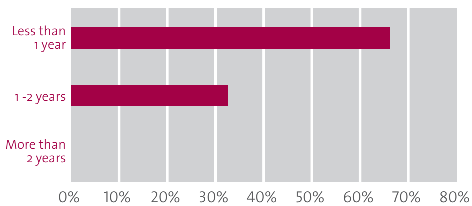
3 Is debt availability increasing, decreasing or neutral over the next six months?





Average of 1, 2 and 3 questions surveyed.

4 How much longer do you expect the low interest rate environment to last?



Do you know your Braganza Duty?

When deciding whether to exercise consent or veto rights, a board of directors cannot simply do whatever it pleases. As the recent Watchfinder case clarified, the board may be required to act in a way that is not arbitrary, capricious or irrational and to follow a proper process when deciding how to use these rights. Karla Dudek of law firm Hogan Lovells explains the practical implications for boards deciding on this issue.

Watchfinder.co.uk Limited buys and sells pre-owned watches through its websites and shops. In 2009, it was looking for investors to help grow its business and turned to a business development company called Adoreum Partners. Adoreum has relationships with a large network of businesses, investors and high net worth individuals, and Watchfinder particularly wanted Adoreum to introduce it to Richemont, the owner of famous brands such as Cartier.

Watchfinder and Adoreum entered into a services agreement requiring Adoreum to introduce potential corporate investors to Watchfinder. In return, Adoreum was paid a monthly retainer and was entitled to a percentage of any proceeds invested as a result of an introduction. The parties also entered into an option agreement under which three directors of Adoreum were issued options in Watchfinder. Clause 3.1 of the option agreement said the option could be exercised only with the consent of the majority of Watchfinder's board.

Adoreum introduced an investor, Beringea LLP, which made a $5 million investment for a 15% holding in Watchfinder. However, despite an introduction to Richemont and considerable efforts by Adoreum to interest Richemont in Watchfinder, Richemont decided not to invest.

Watchfinder served a notice of termination of the services agreement in February 2014, when Watchfinder was at the heads of terms stage with Beringea. A settlement agreement in respect of the services agreement was entered into, and Watchfinder paid Adoreum half of the fee it would otherwise have been entitled to for introducing Beringea.

The option-holders then sought to exercise their options. Watchfinder refused to issue the shares as its board of directors had not consented to the exercise of the options. The option-holders filed a claim seeking an order requiring Watchfinder to issue the shares to the option-holders.

What was Watchfinder's defence?

Watchfinder argued that clause 3.1 of the option agreement gave the board an unconditional right of veto over the exercise of the option, so the board could take into account whatever it wanted when deciding whether to give its consent. The High Court said that, if this argument were correct, the option would be meaningless, because the grant of the shares would be entirely within the gift of Watchfinder, and it would be a "commercial absurdity" to find that the option was worthless to the option-holders.

The judge then considered what the effect of clause 3.1 was, given that it appeared to place some type of restriction or qualification on the option-holders' rights to the shares

An obvious potential conflict of interest applied in this case because the exercise of the options would dilute the existing Watchfinder shareholdings

Discretionary veto subject to a Braganza Duty

The judge found that the board had a discretion on whether to allow the option-holders to exercise their option, but the directors must not exercise this discretion in a way that was arbitrary, capricious or irrational. This Braganza Duty (named after the court case when it was first described) was implied by the court to be a term of the contract as if it had been expressly included. The judge explained that an obvious potential conflict of interest applied in this case because the exercise of the options would dilute the existing Watchfinder shareholdings.

How can a board discharge its Braganza Duty?

The judge explained that, where a Braganza Duty applies, a board must follow a proper process which:

- takes into account the material points; and
- does not take into account irrelevant considerations.

The board should have considered whether Adoreum had made a significant contribution to the progress or growth of Watchfinder

The board needs to know what the target of the discretion is – that is, the board members must work out what they should consider when deciding whether to give their consent or exercise a veto. Identifying the target is straightforward in some situations, such as where the discretion relates to the board's opinion of what a reasonable value is or whether a particular event has occurred.

In this case, the court found that the board should have considered whether Adoreum had made a significant contribution to the progress or growth of Watchfinder. If the board came to a reasonable view that the Adoreum investment had contributed significantly to the growth of Watchfinder, the option-holders should have been permitted to exercise their options. The judge said the board must not base their decision solely on whether the option-holders would be suitable shareholders in Watchfinder; the class of unsuitable shareholders is so narrow that this does not give the board much discretion.

The court also said it would not have been acceptable for the board to have exercised its veto because Richemont had not invested in Watchfinder. If the parties had intended this, they should have written that criterion into clause 3.1 of the option agreement.

Did the board comply with the Braganza Duty?

The court held that the board of Watchfinder had not complied with the Braganza Duty. On the evidence of the case, it was clear that the board had barely even considered whether the option-holders should be allowed to exercise their options, because the board members were under the impression that they had an absolute right of veto. Only the managing director addressed this topic at the relevant board meeting; the other directors simply agreed.

Based on the witness statements, the court was of the view that, if the managing director had provided any particular justification for refusing consent, it would have been only based on Richemont's decision not to invest in Watchfinder. The judge noted that this would have been a mistaken approach, because the board should have considered that Adoreum had introduced Beringea to Watchfinder and that Beringea had made a significant investment which had contributed to the value of Watchfinder or its future ability to grow.

What can we learn from the court's decision?

This case is a reminder that a board should carefully consider all relevant information when deciding whether to exercise a consent or veto right in a contract – particularly where the board's exercise of a discretion could cause some disadvantage to the current shareholders of the company. If such a potential conflict of interest exists, a court may conclude that the board members have a Braganza Duty not to exercise their discretion in an arbitrary, capricious or irrational way.

Where a Braganza Duty could be imposed, the board briefing pack should include all the background information likely to be relevant when the board is deciding how to exercise its discretion, the board should carefully consider the factors they should be basing their decision on and the board members should have a meaningful discussion before deciding how to exercise their discretion. It is also prudent for the board of directors to keep a clear record of the reasons for their final decision.

The case flags how important it is for parties to be precise and specific in the drafting of documents. The outcome of this case would probably have been different if the option agreement had clearly stated that the options could be exercised only if Richemont had made an investment in Watchfinder. As it was, clause 3.1 had been in the first draft of the option agreement, and the parties had never discussed what the clause meant or how it should operate.

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Bull or bubble?

With the bull market for global equities now in its ninth year, some investors are starting to question how sustainable it now is. Here, Mouhammed Choukheir, Chief Investment Officer of Kleinwort Hambros, assesses the state of the market in light of both historical precedents and current conditions. He finds that, while valuations are not cheap, the economic backdrop and solid momentum appear to give it scope to run further.

In the eight and a half years since March 2009, the US's S&P 500 Index has rallied by 230%. How much longer can this bull market* last? Can equities continue to produce decent returns from here? Or are we in a bubble on the verge of popping?

Several previous bull markets have lasted longer; the current one is only the fourth longest in the history of the index. The bull runs which began in 1949, 1974 and 1987 lasted between 12 and 13 years. Furthermore, this bull market is a distant fifth historically in terms of total return *(see chart)*. It trails far behind the 516% gain produced by the legendary bull run of the 1990s; indeed, the average return for the top four has been 427%, almost twice the figure for the current bull market.

While that may provide investors with some measure of comfort, it is unfortunately impossible to tell precisely when a bull market will end or cross the line into bubble territory.

Back to the future

The history of markets is dotted with periods when healthy asset price momentum has turned into an irrational bubble which ultimately bursts, leading to a dramatic collapse in prices.

The reason these periods are so frequent lies in human nature and the psychology of crowds. During the South Sea Bubble of 1720 – when shares in the South Sea Company, backed by the British government, traded at astronomical valuations on hopes of trade with South America – even the great Isaac Newton miscalculated the risks. The hopes proved unfounded – South America was controlled by Spain, after all – and Newton was only one of many investors left with hefty losses.

The roaring 1920s witnessed the first equity mega-bubble of the 20th century, with the S&P 500 climbing nearly 400% in eight years. Financial innovations such as consumer financing duped many investors into believing preposterously optimistic growth projections. The Great Depression followed, bringing the most painful bear market ever. In the three years from September 1929, equities lost 85% of their value.

The 1990s recorded the biggest bull market in history. Initially supported by stable inflation, a demographic tailwind and rapid economic growth, this bull run eventually metamorphosed into the tech bubble. Hundreds of companies promised to change the world by harnessing the power of the newly created internet. As traditional price-to-earnings ratios cannot be computed when earnings are negative, new valuation measures – such as "eyeballs" and "clicks" – had to be invented. When the inevitable crash came in 2000, equities fell 44% by 2003.

The following bull market was characterised by financial innovations, with a flood of new acronyms such as CDO, MBS and ABS. At its root were the widely held – but erroneous – beliefs that house prices could only go up and that business cycles had been tamed by omniscient central bankers† . What followed was the sub-prime crash. Equities lost over half their value, a bear market second only to the Great Depression.

Uncommon sense

The key question for investors is how to tell when healthy equity bull markets are turning into bubbles primed to fall into bear territory.

Although bubbles take many different forms, they tend to share certain characteristics.

- Valuations become excessive, often as a surge in economic productivity – stemming from some genuine technological advance or financial innovation – leads investors to believe that "this time is different", justifying their complacency and excessive valuations.
- Government fiscal or monetary policy tends to encourage risk-taking behaviour.
- Sentiment typically turns over-optimistic, even euphoric. The success of investments made during the bull run makes investors desperate not to miss out on gains.

These three characteristics can act as warning signs for future bubbles. So where are we now?

Valuations (red): Every bull market in history has witnessed multiple expansion, as investors are prepared to pay more for each unit of corporate earnings. Using the cyclically adjusted price-to-earnings (CAPE) multiple – which removes the effects of inflation and the business cycle – we find that multiples in equity bull markets have expanded by 1.9 times on average. The median is 1.4 times, which is probably the more useful measure as it eliminates some wild outliers. The current bull market has witnessed a multiple expansion of 2.3 times, well above both the median and the average. Moreover, the current CAPE value is at its third-highest level in history, surpassed only by valuations during the roaring '20s and the tech bubble. This is worrying. We recognise that this bull market is increasingly mature and further multiple expansion is likely to be subdued.

Policy (red): Nearly a decade on from the financial crisis, there is a broad-based global economic recovery. Indeed, our macro-cycle indicator shows a favourable backdrop for risk-taking: the global economy is in an expansionary regime, less supported by monetary policy. However, financial markets are still underpinned by the colossal efforts of central banks. The resultant lower yields on government bonds make equities appear more attractive in comparison. Many investors are holding more equity risk in portfolios in order to get "pre-crisis returns". This behaviour, typical of previous bubbles, makes us wary.

Sentiment (green): The collective emotional state of investors is perhaps the hardest factor to gauge. As stock markets keep hitting new highs, few would describe the mood amongst investors as complacent. If anything, this bull market has been marked by caution, and some key indicators of sentiment are displaying "oversold" characteristics. For example, safe-haven assets such as government bonds are hugely overvalued, while both gold and the Japanese yen enjoy strong support.

Investment implications

Equities have had a strong run and we expect future returns to be more moderate. Nevertheless, we remain mildly sanguine and still view equities as a core asset class, supported by a strong economic backdrop, positive momentum and attractive fundamentals. Should any of that change, we will adjust our positions accordingly. In the meantime, we find better value in regions such as Europe and emerging markets than in the US.

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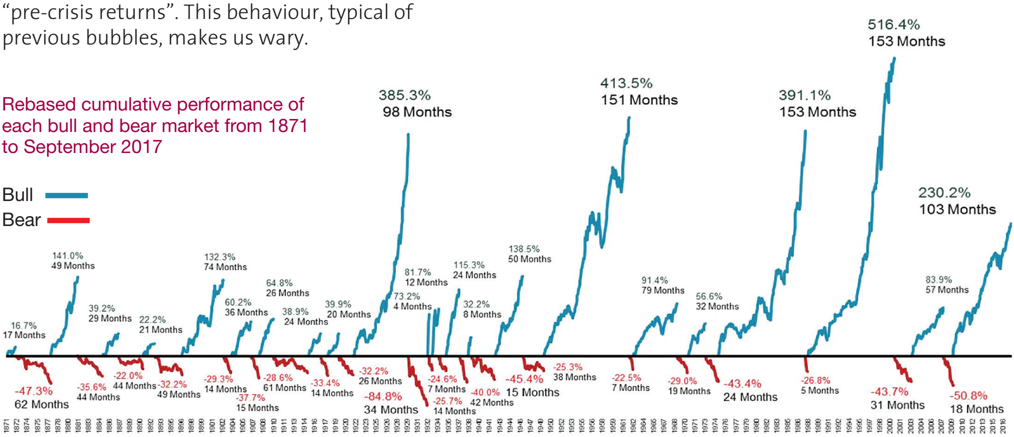
Source: Kleinwort Hambros, Robert Shiller data.

* *Bull and bear runs on the S&P 500 since 1871, using Shiller data. A bull market is defined as a rise in the market by over 20% from its low; a bear market is defined as a fall in the market by 20% from its high.*

† *Steven Webber, "The End of the Business Cycle?", Foreign Affairs, 1997.*



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