Q3 2018

UK Private Company Director

Welcome to the November 2018 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 for privately owned businesses.

We hope you enjoy the updated look of our newsletter and in this edition we welcome our new partner Dechert LLP to UK Private Company Director.

This issue highlights:

- Private Equity activity remaining very robust, with a further acceleration in the lower value segment (pages 2 to 4).
- The benefits and potential pitfalls of the increasingly popular warranty and indemnity insurance for buyers and sellers (page 5).
- Despite growing concerns about a US-China trade war, the global economy continues to grow at a steady pace, supporting companies' earnings, particularly in the US. The current outlook in the stock markets is for sustained growth (page 6).

Best wishes,

Megan Peel, Editor
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Corbett Keeling Corporate Finance
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Still on course

Deal making activity remained robust overall in the UK private company market during the past quarter. And, as Jim Keeling of corporate finance advisor Corbett Keeling notes, market participants remain confident that the current overall brisk pace will continue over the next six months, shrugging off concerns about a possible global trade war.

While the value of deals across the market fell slightly overall during the three months to the end of September, this followed a robust second quarter and was entirely due to an appreciable drop in the value and volume of deals in the larger deal segment of the market. The sub-£150m and early stage/expansion capital deals have been very strong, roaring ahead in the third quarter.

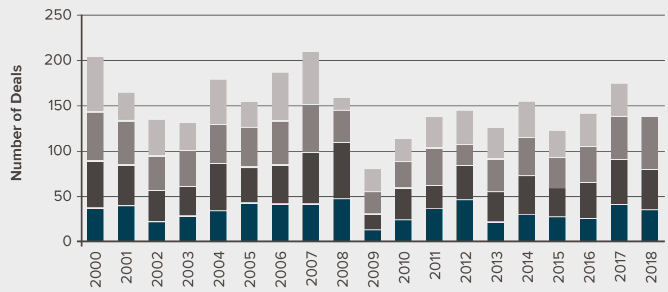
The larger deal segment – where a couple of deals can make a massive difference to the headline figures – tends to be quite volatile from quarter to quarter. In fact, while lower than the previous quarter, the three months from July to September were reasonably strong by historical standards, and the segment looks on course to come in above the annual average for both volume and value over the past ten years.

Our quarterly survey of equity and debt investors shows nothing to suggest a weakening of deal volumes or values. In the smaller value segment, sentiment has actually improved with 70% of respondents predicting an increase in deal volumes. In all, it's shaping up to be a good year for deal making activity, despite the supposed headwinds of Brexit and protectionism.

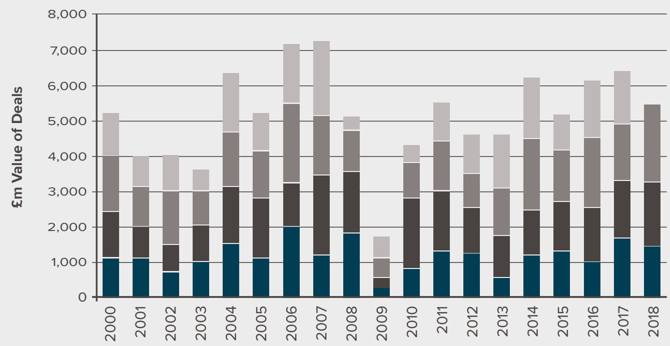
Let's explore the data

- It was a strong three months for the smaller buy-outs sector (transactions with enterprise value of less than £150 million). In fact, when the final figures are in, it may turn out to have been a record quarter for the value of deals, which the preliminary numbers put at £2.1 billion. There were 53 deals, the highest volume since the second quarter of 2008. 2018 could turn out to be a record year for values in this segment.
- Activity in the larger buy-outs sector (enterprise value of £150 million or above) was always likely to struggle to match the previous quarter's 17 deals. In the event, only six deals were recorded, for a total value of £2.7 billion, down from £7.5 billion in the previous three months. Nevertheless, the figures for both value and volume remain historically high for the first nine months of the year.
- Early stage and expansion capital deals picked up what was already a very brisk pace of activity. The volume of deals accelerated to 115 from 103 in the second quarter, the highest figure for four years. The value remained at the same level, a robust £1.8 billion. The total value for the first nine months of 2018 is only marginally down on the record figure for the same period last year.

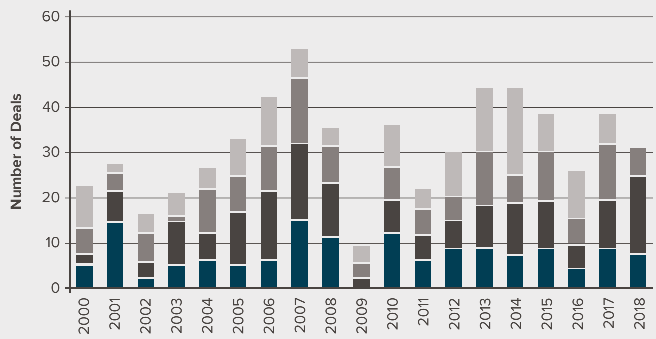
Sub-£150m Buyouts Volume



Sub-£150m Buyouts Value



£150m+ Buyouts by Volume



Key: Q1 Q2 Q3 Q4

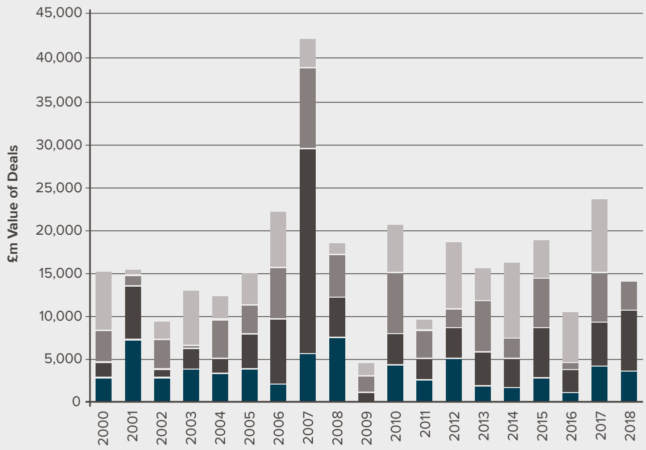
With debt still freely available at competitive rates from a variety of sources, all equity buy-outs remain in the doldrums. The number of such deals fell from four to two in the third quarter, representing only 3% of all deals.

If the overall pace of activity in the market is strong, what does our latest survey tell us about the outlook for the rest of 2018 and beyond? The headline is that we see nothing to suggest a weakening of deal volumes or values.

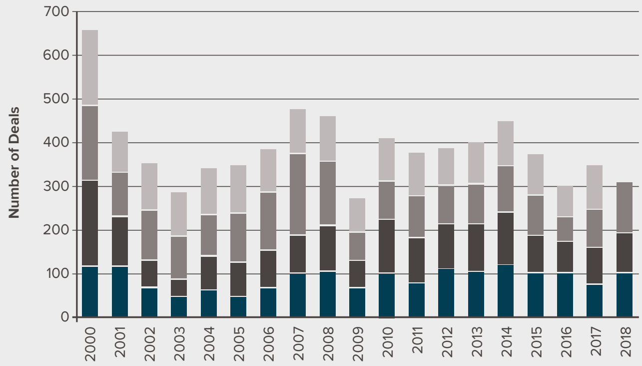
- Sentiment has actually improved for the smaller value segment, with the percentage of respondents predicting an increase in deal volumes rising from 50% to over 70%. The remainder is evenly split between neutral and negative expectations.
- For the larger value segment, the outlook is marginally less upbeat. That said, the optimists still outweigh the pessimists by 29% to 14%, with the rest forecasting broadly similar volumes.
- No end to the current environment of debt availability is in sight. None of our respondents forecast that funding would become any less readily obtainable, while the percentage expecting an increase in debt availability actually rose from 17% in the second quarter to 43% now, reversing the recent trend.
- Despite the persistent flow of headlines about increased protectionism, the mood on the ground is pretty sanguine. Only 29% of those surveyed thought a global trade war would have a negative impact on the M&A market. A clear majority expected no effect, while 14% thought it might actually be positive.

Overall, our quarterly survey results (see page 4) are good news, confirming what we have been seeing in the market place. However, as we have been saying for some time, potential sellers should not be complacent. After a decade of emergency monetary policy, interest rates have now started to rise, and debt will not always be this cheap or this available. Furthermore, the shape of the Brexit deal remains unclear. While we don't believe sellers need to exit before Brexit, there's no time like the present to get the sale process started.

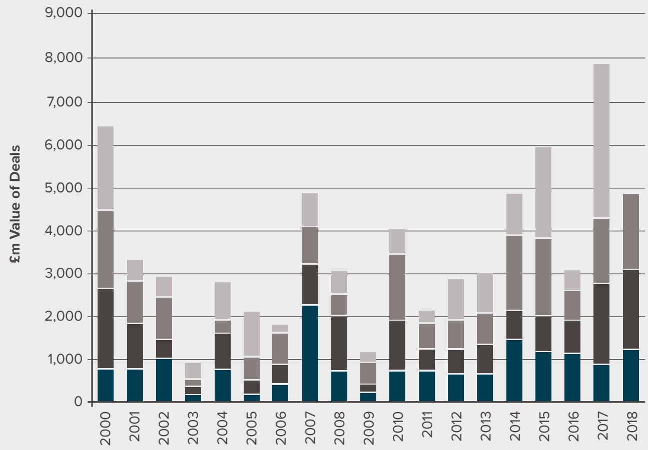
£150m + Buyouts Value



Volume of Early Stage/Expansion Deals



Value of Early Stage/Expansion Deals in £m



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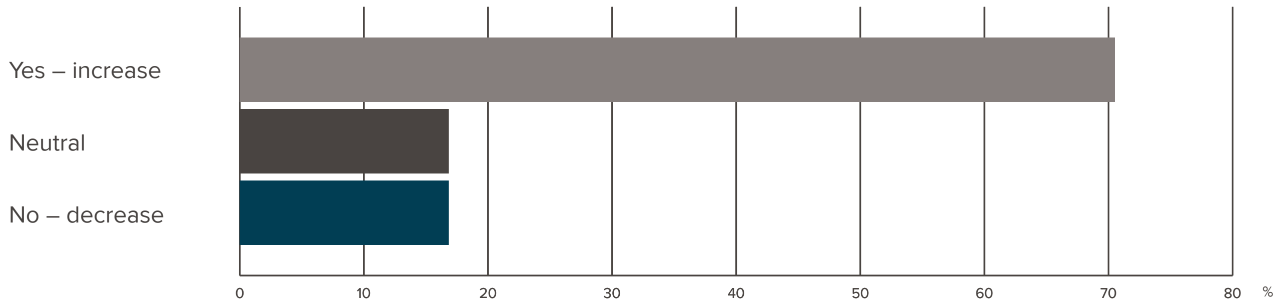
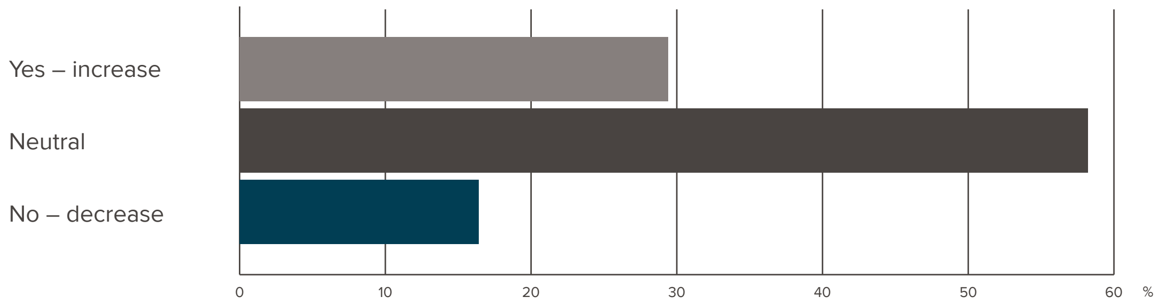
Survey of market expectations

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

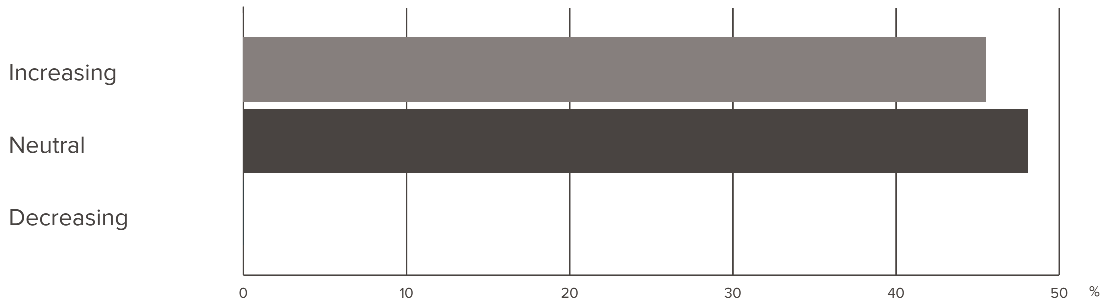
1 Do you expect deal volumes <£100m to increase or decrease?



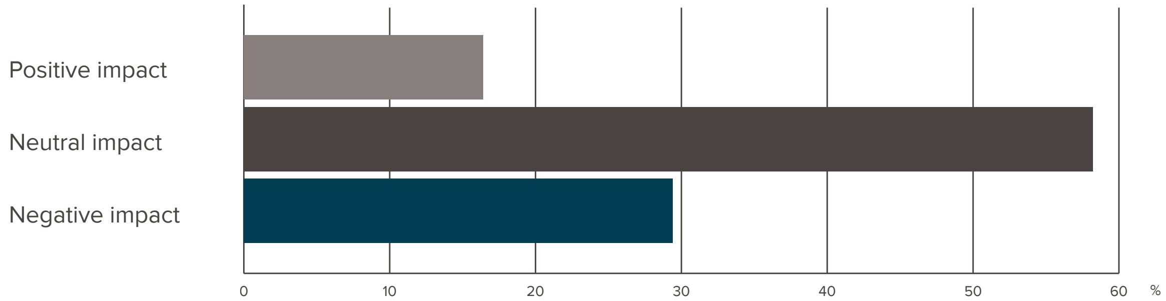
2 Do you expect deal volumes >£100m to increase or decrease?



3 Is debt availability increasing, decreasing or neutral?



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



Dechert LLP

Insuring a clean exit

Warranty and indemnity (W&I) insurance policies are increasingly being used in private M&A transactions in the UK. They can help to bridge the gap between the seller's wish to keep post-sale exposure to the business minimal and the buyer's need for recourse against warranties – essentially, promises that the company is in the stated condition when sold. Here, Jodie Valler-Feltham of international law firm Dechert LLP outlines the main types of W&I insurance policy and explains their key benefits and limitations.

What is a W&I insurance policy?

A W&I insurance policy provides cover for losses resulting from breaches of warranties or indemnities (promises by one party to compensate another party for specified losses) in a sale and purchase agreement (SPA).

There are two main types of W&I insurance policy. A "buyer-side" policy will reimburse the buyer if the seller breaches a warranty or indemnity in a SPA. Typically, the buyer will claim against the seller up to a limit agreed in the SPA (which is negotiated and can be quite low), and then the buyer will be able to claim directly against the insurance policy.

A "seller-side" insurance policy will reimburse the seller for its breaches of a warranty or indemnity in a SPA. The buyer cannot claim directly against the policy. Instead, the buyer will make a normal legal claim against the seller under the SPA or tax deed. Then, if the buyer's claim is successful, the insurance policy will compensate the seller for its liabilities.

Buyer-side policies are more commonly used in auction-style private equity deals, where obtaining a policy is a pre-condition for bidders to be allowed to take part in the auction.

The benefits of a W&I insurance policy...

A W&I insurance policy can provide the seller with a cleaner exit, by reducing the risk that liabilities may arise from future claims.

At the same time, it gives the buyer adequate warranty protection. A W&I insurance policy will reduce or even entirely alleviate the buyer's concern about a seller's ability to meet any liability arising from a breach of a warranty or indemnity in a SPA.

W&I policies often reduce the need for – or size of – an escrow account or similar retention arrangements. As a result, the seller will be able to distribute the sale proceeds immediately. For private equity sellers, this is often considered a key benefit.

...and their limitations

Certain matters will not be covered by W&I insurance policies. In general, policies will not cover liabilities arising from anything made known by a seller during the disclosure process or otherwise discovered by a buyer during it's due diligence. In addition, insurance policies will typically not cover:

- civil or criminal fines or punitive damages;
- certain categories of warranties, including warranties relating to environmental liabilities, receivables and bribery, corruption and sanctions;
- certain tax matters, including transfer pricing/secondary tax liabilities; and
- post-completion price adjustments and non-leakage covenants in locked-box transactions.

Naturally, a premium will be payable for the policy, and there will also be a negotiated excess. However, both buyers and sellers of transactions are increasingly finding that a small price to pay for the peace of mind it can bring and for the greater probability it brings of getting the deal securely over the finishing line.

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Braving the elements

With the storm clouds of rising interest rates and protectionism on the horizon, stock markets have fallen from their summer peaks. Nevertheless, as Kleinwort Hambros' Chief Investment Officer Mouhammed Choukeir argues, the current outlook is for sustained growth, mainly driven by the US, and he remains moderately optimistic on riskier assets for the time being.

From trade war to cold war

In recent weeks, trade tensions have intensified, as the US has slapped tariffs on a further $200 billion of imports of Chinese goods and threatened to tax all Chinese imports (worth $505 billion in total).

The dispute with China goes beyond reining in the bilateral trade deficit. The Trump administration is challenging China's rising economic and technological clout, and national security has become the watchword for most economic initiatives adopted by the administration to maintain US hegemony. The US-China trade spat is both strategic and ideological and is therefore unlikely to unwind soon. The impact on future global trade flows is set to be profound.

Macro fundamentals trump politics

Despite mounting downside risks, the macro backdrop is supportive. Monetary policies remain accommodative and fiscal policies are being relaxed – massively in the US, more moderately in the eurozone and China. Nominal growth is soaring, lifting corporate profits. Increased capital expenditure bodes well for a longer business cycle as it expands production capacity, encourages hiring and paves the way for a pick-up in productivity.

In the short run, this goldilocks environment should prevail, notably in the US. Corporate margins in the US should remain protected by modest wage inflation, the impact of dollar strength on import prices and limited upside for commodity prices. In the eurozone, growth is still running above potential but has started to slow, while European companies have less pricing power than their US competitors, as their profits depend more on global growth.

According to our proprietary model, the probability of a US recession is still low (22%) over one year. The global economy should remain resilient to political risks so long as they do not coincide with trade tensions.

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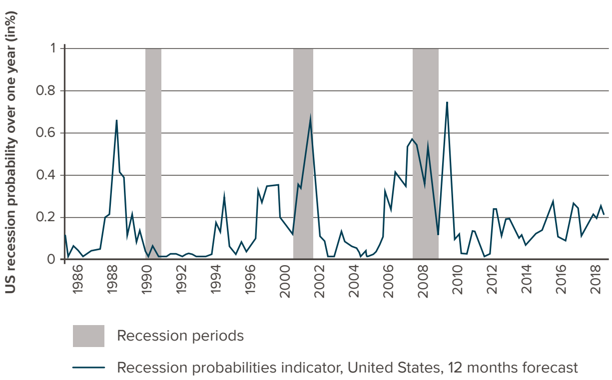

Investment implications

In the current environment, we remain moderately in favour of riskier assets, while remaining vigilant for signs of worsening political tensions. Our highest-conviction positions include:

Prefer equities to bonds – despite growing political risks, company earnings should remain supported by solid global growth and by looser fiscal policy. Interest rates may rise further, denting overall bond performance.

Prefer US equities to Japan and Europe – US corporate earnings should grow over 20% in 2018 thanks to tax cuts. The pace is likely to be more moderate in Japan and Europe, amid concerns about the trade war.

Too early for emerging equities – The longer-term outlook remains positive for emerging equities. However, with trade tensions intensifying and US interest rates rising and with earnings yet to pick up, it is still too early to go bottom-fishing.

Prefer credit to government bonds – Steadily increasing inflation will lead to further rate rises. Bond markets will suffer, but pockets of opportunity remain in credit markets. Given inflation risks, we favour shorter maturities, especially in the US.

Yield hunting in the eurozone – Investors hunting for returns will be attracted by high-yield bonds and hybrid debt in the eurozone, which should benefit from easy funding, investor risk appetite and low default rates in the coming months.

Favour cash-rich companies – Companies with plentiful cash and low leverage should outperform as interest rates continue to rise. These companies will also have greater pricing power, which should help them to keep growing earnings.

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