Q3 2020

UK Private Company Director

Welcome to the October 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 which we believe will be of interest to directors:

- The volume of private company deals bounced back in the third quarter of year, and buyers still appear willing to pay proper valuations, especially at the smaller value end of the market (pages 2 to 4).
- Two main pricing mechanisms are used to determine the equity price paid for businesses, but what are the pros and cons and which will buyers favour in the current environment (page 5)?
- With the US presidential election looming, it's a good time to look at what the historical evidence tells us about market returns under Democratic and Republican presidents (page 6).

Best wishes,

Megan Peel

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Corbett Keeling Corporate Finance

Dechert LLP

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Remarkable resilience

The COVID-19 crisis has caused the severest economic downturn in living memory. Yet the UK market for private company transactions has remained resolutely open for business. Looking at the latest data, Jim Keeling of corporate finance advisor Corbett Keeling finds particular strength at the lower value end of the market.

In recent weeks, the extent of the economic damage from the coronavirus crisis has become increasingly clear. Meanwhile, the rising case count shows the difficulties of escaping from the lockdown and reminds us of the continued toll on the nation's health. Faced with this, owners of private companies who are looking to sell might be inclined to feel a little gloomy. And yet I see several reasons for cautious optimism.

First, activity in the market has remained brisk, particularly in the smaller value segment of the market. I will analyse the data in more detail below, but my personal experience is that plenty of deals are still being done. That is reflected in our survey of market participants, which shows a reassuringly sanguine mood.

The government and the Bank of England have also taken extraordinary steps to support businesses. One example which will clearly be of interest to anyone contemplating the sale of a business is the Chancellor's welcome decision to postpone the proposed increase in Capital Gains Tax.

Furthermore, global stock markets – which often provide a good indication of the future path of the economy – have stabilised in recent months.

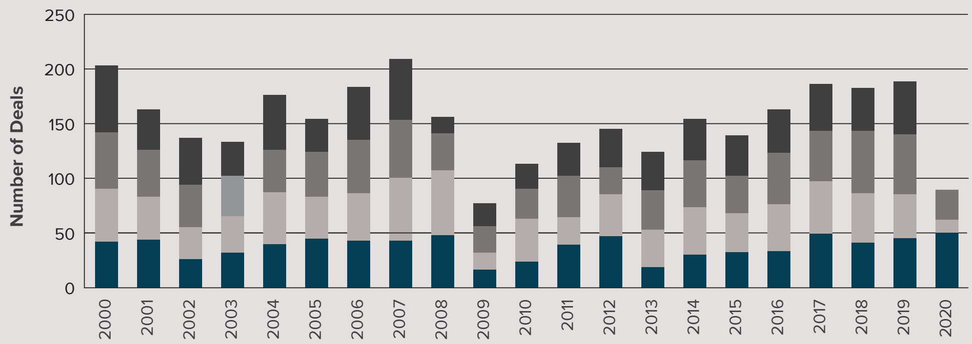
Most of all, though, I am encouraged by the large number of well-funded private equity and trade buyers who are still actively looking for opportunities to buy businesses. And I'm delighted to report that many sellers are obtaining high valuations.

Yes, the current environment is tough for many business owners. But I have been impressed by the resilience shown by everyone in the market and their determination to keep getting deals done.

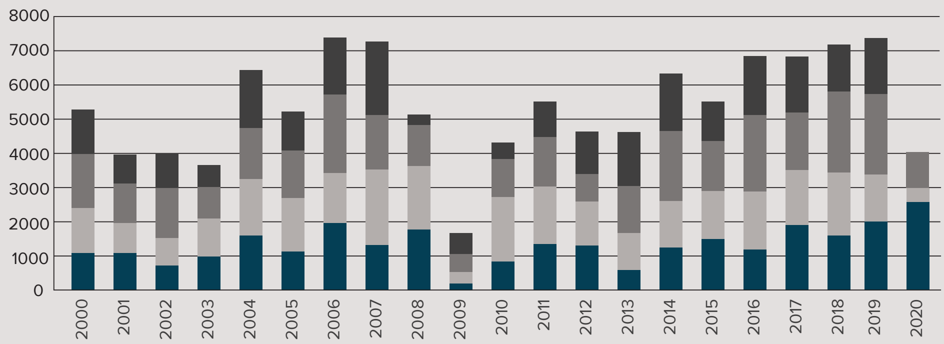
Assessing the deal data

After a steep decline in the second quarter, the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) staged something of a bounce back. The volume of deals rose from 12 to 27, and the value leapt from £420 million to £1 billion. While these figures for both volumes and value were well down on the recent quarterly average, they were appreciably higher than in the aftermath of the global financial crisis.

Sub-£150m Buyouts by Volume



Sub-£150m Buyouts by Value

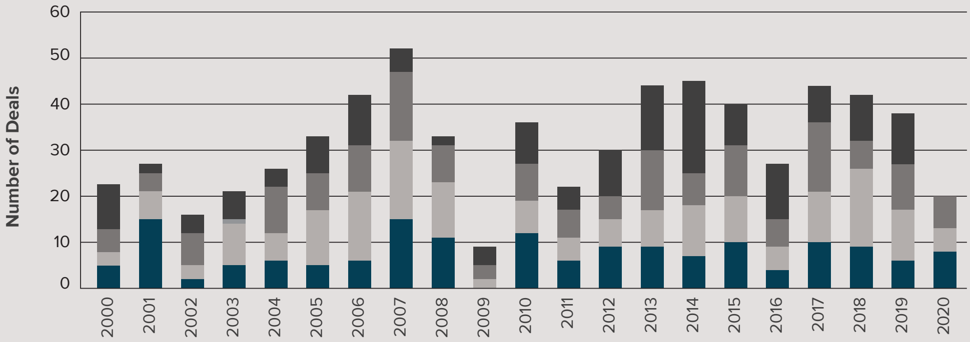


Key:

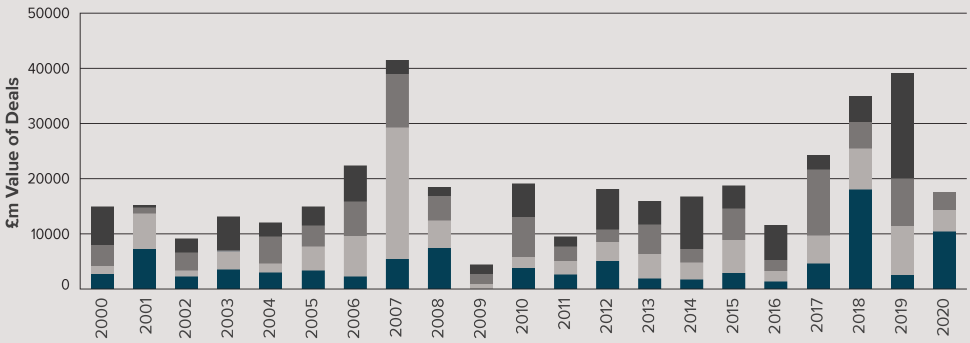
- Q4
- Q3
- Q2
- Q1

The **larger buy-outs** sector (enterprise value of £150 million or above) was little changed from the second quarter, when it was the least hard hit segment of the market. The number of deals rose from five to seven, around the long-term average. However, the value of transactions was down from £3.9 billion to £3.2 billion.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value



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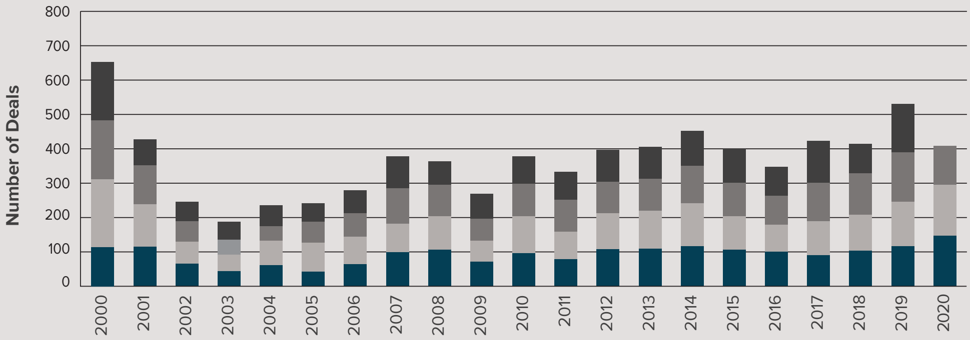
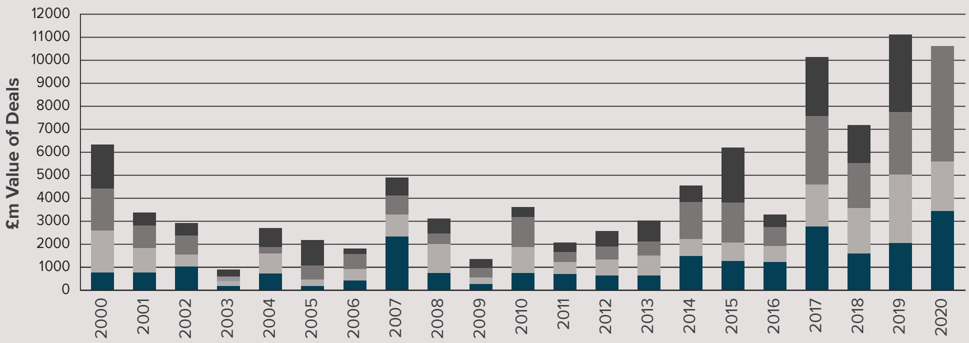
Early-stage and expansion capital deals had been easily the most resilient segment of the market during the second quarter, with volumes almost matching the recent record level. In the latest three months, the number of transactions declined from 147 to a still respectable 114. However, the value of these deals surged from £2.2 billion to a staggering £5 billion, comfortably the record quarterly figure for this segment, setting it on course for a record yearly total.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



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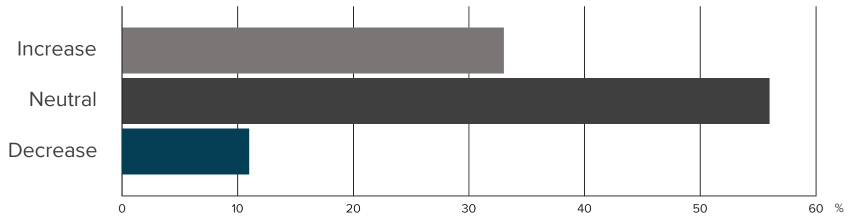
So what does our latest survey suggest?

Even after seven months and counting of COVID-related restrictions and the severe toll on the economy, the mood among market participants remains encouragingly upbeat.

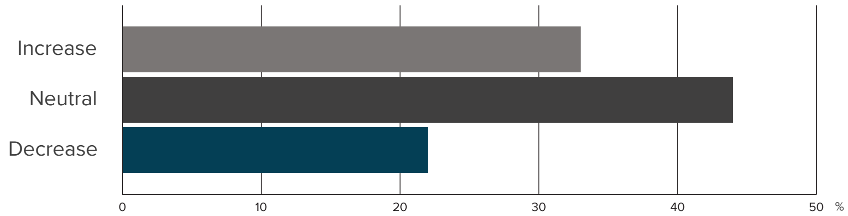
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months held steady, at 33%. However, the proportion forecasting a drop in activity halved, falling from 22% to 11%. The majority (56%) expect activity to remain around current levels.



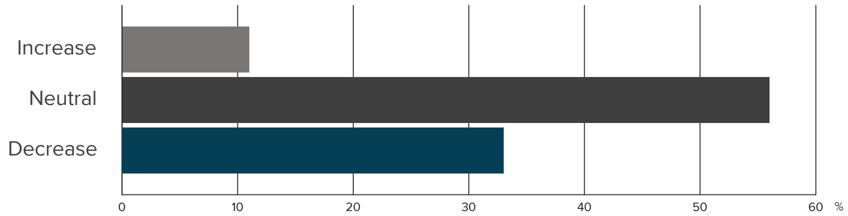
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment, the survey shows a slight increase in optimism, with a third now expecting an increase in activity, while only 22% predict a decline.



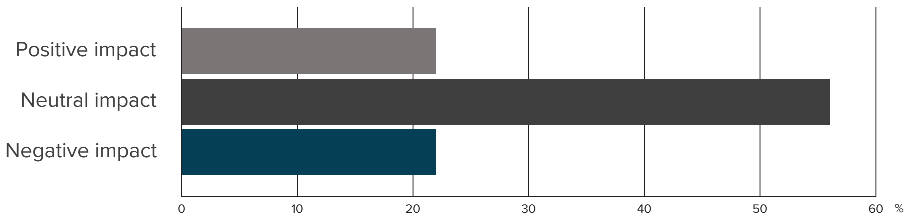
3 Is debt availability increasing, decreasing or neutral?

One slight concern is that the proportion of respondents saying that debt is becoming less available rose from 11% to 33%. That outweighed the 11% reporting an increase in debt availability.



4 On balance, how has the impact of Covid-19 affected your portfolio companies?

When asked how the restrictions related to COVID-19 have affected portfolio companies, the majority (56%) said they had seen little impact overall. The remainder were evenly split between those reporting a positive and a negative effect.



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Dechert LLP

Pricing for a sale: completion accounts vs locked box

In a sale and purchase agreement (SPA), two main mechanisms are used to determine the equity price to be paid for the target business: completion accounts; or locked box accounts. Here, Ivo Cavrak of Decherts LLP explains how each works and what their pros and cons are for both buyers and sellers. He also assesses which is likely to be more commonly used during the COVID-19 crisis.

Completion accounts

The buyer pays an estimated equity price for the target business, which is calculated by adjusting the agreed enterprise value for the estimated levels of cash, debt and working capital as of completion. Either the estimated equity price is written in the SPA or the seller notifies the buyer shortly before completion. Subsequently, the paid estimated equity price gets trued up for the actual levels of cash, debt and working capital, which is known as a post-completion price adjustment.

This mechanism aims to ensure that the ultimate equity price paid for the business reflects the actual levels of net cash and working capital at completion. Therefore, the economic risk and reward transfer to the buyer at completion.

Locked box

Under a locked box mechanism, the equity price is calculated by reference to a historic "locked box" accounts. The agreed enterprise value is adjusted for the actual levels of cash, debt and working capital as of the date of the locked box accounts. The equity price is fixed ahead of completion, and there are no post-completion adjustments. Instead, the buyer will rely on contractual protections that, since the locked box date, the seller has been running the business as normal and has not extracted value from the business. This is known as leakage protection. The economic risk passes to the buyer at the date of the locked box accounts, not at completion.

Key pros and cons of completion accounts

Pros for buyers	Cons for buyers
• Economic risk transfers on completion • Speed of execution	• Price uncertainty and cost: delay in ascertaining final price & potential dispute over post-completion adjustments
Pros for sellers	**Cons for sellers**
• Economic reward transfers on completion	• Same as for buyers

Key pros and cons of a locked box

Pros for buyers	Cons for buyers
• Price certainty • Simplicity of the SPA • Cost savings, as no post-completion adjustments	• Economic risk transfers at the locked box date
Pros for sellers	**Cons for sellers**
• Economic risk transfers at the locked box date • Same as for buyers	• Economic reward transfers at the locked box date

Making the right choice in the COVID-19 era

Completion accounts are generally regarded as buyer-friendly, as the economic risk transfers only on completion. At times of economic uncertainty, buyers are usually less willing to take a gamble on the business's performance between the locked box date and completion. As a result, we are expecting to see a downward trend in the usage of locked box deals in the COVID-19 era.

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US election: taking the long view

Memories are short. Before the last US presidential election, investors were worried that Donald Trump might win. Now, they seem nervous about potential tax rises under a Joe Biden presidency. Fahad Kamal, Chief Investment Officer of Kleinwort Hambros, argues that looking at history can give us invaluable perspective.

Some of the market's concerns about this US election may have validity. For instance, US corporate taxes are likely to increase under a Biden presidency from 21% to 28%. Yet that is still well below the tax rate in several major advanced economies (e.g., Australia, France). Besides, large US companies have probably already repatriated waves of foreign-held cash during the last few years of favourable tax treatment.

But that is not our main consideration. As long-term investors, we don't focus on the election and its aftermath. Rather, we try to work out where we expect markets to be in five years' time. Why?

Firstly, no one knows who will win the election, if it will be controversial or how markets will react. And, in recent years, unexpected election outcomes have often been followed by equally unexpected market reactions. Anyone who sold shares after Trump's victory four years ago would have missed out on the strong rally in stock markets in the US and globally.

Secondly, history suggests there is little to choose between the two main US parties in terms of equity market performance over the long term. We looked at the period for which we have reliable data for US equity market performance, which begins in Rutherford Hayes's presidency (1877 – 1881). From then to now, the average real (i.e., net of inflation) annual equity market return is +7.3% for Democratic administrations – and an almost identical 7.4% for Republicans.

Regardless of the party in power, returns tend to average out over time. That's probably because the US enjoys the rule of law and established institutions that handle the basics of governance (e.g., enforcing contracts, ensuring peaceful transfers) relatively well.

Some say that the situation is different now. We disagree. The political divisions are deep, but that's nothing new. Sadly, we've seen race riots before. Arguably, the US was far more divided – and racial tensions even more embittered – at the time of the landmark civil rights legislation in the 1960s. Contested elections are not new. Four US presidents in the last 150 years have lost the popular vote but gone on to occupy the White House via the electoral college. Most recently, Al Gore was pipped by George W. Bush because of a few hundred "hanging chads" in Florida. Major scandals are not new either. Think of Watergate, the intelligence supporting the wars in Vietnam and Iraq and, for those with longer memories, the 1920s Teapot Dome bribery scandal.

The bottom line

As we have noted before myriad previous geopolitical risk events, our investment process seeks to evaluate the long-term fundamentals rather than focus on short-term movements. The aim is to ignore the noise surrounding these events and look to what we consider the invariable drivers of asset returns: the economic climate, valuation, momentum and sentiment. When geopolitical events impact the fundamentals, we pay attention. When they don't, we remain poised to take advantage of any excessively bearish sentiment by adopting contrarian positions.

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