Q4 2018

UK Private Company Director

Welcome to the January 2019 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.

This issue highlights:

- Private company deal making in 2018 was robust, with particular strength in the lower value segments of the market (pages 2 to 4).
- A recent High Court decision may have important implications for shareholders who are looking to sell (page 5).
- Global stock markets fell at the end of 2018 and remain volatile, but the current environment appears more supportive of equities than other types of assets (page 6).

Best wishes,

Megan Peel

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Rounding off another strong year

Jim Keeling of corporate finance advisor Corbett Keeling reflects on the past year and what 2019 has in store for deal making activity.

What a year that was! Throughout 2018, the headlines were full of doom about the possibility of a full-blown trade war between the US and China and other instances of rising protectionism around the world. Nearer to home, of course, Brexit dominated the news, with the media projecting blood-curdling predictions of mayhem for British businesses. Meanwhile, every fresh display of no confidence in the Prime Minister raised the prospect of a Labour government led by Jeremy Corbyn, whose policies could scarcely be described as business-friendly.

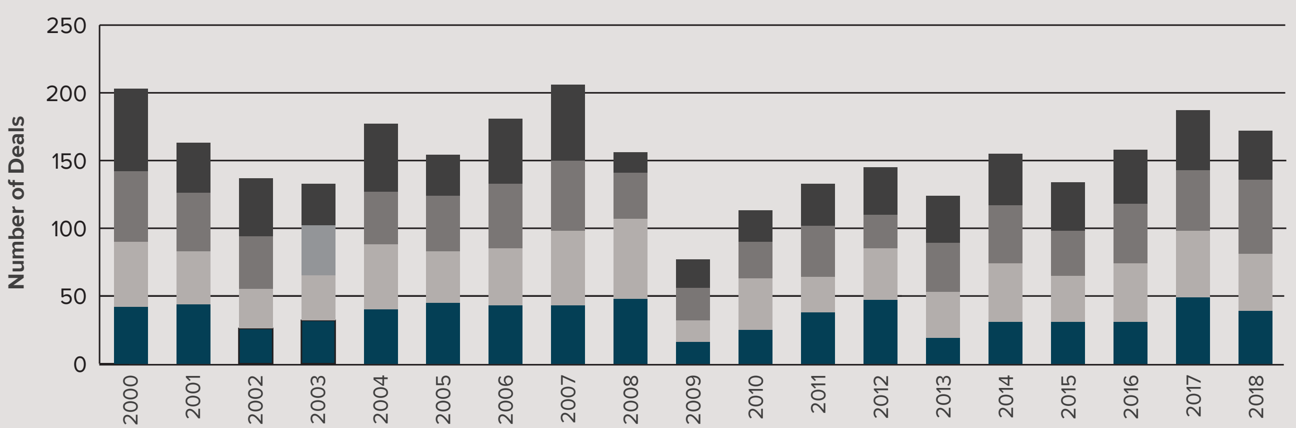
And how did the owners of private companies respond? Just as we'd expect, they rolled up their sleeves and got down to business, and that included a large quantity of mergers and acquisitions. Indeed, activity in 2018 was not far off the heights of the previous year, and the middle and smaller-value segments of the market held up especially well.

Was this a case of buyers and sellers frantically making hay while the sun was shining, or will the momentum be sustained? Only time will tell, of course. Our latest survey shows no sign that market participants are expecting a precipitous decline in activity after 29th March. Far from it.

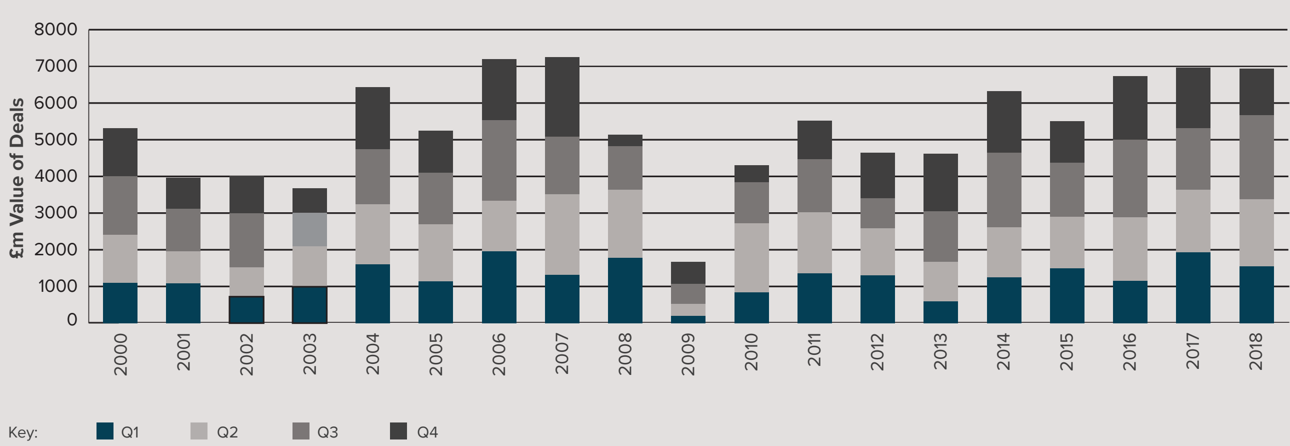
Assessing the deal data

Activity in the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) was always likely to see something of a pause in the final three months of the year after setting a new all-time high for values in the third quarter. The volume of deals declined from 55 to 36, while the value was down from £2.3 billion to £1.3 billion. These were nevertheless respectable figures, wrapping up an excellent year which will be only fractionally below the highest value since the data series began in 2000.

Sub-£150m Buyouts Volume



Sub-£150m Buyouts Value



Key: Q1 Q2 Q3 Q4

After a sluggish third quarter, the **larger buy-outs** sector (enterprise value of £150 million or above) bounced back. The volume of deals increased from six to ten, and the value soared from £2.7 billion to £5.2 billion. Although below 2017's post crisis high, the value of transactions in the year as a whole was the 2nd highest since 2010. The annual volume was comfortably above average.

Key:

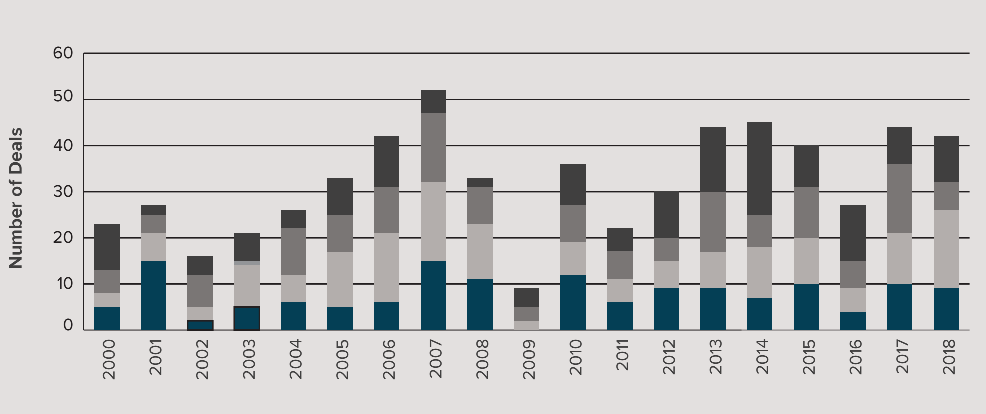
Q1

Q2

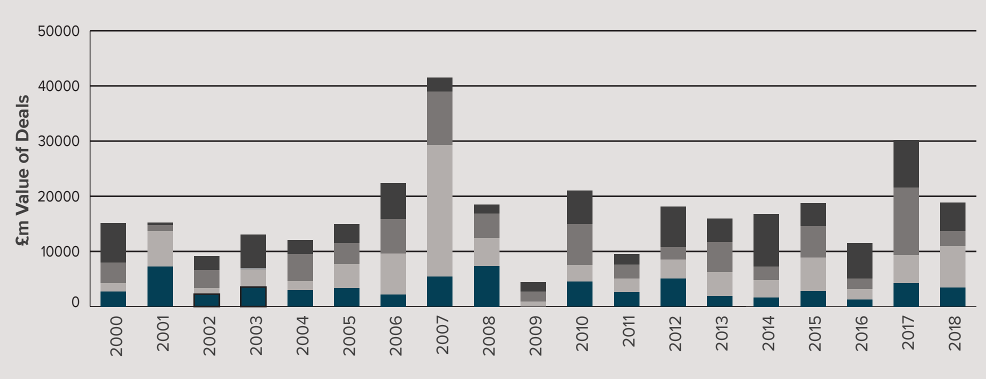
Q3

Q4

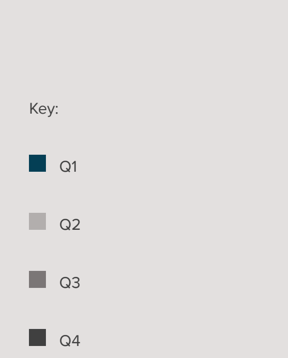
£150m+ Buyouts by Volume

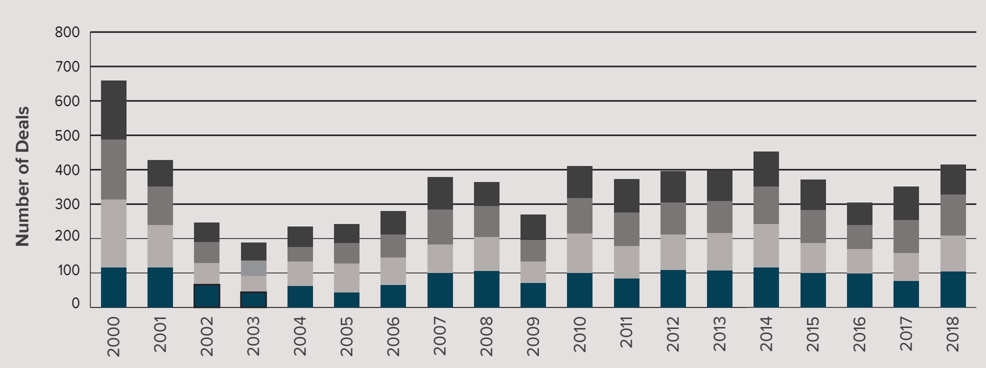


£150m+ Buyouts Value

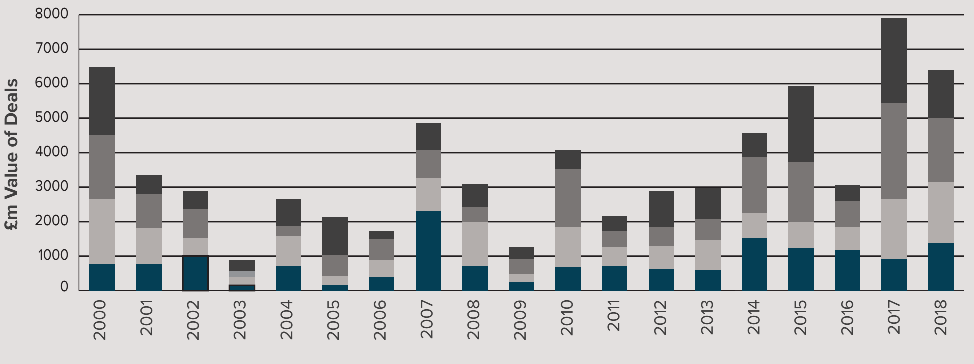


Early stage and expansion capital deals faded slightly after a very strong third quarter. The volume of transactions fell from 120 to 86, while the value was down from £1.8 billion to a still solid £1.4 billion. That rounded off a bumper year for the segment, with the volume of deals at the second-highest level since 2001, and the final figure for values likely to be second only to 2017.





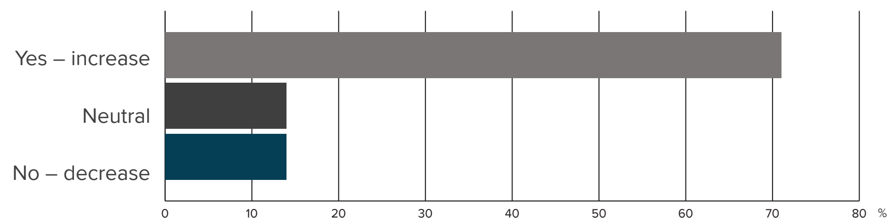
Value of Early Stage/Expansion Deals



So what does our latest survey suggest about the outlook for 2019?

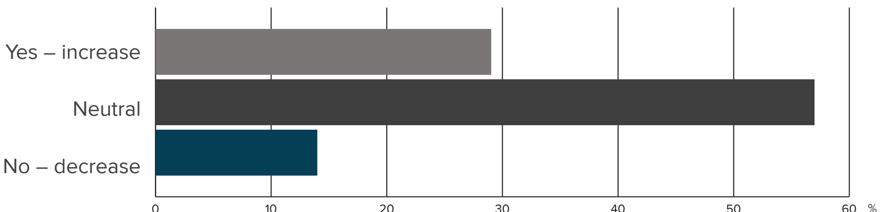
1 Do you expect deal volumes <£100m to increase or decrease?

Sentiment remained optimistic for the smaller value segment, with the percentage of respondents predicting an increase in deal volumes holding above 70% and only 14% expecting activity to decline.



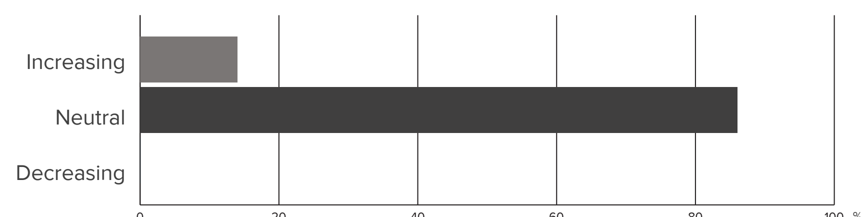
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment, the outlook remains broadly sanguine. The majority of respondents expect volumes to stay at a similar level, while twice as many expect the number of deals to rise as to fall.



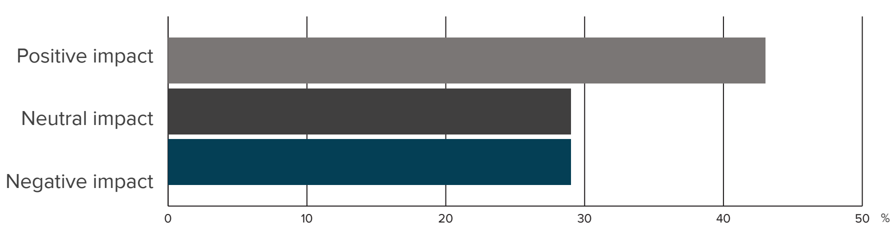
3 Is debt availability increasing, decreasing or neutral?

Market participants still see no end in sight to the current easy credit picture. None of our respondents expected debt availability to decrease any time soon, while 14% thought it might actually become more plentiful.



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

Asked what impact a global trade war might have on the UK M&A market, a perhaps surprisingly high 43% of respondents said they expected a positive impact. The rest were evenly split between predicting a neutral effect and a negative one.



With debt still in plentiful supply at attractive rates, it was little surprise that the proportion of all equity buy-outs continues to bump along the bottom. The number of deals ticked up from two in the third quarter to three in the fourth, for an annual total of 12.

We would certainly not rule out the potential for some disruption in the year ahead, particularly if the risk of a Corbyn government increases. However, the survey – and our own experience of the market over recent months – gives us confidence that sellers of privately owned businesses who know where to look will still be able to find buyers looking to put cash to good use.

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Seller beware of Greenhalgh

A recent High Court decision cast light on how the court will interpret share transfer restrictions in a shareholders' agreement. As David Nicholls of international law firm Dechert LLP explains, this could have important implications for shareholders who are looking to sell.

Rusal plc v Crispian Investments Limited concerned a shareholders' agreement entered into between the three major shareholders of PJSC MMC Norilsk Nickel, a Russian metal producer – Crispian Investments, Whiteleave Holdings and Rusal plc.

The agreement contained a right of first refusal (ROFR) mechanism, whereby Crispian was not permitted to sell its shares unless it first offered them to Rusal and Whiteleave at "the price proposed by a bona fide third party purchaser".

In early 2018, Bonico Holdings – a subsidiary of Whiteleave – offered to buy some of Crispian's shares. Crispian wished to accept and served notice on Rusal and Whiteleave to offer them the shares under the ROFR at Bonico's proposed price. Rusal claimed that the ROFR notice had not been validly served as Bonico was not a "third party" and argued that Bonico had inflated the price to deter Rusal from exercising its ROFR.

A question of interpretation

The court ultimately determined that Bonico was not a "third party" but, in doing so, it made some interesting comments about how a shareholders' agreement should be interpreted.

When interpreting a commercial contract, the court usually focuses on the objective meaning of the language the parties have agreed. However, Crispian argued that it should apply the Greenhalgh principle – that a share is personal property and should be freely transferable, with any ambiguity in the restriction resolved in the seller's favour.

The court has generally only applied the Greenhalgh principle to a company's articles, but a recent case had suggested the Greenhalgh principle could also apply to shareholders' agreements. In Rusal, the court concluded that a shareholders' agreement is a private agreement negotiated between the parties and should be interpreted according to normal contractual principles. However, a company's articles apply to all shareholders whether or not they had a role in negotiating them and therefore warrant a narrower interpretation.

Although a superior court may reach a different conclusion, the decision not to extend the Greenhalgh principle to shareholders' agreements is a good result for sophisticated investors who are keen for carefully negotiated transfer restrictions to be upheld.

Draft carefully

Some questions remain about which document should include share transfer restrictions:

- Restrictions in a shareholders' agreement are generally easier to enforce, as the court should give weight to the fact that the parties adopted them voluntarily.
- If the desire is for a wrongful share transfer to be ineffective and not just a breach of contract, the restrictions should also be included in a company's articles, but these are publicly filed and available to third parties.

Restrictions can be mirrored in both the articles and the shareholders' agreement. However, if the wording diverges between the two documents, it is uncertain how a court would interpret any discrepancies. Any material overlap may also make it easier for a prospective transferee to argue that the shareholders' agreement is "standing in" for the articles and so the Greenhalgh principle should apply.

In summary, drafting transfer restrictions in corporate documents is complicated. Unless clear language is used, the court may interpret in favour of a shareholder looking to sell. Taking legal advice when drafting documents will give you the best chance of achieving your desired outcome.

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Looking through the volatility

Global stock markets plunged at the end of 2018 and remain volatile. Mouhammed Choukeir, Chief Investment Officer of Kleinwort Hambros, argues that such declines are normal and market conditions in fact suggest that equities look likely to perform better than other types of assets over the course of this year.

Most investors had a poor last quarter of 2018. In December alone, the US market tumbled by 9%, its worst December return since 1931, when it dropped 18% during the Great Depression. There was no single cause for this sudden risk-off turn, but we would point to the following factors:

- **Higher interest rates and the prospect of further rate rises in the United States** – The US Federal Reserve remains poised to continue its monetary tightening by both raising interest rates and reducing its balance sheet. This is draining the liquidity which has underpinned global stocks for many years.
- **The US-China trade dispute intensified, adding further downside impact to slowing global economic growth** – Markets remain unnerved by evidence of the slowing economy in China, partly attributed to the impact of the trade dispute.
- **Brexit and other European issues** – These include rows over the Italian budget, unrest in France and a change of leadership in Germany.
- **Doubts about the sustainability of the spectacular growth of the champions of the US technology sector, and about corporate health in general** – Debate still rages over whether the surge in US profits can last when the effect of the Trump tax cut runs out, and whether falls in unemployment will eventually lead to higher wages at the expense of profits.

Yet most of these factors are concerns for the future as much as actual bad news, which we believe makes room for positive surprises. For example, the Fed might decide that interest rates do not need to rise as much as they hinted in December, or material progress may be made towards resolving the US-China trade dispute. It is also worth noting that equity and credit markets have become significantly cheaper than they were three months ago. This is at odds with the reasonably robust global macroeconomic backdrop – despite a deceleration, a recession is far from imminent – and strong corporate earnings, coupled with low rates of defaults.

Indeed, much of what we witnessed in the fourth quarter is relatively normal: equities are a volatile asset class, and sell-offs of more than 10% occur most years. Over the long run, however, equity returns are very compelling, especially when compared with returns from other asset classes. Volatility, and sometimes sharp falls, are simply the price investors have to pay for those superior long-term results.

In real time, it is impossible to know if this current sell-off in equities is just “noise” – a typical correction – or if it is a precursor to a bear market and further losses ahead. We rely on a dispassionate process to guide us, taking into account the current economic regime, along with indicators of valuation, momentum and sentiment.

At present, the global macroeconomic environment remains supportive of risk assets and corporate profits. Moreover, equity valuations are fair: the often cited price-to-earnings ratio for US equities is 14.8 times the next 12 months’ earnings, appreciably cheaper than the 17.1 times at this stage last year; other regions of the world remain cheaper still. Equities remain far more attractive than most other investments. Furthermore, sentiment is broadly negative, suggesting that the bulk of the selling may already have occurred. However, momentum is clearly in a downtrend, which gives us some grounds for caution. We continue to monitor market conditions closely.

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