Carlton Strategy Advisors Limited
Commercial | Market | Advisory
NEWSLETTER

CSA Insight | November 2019

CorporateLiveWire Private Equity Round Table

Pictures by CorporateLiveWire

Introduction and Contents

The private equity landscape is changing with competition between investors, increased regulatory pressure and low interest rates shifting the way managers invest. David McClelland, Director, Carlton Strategy Advisors discusses the latest investment strategies and trends in the UK deal market in an extract from his contribution to a Private Equity Round Table, published by CorporateLiveWire in October 2019.

Q1. Can you talk us through the current private equity landscape?
Q2. Have there been any recent regulatory changes or interesting developments?
Q3. What investment strategies and acquisition trends are currently being implemented by PE firms?
Q4. Which sectors currently offer the most attractive opportunities?
Q5. What are the biggest challenges currently facing PE firms?
Q6. How can a PE group benefit small and medium sized enterprises?
Q7. What can an owner do to make his or her company more attractive to PE buyers?
Q8. What are the reporting requirements in your jurisdiction and how can they be efficiently managed?
Q9. What impact will Brexit have on PE markets?

***Q1. CorporateLiveWire**: Can you talk us through the current private equity landscape in your jurisdiction?*

A1. McClelland: The era of low interest rates in the UK has persuaded increased numbers of savers and investors to put their money into alternative asset classes in search of higher returns. Private equity has benefited, but new firms and funds are frequently chasing the same investment portfolio opportunities as business owners and managers defer corporate finance decision making in a flat, Brexit-stymied, economic landscape.

As independent commercial due diligence advisors to PE sponsored transactions, Carlton Strategy Advisors is seeing deals done, but slower to complete and with a greater number of aborts.

***Q2**. Have there been any recent regulatory changes or interesting developments?*

A2. Changes to UK venture capital trust rules – designed to clamp down on perceived low-risk investment schemes – have tipped many fund managers into greater numbers of smaller sized investments. As an example, a fund might have previously invested £5m in a single qualifying but relatively low risk portfolio opportunity. Now it might invest only £1-2m in a somewhat earlier stage and comparatively riskier growth capital opportunity, following this up later with second-round top-ups of £2-4m where the earlier investment has proven successful.

This has affected the traditional role played by transaction services firms, such as CSA. For instance, due diligence scope on the previously qualifying and larger-sized deal had tended to be more encompassing, as investors sought greater comfort before backing the bigger ticket transaction. Presently, CSA is seeing VCT funds carry out relatively light scope diligence on these lower valued investments: often tech companies able to demonstrate initial proof of concept across a still limited business base in need of further expansion capital; for example, to take on addition people or fill out particular resource gaps. As these companies go on to seek increased funding in order to solidify the totality of their proposition, the funding VCT may seek additional diligence (e.g. research to more comprehensively understand regional market opportunities and references to test customers' evolving preferences and attitudes towards emergent technology, and around the true market quantum or services fulfilment level). One issue identified by CSA is where an investee tech business has had a particularly enthusiastic product technology champion in a constricted customer base. In such circumstances it may be prudent to further stress test indicative demand within the wider customer universe ahead of the intended injection of the extra development capital.

***Q3**. What investment strategies and acquisition trends are currently being implemented by PE firms?*

A3. Well-funded, UK PE investors are having to 'work harder' to identify and pursue potential investments. Due diligence has become more rigorous at the same time as many PE houses are changing their adopted modus operandi in order to better differentiate their proposition. Most mid-market PE firms are sector agnostic, functioning on a typical portfolio investment cycle of three to five years. However, some are increasingly prepared to adopt longer hold periods, looking for the on-going yield more so than the standard expected three-times return on exit.

***Q4**. Which sectors currently offer the most attractive opportunities?*

A4. Whilst some PE investors search out businesses in markets offering accelerated growth, others look for safer passage from proven and robust trading fundamentals. Overall, CSA is witnessing client investors becoming increasingly attracted to businesses operating in sectors driven by favourable structural change be it socioeconomic, technological and environmental or other. PEs appear to have become less willing to invest

in businesses where patterns of trade simply follow the cyclical phasing of the developed economy. Family offices are often the exception, taking up longer term positions in traditional businesses able to demonstrate a track record of trade across several historical economic cycles.
From recent project work, two sectors where CSA believes there are opportunities for value creation through strategic, operational or management initiatives in conjunction with private equity are:

- Eyewear products and related eye care services, where consumers are buying branded reading glasses and sun glasses, and making repeat product purchases as one fashion label sparkles and another wanes. Additionally, an ageing population and rising obesity (triggers of diabetes and glaucoma) fuels demand for ophthalmology equipment and services.
- Online order fulfilment and related building construction services, where the growth of online shopping and home delivery has fuelled demand for logistics warehousing and regional retail distribution hubs. Aside from demand for both permanent and temporary labour as a result of the resident workforce, big-box warehouse construction requires to be fitted out with extensive internal hardware ranging from integrated conveyor belt systems, robotic stacking machinery and equipment, HVAC, CCTV and access control together with all their automated supporting process controls and management information systems.

***Q5**. What are the biggest challenges currently facing PE firms?*

A5. The biggest challenge currently facing the UK PE community emanates from the high level of direct competition between the different deal sponsors, including that from the noticeably more active family offices. In mitigation, PEs are tending to carry out a greater quantum of business pre-screening and market analysis in order to identify potential 'off market' portfolio company investment opportunities; either doing this work themselves or with the help of independent consultants, such as CSA. Otherwise, PEs can become party to 'beauty parades' with all of the associated costs, risks and uncertainties of pitching to a company or business considering a sale, MBO or other corpfin event.

***Q6**. How can a PE group benefit small and medium sized enterprises?*

A6. When a PE commissions independent due diligence as a potential financial backer of a business enterprise, the reporting output enables the business and its senior management team to 'see itself as others see it'.
Commercial due diligence reviews target company strategy and direction; competitive standing in the supply chain and relations with customers/suppliers/market middlemen as drive forward revenues and influence profitability. Full scope CDD will also recommend performance improvements for consideration in the post deal environment.
Diligence affords the potential investor the opportunity to sit down with a company's owners and management – forewarned and pre-armed – ahead of further conversations about business valuation and the opportunities arising for the enterprise within the timeframe relevant to the intended PE investment cycle.
Most PEs will take a seat on the investee company's board, depending on the level of its equity holding and other matters. Some PEs are more 'hands-on' and operationally active in their management of the portfolio business than others. The investment director leading the transaction for the PE may fulfil that role, but often the business will be placed into the care of a dedicated portfolio director. In other circumstances, the PE may introduce someone with recognised sector expertise or particular functional skills. Much of these matters will have been identified from the results of the due diligence and PE preplanning. However, the end benefit to the portfolio business will be dependent on the exact nature of the transaction. Is there a competent tier-II management team remaining within the business to support the deal going forward? Such as in the case of an MBO. Or, is the PE expected to bring in a new executive chairman or CEO to replace outgoing company management? Such as with a BIMBO.

***Q7**. What can an owner do to make his or her company more attractive to PE buyers?*

A7. All business owner's and management teams looking to attract PE investment should do some 'housekeeping' and be prepared to 'dress the business' for best presentation in order to attract a suitor. However, business owners and managers may have never run a major corpfin event or lack the confidence to do so. One option is to bring in the services of a third party professional, usually a corporate finance 'lead adviser'. The advantage of this approach is usually in terms of accelerated deal timing, knowledge of business sector valuations and established contacts within the PE community. Additionally, the lead adviser will help in

the design and population of the usual electronic data room; the initial focus of the buy-side PE team, inclusive its accompanying advisors.

The lead adviser will work with company management to prepare an initial information memorandum for circulation to all interested parties as a business prospectus. This usually focuses on such fundamentals as business ownership and structure; historical trading and forecast; market size and growth rate, competitive position and market share; customer rankings and business performance indicators deployed in the business. Often, the IM is augmented with additional vendor due diligence, as if to save the PE from having to do this at a later stage of the transaction.

No company's system of management reporting is perfect; but it is our experience from 10 years' of conducting due diligence that one can quickly identify which management team has, or has not, prepared well. Business managers can substantially underestimate the intensity of the PE investment process, something we can soon see after submitting our request for information upon project commencement. When it happens, we may have to recommend that the process is stopped until the company is better prepared.

A common issue is where company information is 'locked in a particular manager's head' and 'things have always been run this way' or 'there is no need to keep or track that type of data'. One remains pragmatic about what level of management information a target-co should be expected to have to hand within the data room or access on request, but it is CSA's experience that levels of quite rudimentary information, which may have served the company adequately over the years, may well be insufficiently comprehensive or thorough to suit the portfolio reporting requirements of the PE as an on-board investor.

Management accounts, trading forecasts and other management reporting information in smaller-sized businesses are frequently prepared by somewhat junior and part-time finance clerks or managers. Much can be gained if this is recognised by the business vendor or prospective MBO team in advance of the transaction and addressed in the form of an interim FD or ACA, for example. Requested and reviewed facts and figures obtained from the pre-deal due diligence often becomes 'bread and butter' management information in the post deal environment.

***Q8**. What are the reporting requirements in your jurisdiction and how can they be efficiently managed?*

A8. Pre-deal commercial due diligence, where it is a mandated requirement of the prospective PE sponsor, is typically a five to six week reporting process. This timescale, however, is dependent on the size and complexity of the transaction, including numbers of revenue streams and profit centres reviewed. CDD is frequently the first activity to kick off at the start of a client transaction, followed by financial DD and any other due diligence the PE client requires. CSA's approach to CDD is in itself heavily process based, consisting of a number of parallel work streams or modules, depending on exact scope:

- Review of the business's historical trading numbers and forecast
- One-to-one interviews with company senior management re- strategy and direction
- Desk top market research, inclusive of competitor analysis
- Customer referencing (lost customers, suppliers, agents/distributors)
- Opinion of 'deal attractiveness' and steps to improve trading performance

***Q9**. What impact will Brexit have on PE markets*

A9. The UK general business landscape has changed in the last three years and since the EU referendum in June 2016. CSA industry research and customer referencing evidences increasing instances of domestic businesses acting to curtail, or defer, capital investment decisions at the same time as overseas investors shy from inward investments.

Where a target company's revenues have been derived from sales of a primary capital item, followed by a secondary consumable (operational expenditure), we have seen sales of the former decline as the latter have increased. Stockholdings having increased as UK importers and their export customers have both bought forward in anticipation of possible crosschannel logistics disruption and tariff or non-tariff barriers to trade arising from Brexit. Many businesses are consequently 'buying from the future', implying that today's rosy trading figures may be pumped, raising questions about valuations against prospects for trade in the longer term.