Reuters Legal News

UK capital markets: Everything must go?

By Andrew Gillen, Fabian McNeilly and Laura Kelly, Travers Smith LLP

DECEMBER 14, 2022

For a financial buyer with dry powder to deploy, the London Stock Exchange offers attractive opportunities. From 1 January-30 November 2022, 45 firm offers were announced for UK-listed companies, with 64% coming from overseas, including 22% from U.S. bidders. In September, the Financial Times reported that UK companies with an aggregate valuation of £41 billion have been acquired in the first three quarters of 2022.

This has prompted many to ask — is everything in UK plc for sale?

The movement in foreign exchange rates has made takeovers significantly cheaper for an overseas buyer, particularly a U.S. buyer. This is particularly the case for the many UK-listed companies that derive a significant proportion of their revenues in U.S. dollars or other stronger currencies.

In Part 1 of this article we give our insights into takeover opportunities in the UK and issues that may arise for international bidders. In Part 2 we will also look at the impact on different sectors and how UK-listed companies can avoid opportunistic advances, and ask whether, in view of the global context, this M&A bonanza is really a threat to the UK listed market.

Takeovers in the UK: Is regulation a barrier?

For a long time, the regulated, uncertain and public nature of takeovers curbed the enthusiasm of financial buyers looking for a slick M&A process and low execution risk. More recently, competition for overpriced assets forced international and domestic private equity bidders into the public markets, where they discovered they could, in fact, play the game rather well.

Takeovers are still, however, a highly specialised field, where the Takeover Panel regulates acquisitions via the UK Takeover Code (the **Code**) to ensure equality of treatment and information for shareholders, avoid false markets in target shares and prevent companies being hindered by a drawn-out offer process. Unlike private M&A transactions, takeovers take place in real time and usually in the public eye.

In this environment, it pays to have experienced advisers with a deep understanding of the process and an ability to react rapidly to changing events.

Trending: Why are UK targets so attractive right now?

Valuation: Whilst there are many different methods of valuing a company, some estimates put the relative discount on the price of UK equities as high as 45% compared to U.S. peers and even 20% against EU comparators.

Foreign exchange (FX) rates: Although the pound has recovered significantly against the U.S. dollar from the lows experienced immediately following the calamitous "mini-Budget" of the short-lived Truss administration, it is still trading in the low 1.20s, around 15 cents lower than the mid-to-high 1.30s enjoyed over the preceding 12 months.

This movement in FX rates has made takeovers significantly cheaper for an overseas buyer, particularly a U.S. buyer. This is particularly the case for the many UK-listed companies that derive a significant proportion of their revenues in U.S. dollars or other stronger currencies.

Economic instability and the threat of recession: COVID-19-related protections have kept many companies alive but on life support. Additionally, lockdowns and a sluggish recovery have continued to have a material cashflow impact on issuers whilst higher interest rates, high inflation and energy costs are substantially increasing operating costs. Although these factors affect businesses globally, the UK's economic recovery has lagged other countries, leaving an increasing number of companies facing financial distress. Such companies will be more willing to entertain more speculative approaches to try and preserve some value for shareholders where the alternative is insolvency.

Additionally, the Takeover Panel is currently consulting on amendments to the Code to give it more flexibility to waive the requirements of the Code in exceptional circumstances, such as where a company is in serious financial difficulty. This is likely to make it easier for a buyer to acquire a distressed asset.

Private equity and financial sponsor 'dry powder': Whilst many bidders on UK takeovers so far this year have been corporate buyers, we see an increasing interest from sponsor clients in exploring "Public to Private" or "P2P" takeovers (takeovers where the target company is acquired by a private equity house or financial sponsor). A recent Numis survey reported that 92% of private equity

THOMSON REUTERS®

professionals specialising in 'mid-market' companies are drawing up plans for take-private deals, with 73% of respondents specifically focusing on UK-listed targets.

According to PwC, global private equity dry powder (effectively, unspent cash) stood at U.S.$2.3 trillion as of June 2022. In order to generate returns for investors, and hence drive fees for investment managers by way of incentivisation, that cash needs to be invested.

Getting technical: What do I need to know?

A potential bidder, particularly an overseas investor, considering a takeover of a UK-listed company should bear in mind the following factors in particular:

Commercial

Pricing: In a falling market, price discovery is incredibly difficult. Buyers need to balance offering a good enough price for an issuer to achieve board recommendation / shareholder acceptance with being sufficiently clear on the expected future value of a business when it comes to an exit (for private equity and financial sponsors) or strategic value (for corporate buyers).

Interest rates: Debt servicing costs have risen dramatically over the last 12 months, and credit is either unavailable or only available at significantly increased cost. This reduces the economic benefit of a highly leveraged buyout and is expected to encourage more private equity buyers (who are particularly likely to employ this acquisition model) to fund a greater proportion of the purchase price via equity, with a view to leveraging the business once debt markets are more favourable in the medium term.

Takeover Code

Management incentivisation: Under the Code, all shareholders must be treated equally and so agreeing (or even having advanced discussions in relation to) incentivisation packages with a target's management before completion is more difficult. Any package agreed upon pre-completion requires a 'fair and reasonable' opinion from the target's advisers and, potentially, approval from its shareholders. Specific advice must be taken before discussing future incentivisation with management pre-completion — a key concern in particular in the private equity sphere, with management incentivisation being an imperative consideration.

Deal protections: The Code does not permit any break fees (fees payable by a seller to a buyer if the transaction aborts), nor does it permit any exclusivity arrangements, so a potential buyer will have less certainty around the acquisition than on a private M&A transaction. Competing bidders can arise even late in the process, leading to a bidding war.

Due diligence: All bidders must be granted access to the same level of information from a target, so issuers will generally divulge less information to a bidder during due diligence than on a private M&A deal.

Whilst many bidders on UK takeovers so far this year have been corporate buyers, we see an increasing interest from sponsor clients in exploring "Public to Private" or "P2P" takeovers (takeovers where the target company is acquired by a private equity house or financial sponsor).

'Certain funds': The Code requires an offer to be made on a 'certain funds' basis (i.e., the bidder must have proof of funds to complete), and the bidder's financial adviser is required to give a confirmation that it has sufficient cash available. The related cash confirmation process will apply to a bidder's equity and debt financing and is more invasive/time-consuming than the equity commitment letter process familiar to private equity houses and financial sponsors in private transactions. The requirements of the Code relating to the settlement (i.e., payment) of the purchase price need to be coordinated with the draw-down process for any fund equity bridge facility.

Legislation

National Security and Infrastructure Act 2021 (NS&I Act): Under this new UK legislation, transactions (including takeovers) in certain mandatory sectors, including data infrastructure, energy, and suppliers to emergency services, need to be notified and cleared by the UK Government's Investment Security Unit (**ISU**) before completion. Additionally, the ISU can 'call-in' transactions which may otherwise impact national security.

Potential purchasers, particularly those from a non-UK jurisdiction or where the target could be considered an asset of national significance, should take careful advice around whether a potential takeover may be affected by the NS&I Act.

Pensions Schemes Act 2021: Certain targets may have defined benefit (**DB**) pension schemes. Recent pensions legislation changes have increased the grounds on which a 'contribution notice' can be issued by the UK pensions regulator, which could require a buyer to make an additional financial contribution to the company's DB scheme. Appropriate diligence should be undertaken on the target to assess this risk.

About the authors



Andrew Gillen (L) is the head of the corporate M&A and ECM (equity capital markets) group at **Travers Smith LLP**. He can be reached at andrew.gillen@traverssmith.com. **Fabian McNeilly** (C) is a senior associate in the corporate M&A and ECM group. He can be reached at fabian.mcneilly@traverssmith.com. **Laura Kelly** (R) is a senior associate in the private equity and financial sponsors group. She can be reached at laura.kelly@traverssmith.com. The authors are based in London.

This article was first published on Reuters Legal News and Westlaw Today on December 14, 2022.