THE GREAT DIVIDE
An Outlook on M&A, Private Equity and High Yield Investment After The Brexit Vote
1st July, 2016
The votes are in. The decision has been made. Brexit it is! Now what? For the Mergers and Acquisitions (M&A) industry, a return to normal - 2015 was a record year in the UK - is highly unlikely in the short to medium term.

In the run-up to the European Union (EU) referendum, held on 23 June in Great Britain, The M&A Advisor, a financial services think tank, and Merrill Corporation, a financial services information management company, published an exclusive industry risk report. The research process engaged over 600 leading financial services industry professionals in the UK and 34 countries around the world through survey and 12 industry stalwarts by interview to opine on the effects of the vote on M&A, Private Equity (PE) and High Yield Bond (HY) investment.

Dealing In Uncertainty
In the past six months, M&A, PE and HY market volume slowed to a near stop. After a record year of domestic and foreign investment in the UK, we have witnessed dramatic slowdown in deal flow over the first half of 2016. In fact, during Q1 2016 Private Equity/Venture Capital volume finished at a paltry 500 transactions compared to over 800 one year earlier. And Q2, through June 1, of this year saw volume slide to under 300 deals with a target of 350 for quarter end.

In line with our findings - 67% of investors and advisors said that investment decisions were being negatively affected by the vote. Coincidentally, M&A – both strategic and private equity, is off almost 70% year-to-date from the same period in 2015. And, we can only conclude that, as global M&A is off only 20% YTD, in part due to the UK slowdown - both inbound and outbound, that the decline of UK M&A reflects the volume of uncertainty resulting from the EU Referendum Vote.

Events such as the Brexit vote, also typically result in a notable selloff in corporate bonds and the markets on Friday, 24th June did not break that trend. Rising yields and widening credit spreads are just one of the fallouts in a risk asset class that typically follows the stock market and as a rule greatly dislikes uncertainty.

With the Brexit vote behind us, “uncertainty” becomes the new buzzword for the M&A industry. What is reasonable to expect? How will domestic and international investors react to the decision to “Brexit”, and at what pace? While the decision has been made in the ballot booths, the hangover effect is yet to be determined.

In fact, in our research, over 65% of respondents felt that the UK would be less likely to prosper if it left the EU and an equal number, 65% said that Britain would be less likely to attract overseas investment if it leaves the EU.

From The Trenches
While the veteran experts interviewed for our report largely agreed with the statistical findings of our initial survey, almost all of them did not believe it likely that the UK would actually vote to leave the European Union. However, what was, to many in the markets, an unthinkable outcome, has come to pass.

And so, this week, we engaged 6 stalwart investors and advisors to visit the transition of uncertainty, from the voting decision to uncertainty in the preparation for and timeline of the actual departure from the EU. Here’s the insight they shared:

“We are going to have to get used to an extended timetable of uncertainty,” according to Nick Allan CEO, Europe & Africa, at Control Risks.
underlined the importance of the trade agreement that the UK will be able to strike with its EU neighbours, pointing out that it was as important a matter for them as it is for Britain, as trade relations are deep and wide ranging with countries such as Germany and France. He concluded by saying that acquisitions of UK companies could now be timely as uncertainty and a weak sterling may offer cheaper pricing for UK assets.

Ian Bagshaw, a partner at law firm White & Case, lamented the lack of a coherent UK Government Brexit plan, saying that this leads to instability and uncertainty in the financial markets. “All Private Equity buyers and High Yield and bank lenders have a three to seven year horizon. In terms of the businesses they lend to, being able to predict a stable cash flow over that period will be quite difficult for some of them to do.” He highlighted the difficulty of businesses with cross-border revenues predicting currency movements and in trading internationally.

However, he again noted that entrepreneurial clients of his firm might spot acquisition opportunities among the volatility in current markets. Vendors might be prepared to drop their prices. “Some people cope better with crises than others,” he concluded. “Others will prefer to sit on their hands and wait and see how things develop.”

Operating from both other sides of the Atlantic, New York and London-based Ceasar N. Anquillare, Chairman & CEO, Winchester Capital was quite bullish about the longer-term prospects. “Withdrawing from the EU will result in greater focus on UK domestic transactions. I also expect more USA/UK transactions due to greater certainty by US acquirers in the future of UK assets and vice versa, without interference and required approvals from Brussels. In short, we in the UK will take greater control of our destiny and I see a surge in the transatlantic mid-market, whilst larger multi-nationals may move more slowly, which will impact the bigger banks.” Anquillare noted that where funding could be provided out of the US, in support of US acquirers, or local funding was available for domestic UK transactions, deals may well go ahead. However, he was less optimistic about the outlook for funding of large transactions by the major international banks.

Wayne Rapoza of London based Rapoza Consulting, an independent law and transaction consultancy firm, shared this view, “Having taken soundings among funders in the immediate aftermath of the Brexit announcement, the already depressed High Yield markets looked unlikely to open up for new transactions until the summer is over, and possibly not even then unless and until the markets settle down. While some strategic and PE M&A deals already in the pipeline might be completed, new ones are likely to be few and far between at least until there is some confidence that there will be a reasonable path forward. Ultimately, companies and market players are looking for some kind of clarity on nature of the relationship between the UK and the EU and that negotiations will be generally amicable or at least civil and not emotional.”

In the same vein, Ian Jamieson CEO of advisory firm Jamieson Corporate Finance noted that arriving at valuations for businesses, in the current climate, was going to be difficult. “No matter if it is debt valuation or debt pricing or standard company valuation, across the board there is compete uncertainty about what Brexit means for anybody.” He adds that while some transactions that were nearing completion at the time of the referendum may well complete, it looks unlikely that new transactions will now come to market much before the autumn. “We are in unchartered territory now.”

Speaking as a US investor in UK businesses, James B. Lockhart III, Vice Chairman, at WL Ross & CO LLC sums up the view of many in the market place. “We are surprised and disappointed at the outcome and there will be a long period of uncertainty to come. We think that there has been some over-reaction in the markets and this may give rise to some buying opportunities. However, in the meantime it is a little early to predict what is going to happen. Longer term,” he adds, “we think that the
economy will come through this and that the UK will continue to be a viable market to invest in.”

**Deal Terms**
In the short term - for convenience sake, let’s call that the balance of this calendar year, the effect on M&A is relatively predictable. Frankly, it is extremely unlikely that even if the vote to Remain was the victor, that “production” could ramp up to 2015 levels fast enough to finish ahead of, or catch up to, that record year. While the completion of the referendum voting process signals a return to business for some investors, our estimate is that the UK domestic M&A market could be off by as much as 35% on the year when it comes to an end.

What is less predictable, as our contributors noted, is the effect on M&A over the next 2 - 4 years. Unquestionably, the country’s division brought about by this debate, and the unanswered question of what an exit truly looks like, will have an effect on both domestic and foreign investment during the medium term in the UK. Cross-border M&A’s growth, for the second year in a row, outpacing domestic investment, is testament to the M&A investment alternatives available across the world.

**Waiting For A Signal**
In conclusion, we are hopeful that wisdom prevails in the Leave campaign team’s future plan and the signal to the market is one of calculated recovery vs prolonged uncertainty.

On the pages to follow you will find key interview and survey highlights from the original report.

To download and read “A Suspended State of Uncertainty - The BREXIT Effect on M&A, Private Equity and High Yield Investment” [Click Here].

**Alun Baker**
Managing Director - Europe, Middle East and Africa
Merrill Corporation

**David Fergusson**
President & Co-CEO
The M&A Advisor
Pre-Vote Interview Highlights on The Effect of Brexit

Between 15 May and 15 June, 2016 we conducted extensive interviews with active investors and advisors in the M&A, private equity and high yield investment markets.

In those discussions, the conversation focused on the range of possibilities presented by the impending EU Referendum Vote. In the aftermath of the UK’s decision to exit the European Union, we wanted to draw attention to some of the key messages from our distinguished contributors:

“We believe a hiatus in dealmaking is likely if Brexit wins the vote, and one that could persist for a number of years until we all understand what the full terms of Brexit really mean. Overall, a strong deals market requires confidence in the direction that the economy is traveling. We witnessed this at the outset of the 2008 recession and again in the second Euro crisis of 2011-12.”

– Stewart McKee, PwC

“If I look at our forward pipeline, there is very little new stuff coming to market in the next quarter or two. There is definitely a dropping off of M&A activity and without doubt Brexit is one of the reasons for this.”

– Charlie Johnstone, ECI Partners

“Brexit could catalyse the realisation of the fundamental flaws in the EU model,” in the opinion of “Even with the UK remaining in, a Pandora’s box has been opened across the EU. The significant proportion of the UK population who will vote against EU membership will mean the UK will not be a comfortable member of the EU project and this will encourage other countries to review the issues.”

– Tony Dalwood, Gresham House

“Where there is no immediate pressure for a transaction to happen, I’d expect both buyers and sellers to pause and see how events unfold over the next six to 12 months.”

– David Evans, Alvarez & Marsal

“[The referendum is] definitely affecting UK deals but not international ones. So international advisers, like myself, remain busy although UK-centric advisers are quiet. We are redeploying accordingly. The UK lenders are shut for business.”

– Robin Johnson, Eversheds

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“London as a market is about people; about international people. It is a market with these people choosing to work in London and about the free movement of workers and a culture of bringing together the best brains from all over the world whether from the EU or from elsewhere, say in Africa, the Middle East and Asia. So the question is how would Brexit affect that? And I think that the effect would be slow but either it will shore up people’s resolve to ensure that London remains the leading financial centre or European centres such as Paris and Frankfurt will try and take back some of their financial services industries, which is so lucrative and has driven strong UK tax revenues and job creation. To me, that is the big question because if the people are here, activity - M&A, HY, PE - will happen here.”

– David Crook, White & Case

“It is possible that there could be a complete EU breakdown, perhaps if we see a resurgence of debt issues around markets like Greece and so forth. But then the remaining countries of the EU, led by France and Germany, might go down a different path than that they pursue today. But I think, in a way, if there is a leave vote for the UK, the remaining EU institution will come even closer together to ensure the stability and longevity of the rest of the structure.”

– Darren Redmayne, Lincoln International

“A vote to leave would place at risk London’s preeminent position as a financial centre. While EU financial services regulation would continue to evolve, the other European financial centres would have a voice in that process and the outcome might well support their interests and not London’s.”

– Mike Hinchliffe, Merrill Corporation
Pre-Vote Survey Findings on The Effect of Brexit

The respondents were asked two types of questions: 1. To rate, on a scale of 1 to 5, the likelihood of the presented scenarios where a rating of 1 indicated less likely and 5 was more likely; and 2. Whether they are in favour or not of proposed possible scenarios.

To follow are the survey findings that warrant special consideration in light of the EU Referendum decision:

1. If Britain leaves the EU, will the UK economy be more or less likely to prosper?

2. If Britain leaves the EU, will it likely attract more or less overseas investment?

3. If Britain leaves the EU, will UK businesses be more or less attractive to overseas acquirers?
4. If Britain leaves the EU, will US businesses be more or less likely to acquire businesses based in continental Europe than ones based in the UK?

5. If Britain leaves the EU, will UK businesses be more or less likely to acquire businesses in the EU?

6. If Britain leaves the EU, will EU based businesses be more or less likely to acquire businesses in the UK?
7. Those in favour of Brexit say that Britain will be better placed to trade with the rest of the world if it leaves the EU. Do you think they are right?
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CONTACT
David Fergusson
President & Co-CEO
The M&A Advisor
E. dfergusson@maadvisor.com
T. +1 212 951 1550
T. +44 203 318 6585

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CONTACT
Alun Baker
Managing Director - EMEA
Merrill Corporation
E. alun.baker@merrillcorp.com
T. +44 (0)20 7422 6194

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