

BREXIT PERSPECTIVE

Brexit and Private Equity: Business as Usual?

In this perspective, FTI Consulting looks at the potential implications of Brexit on the Private Equity sector.

Quick Read!

- Private equity (PE) is increasingly considered an important funding channel for businesses in Europe even if bank financing is still dominant.
- Global PE assets under management have been on the rise in recent years and a similar trend can be seen in Europe. The UK still has the most significant PE industry in the EU - this is likely to remain the case for the foreseeable future.
- Although transactions slowed down around the time of the UK referendum uncertainty seems to have waned. Acquisitions and refinancing of portfolio companies have taken place against the same or similar terms as were applicable before the UK referendum.
- The EU internal market is based on four essential freedoms. The freedom of capital is the only freedom that does not explicitly refer to EU membership so PE houses situated outside the EU will continue to benefit from it.
- The inevitable regulatory divergence that Brexit will bring about will nevertheless have consequences for the regulatory framework and investment climate in which PE managers operate.
- Brexit will affect PE's most important investors and many of its existing portfolio companies and targets. This is true for the UK, US as well as EU PE houses. Corporate governance, taxation, trade and investor protection rules are likely to change significantly in the coming years – Brexit will occur in the middle of this process.
- Irrespective of the exact outcome of the Brexit negotiations, it is clear that investment strategies will have to be adjusted in view of the coming regulatory divergence and legal uncertainty.

What Brexit means for Private Equity

1. Introduction

Private equity (PE) is increasingly considered an important funding channel for businesses in Europe. While the buyout segment of the PE sector is now less prominent, the seed and growth elements of the industry are increasingly understood and appreciated in Europe, particularly for venture capital.

In addition, enhancing non-bank financing – through its Capital Markets Union (CMU) - is one of the European Commission's top policy priorities. The CMU should, for example, improve the 'funding escalator' within the European Union (EU) by offering alternatives to bank financing for each stage of the development cycle of companies.

But whereas the banking, insurance and asset management sectors are highly dependent on EU legislation in providing their core services, the activity of acquiring private ownership of companies is not regulated in the same way.

Nevertheless, there is a range of EU legislation that impacts the PE sector and given the impending exit of the United Kingdom (UK) from the EU, it is important to take a close look to consider the impact of Brexit on the sector.

While some research suggests that transactions slowed down around the time of the UK referendum (e.g. deferred fund launches), there is also evidence that the number of deals has increased more than expected since the summer¹. It will be important to keep under review the impact of Brexit on these figures.

2. Global and European PE trends

Global PE assets under management have been on the rise in recent years, reaching a new high in June 2015 at \$2.4 trillion². Another sign of this trend is the increase in the total value of cross-border M&A activity backed by PE funds. This increased to \$200 billion in 2014, around 17% of the global total, with a clear focus on targets in the US and Europe³.

A similar trend can be seen in Europe, even if bank financing is still dominant. While 2008/09 saw leverage availability dry up and as a consequence fewer PE deals, once leverage returned, deal values and volumes increased despite a weak economy.

PE, as an alternative asset class, has been growing since 2012, although consolidation has taken place over the last two years and the sector's growth is not evenly spread:

- PE investment in European companies increased by 14% in 2015 to €47.4 billion.
- 5000 companies benefit from PE capital - 86% of which are SMEs.
- PE fundraising reached €47.6 billion in 2015 (€48 billion in 2014)
- Divestments were at a cost of €40.5 billion (approximately 2,500 companies were exited in 2015, equals to the 2014 number).

PE in EU Member States'

The UK has the most significant PE industry in the EU. In 2015, just under half of PE funds were raised in the UK and Ireland (€22.5 billion), followed by France and Benelux (€11.9 billion) and the Nordics (Denmark, Finland, Norway, Sweden - €7.8 billion). Germany, Austria and Switzerland accounted for €2.8 billion.

With regard to investment, France and Benelux represented 28% of PE investments in 2015, followed by the UK and Ireland with 25% and Germany, Austria and Switzerland with 17%. PE investments are predominantly domestic in Europe to a value of €31 billion, whereas cross-border investments stand at €13.1 billion. €3.1 billion is invested in European portfolio companies by non-European PE firms .

Research shows that global PE fund managers are positive about the sector's outlook for the coming 12 months. As long as leverage remains available, the strong track record of recent fundraising means investment will continue during the lifespan of the funds. Research also estimates that it is more likely that PE investment will decrease in European companies than UK companies⁴.

3. The Four Freedoms?

As is often referenced, the EU internal market is based on four essential freedoms: the freedom of movement (people/workers), the freedom of goods, the freedom of

¹ Moutant Ozannes Global Private Equity Research 2016

² 2016 Preqin Global Private Equity & Venture Capital Report

³ UNCTAD, World Investment Report 2015

⁴ Moutant Ozannes Global Private Equity Research 2016

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services and the freedom of capital. It is less well known that only three of these freedoms in fact apply to EU members. The fourth, the freedom of capital, does not explicitly refer to EU membership.

Art. 63 of the Treaty on the Functioning of the European Union (TFEU) states:

“All restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.” EU Member States decide themselves on direct taxation, but must avoid discrimination on the grounds of nationality. The movement of capital is not defined under EU law, but it is up to the Court of Justice in Luxembourg to decide whether a measure constitutes a restriction.

This means that PE's core business of acquiring full ownership of, and/or investing, in EU companies should, at least theoretically, not be impacted by the UK's exit from the EU. However, the inevitable regulatory divergence that Brexit will bring about is likely also to have consequences for the regulatory framework and investment climate in which PE managers operate. This includes EU financial regulation that is of particular importance to the PE industry, such as the Alternative Investment Fund Manager Directive (AIFMD), as well as regulation covering the industry's key investors in the banking, insurance and pension fund sectors. However, it also could involve a wider range of policies that shape Europe's broader investment climate such as taxation, corporate governance, investor protection and trade.

4. Private equity and EU financial services regulation post-Brexit

Passporting rights and equivalence have understandably been at the forefront of the debate on Brexit and EU financial services (FS) regulation. Once the UK leaves the EU, it will effectively become a third-country for EU FS regulation purposes. This can only be avoided upon exit if the UK either becomes a European Economic Area (EEA) member, which seems unlikely at this stage, or if some kind of transitional arrangement is put in place that would allow the UK to continue business as usual until a new, future relationship is adopted allowing both sides some form of privileged market access. Third-country status would also remove the assumption of regulatory equivalence as well as the access to the system of EU passports for the UK FS industry.

For the PE industry, the AIFMD is the most important piece of EU regulation.

It provides European managers/funds with a passport that can be extended – after an equivalence decision - to non-EU managers and European managers marketing non-EU funds, allowing them to offer their services throughout the EU.

The first equivalence decisions have, however, proven to be very difficult. Indeed, the European Commission is yet to take such a decision and appears to be adding new and additional criteria to its decision making process following the UK's referendum. The difficulty and long duration of these decisions is an ominous sign of what the future might look like for PE funds that passport into the EU via the UK.

The AIFMD is also due for review next year. Although the UK has already implemented the AIFMD and, therefore, granting the UK equivalence should in normal circumstances be relatively straightforward, it remains to be seen what will happen to the revised AIFMD. It is unlikely to enter force before the UK has left the EU. In addition, it is not certain that a new UK regime would mimic the revised AIFMD. If not, this could negatively impact any future equivalence decisions by authorities on both sides of the Channel. On the basis of the current rules, even if a UK PE firm were to be declared fully equivalent, it would have to appoint an EU-based depositary and legal representative, adding to compliance costs as well as facing a lengthy authorisation process. Therefore, it might financially be more attractive for UK PE funds to already set up EU subsidiaries rather than to wait for a comprehensive post Brexit regime.

Banking and insurance face similar challenges.

Banks are heavily dependent on passporting. Without a passport, the number of non-EU banks investing in the EU could reduce. Banks are important PE investors as well as significant providers of funding for EU businesses. Reduced bank financing could therefore have a serious impact on PE for several reasons: it could lead to smaller war chests and a decreased reach of PE; it could reduce opportunities in the future because with less initial bank financing, there could be less companies starting up and growing, and therefore looking for expansion capital from PE. On the other hand, the withdrawal of banks could enhance the need for alternative providers of capital.

Regulatory divergence also looms large on the horizon as the EU has recently proposed revised prudential legislation for banks. The EU will revise its capital

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requirements framework for banks and will implement, among others, the 2013 Basel standard for treatment of banks' equity investments in funds as well as the Financial Stability Board's Total Loss Absorption Capacity Standard (TLAC) into EU law. This could further reduce the lending capacity of European banks. The new rules are likely to come into force around the time the UK exits the EU. While the UK has always been one of the staunch defenders of the global regulatory approach, its impending exit from the EU and reduced influence might lead the EU 27 to be more inclined to deviate from the stricter Basel capital requirement rules in order to help EU banks lend more again.

Potential impacts on the insurance sector should also be closely monitored by the PE industry, including the likelihood of diverging regimes for UK and EU insurers, for example, with regard to capital requirements. While the Solvency II regime has now entered into force, the UK's House of Commons Treasury Select Committee has already launched its own inquiry into the regime - two years ahead of the EU-wide review. PE managers should also bear in mind that **equivalence decisions are inherently political** and rights based on 'equivalence' can be withdrawn if one side considers that the other side's regulatory regime no longer provides a sufficiently comparable outcome. An important consideration is that the EU is currently mapping all different models for third country regimes in the EU and could propose to harmonise them. While the free movement of capital might not be restricted as a result of Brexit, the ability of UK PE managers to offer services across the EU might be seriously hampered. Legal uncertainty caused by divergence will also have an impact on the funding abilities of their key investors in the insurance and banking sectors.

5. Brexit and the European investment climate

PE investment does not occur in a vacuum. There are other important policies that shape the overall investment climate and are taken into account by PE managers when making investment decisions. Below we assess the possible implications of Brexit for some of the most important issues.

a) Taxation and corporate governance

The fight against tax avoidance has been high on the global agenda in recent years. This has resulted in a raft of new policy proposals by the EU in 2016 to introduce tax transparency and reduce tax avoidance. The

measures to a large extent are based on the OECD Base Erosion Profit Shifting proposals. Three EU proposals are of particular relevance for the PE sector: the Anti-Tax Avoidance Directive (ATAD), the Country by Country Reporting Directive (CBCR) and the Common Corporate Tax Base Directive (CCTB).

The EU adopted the ATAD directive in June. This Directive, among others, limits the deductibility of interest as well as introduces a general anti-abuse clause that could have an impact on PE's access to tax treaties. It will come into force by the end of 2018. The CCTB proposal came out in October and proposes an additional tax deduction of 50% R&D costs under €20 million (25% above) and 100% in the case of start-ups – but no additional tax refunds. It also introduces an allowance for growth and investment (AGI) to encourage equity financing (a deductible amount that would be calculated on the basis of AGI equity and multiplying it by the 'notional yield' which is a yet to be defined number). The CCTB – if adopted – would only enter into force after Brexit. In turn, the CBCR proposal focuses on transparency. It aims to introduce public reporting of profits and loss by Multi National Enterprises (MNEs) with a global turnover of €750 million or higher. This would include reporting the number of employees, annual amount of profit before tax and annual amount of income tax paid. The UK and France are big supporters of this proposal.

On the corporate governance side, the EU is currently **updating the existing Prospectus and Shareholder Rights Directives**. The new **Prospectus Regulation** should make it easier for smaller European companies to access capital markets, notably by reducing disclosure requirements and increasing the exemption threshold. This should reduce barriers at the fundraising and exit stages, which should also make investment in companies more appealing for PE managers. The new regime will take the form of a Regulation (it is currently a Directive) which means that it will become directly applicable in the Member States and does not have to be implemented into national law. Clearly, if the UK adopts a new regime post-Brexit, companies wanting to be listed in both the UK and in the EU may end up drafting two sets of prospectuses.

The **revision of the EU Shareholder Rights Directive** should improve corporate governance in listed companies. It focuses on issues such as insufficient engagement of institutional investors and asset managers and the inadequate transparency of

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proxy advisors. The European Commission wants more disclosure by institutional investors and asset managers. For instance, institutional investors and asset managers will be required to develop a policy on shareholder engagement, which should contribute to managing actual or potential conflicts of interests with regard to shareholder engagement. The new Directive could be adopted at the start of 2017 and could enter into force just before Brexit in 2019.

EU corporate taxation and governance rules are likely to change significantly in the coming years. Brexit will occur in the middle of this process. The UK's tax regime is likely to be aligned to the EU's, also because most of the changes are implementing the OECD's BEPS initiative. However, the corporate governance rules are not based on international agreements. Although the changes are likely to offer both new opportunities as well as challenges for PE, a period of relatively high legal uncertainty when it comes to corporate taxation and governance is to be expected. Uncertainty on the future applicable legal and taxation regimes could very well discourage investments.

b) Investor Protection(ism)?

A separate risk to PE investment is the increasing scrutiny of foreign takeovers by national governments in Europe. The EU Treaty allows Member States to protect themselves against proposed foreign investments posing a legitimate national or public security risk, though only under strict conditions.

Prime Minister May is considering introducing a new industrial policy that would enable her government to apply tighter scrutiny of foreign takeovers of domestic companies. The French government already has the right to veto foreign takeovers in strategic sectors and has used this in the past for the Pepsi takeover of Danone and also threatened to use it recently when GE took over Alstom. The German government is also currently beefing up a law that would allow it to block take-overs in strategic sectors after concerns arose about a series of Chinese takeovers of German high-tech companies in recent months.

It has also been reported that Germany would like to turn its approach into an EU-wide regulation. It is not clear how this would interact with the existing UK and EU merger control regimes which already allow the application of a public interest test. The EU's approach to bilateral investment treaties (BIT) with non-EU countries would probably also have to be revised if this trend

continues. Indeed, the EU has been including investment chapters in its recent trade agreements – very controversial in the case of TTIP and CETA – to provide EU investors and investments with market access and with legal certainty. This indicates how complex discussions on investor protection between the UK and the EU27 will be post-Brexit. While this will probably be part of a larger trade deal between the EU27 and the UK, if both sides intend to increase scrutiny of takeovers/mergers this would be a negative development for the PE industry. It also remains to be seen what such a new deal would mean for the UK's existing BITs with central and eastern European countries as well as for international investment deals with countries such as China (already in advanced negotiations with the EU on an investment agreement).

c) Trade?

Trade should also be on PE managers' minds in anticipation of Brexit, in particular because a so-called 'hard' Brexit seems a realistic potential outcome at this stage. Hard Brexit would mean that both sides would have to trade with each other on WTO terms. Tariffs and non-trade barriers (customs inspections, rules of origin ('made in'), standards, etc.) would be applied again to the trade of goods. Supply and value chains could be significantly impacted. Investments in sectors that still apply tariffs, such as motor vehicles (and their parts), chemicals and agricultural commodities and those with a supply chain that involves both the EU and the UK should be carefully assessed. In any case, the EU27 could well adopt a more protectionist trade policy. Trade in services could be equally impacted with increasing regulatory divergence; an end to the recognition of professional skills and caps on labour migration are realistic outcomes post-Brexit. This could further increase the skills gap on both sides and also result in a significant – and very costly - relocation of staff. Some banks and asset managers have already announced that they will have to relocate staff from London to the European mainland or elsewhere.

d) Foreign Exchange (FX)

The depreciation of sterling provides non-GBP denominated funds (which form a majority of the funds operating in the EU) an opportunity to acquire UK assets at a potential discount in the short term (as has been seen recently with some large deals being completed post Brexit to take advantage of the FX benefit). Future fluctuations in foreign exchange can certainly further impact relative prices and thus attractiveness.

6. Conclusion

Following the outcome of the Brexit referendum there was initial scepticism from banks in providing leverage. This uncertainty seems to have waned; acquisitions and refinancing of portfolio companies have taken place against the same or similar terms as were applicable before the UK referendum with, for example, no major changes seen in the valuation multiples. Therefore, for the time being, it seems that it is business as usual.

However, as this Perspective makes clear, Brexit should not be ignored by PE houses. Although the free movement of capital will apply to PE houses situated outside the EU, the legal and political uncertainty caused by Brexit will have a direct impact on the PE industry and the regulation that governs it.

Brexit will also affect PE's most important investors and many of their existing portfolio companies and targets. This is true for the UK, US as well as EU PE houses. The UK is by far the most important and sophisticated PE market in the EU and this is likely to remain the case for the foreseeable future. The scenarios regarding potential outcomes of Brexit negotiations are manifold and the negotiating parties have not yet given much clarity. Yet in every scenario, be it hard, soft or any other type of Brexit, it is clear that investment strategies will have to be adjusted in view of the coming regulatory divergence and legal uncertainty and the industry should position itself to benefit from the new opportunities that Brexit will undoubtedly unlock.

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