# INVESTMENT PERSPECTIVES

CapitalDynamics
TRULY INVESTED.

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# BREXIT COME, BREXIT GO...PRIVATE EQUITY POWERS ON?

## KEY COMMENTARY

THREE YEARS ON FROM THE BREXIT REFERENDUM, THE UK HAS MISSED ITS DEADLINE FOR LEAVING THE EU AND IS NOW IN SEARCH OF A NEW PRIME MINISTER. WITH A NEW DEADLINE OF OCTOBER 31ST, THE CLOCK TICKS EVER FASTER. HELLO HALLOWEEN BREXIT!

Since the Brexit vote, the UK private equity (PE) market has proven to be surprisingly resilient and remains one of the leading global PE markets – but this does not mean there has been "no" impact. Several industry commentators have noted that the UK private equity market is perceived as marginally less attractive today. IESE Business School's Venture Capital and Private Equity Country Attractiveness Index 2018 predicts the UK will fall to sixth place in the global rankings after almost a decade as a top three nation. Meanwhile, surveys by PwC show that the UK is now viewed as a less attractive medium-term investment destination by private equity professionals compared to before the Brexit vote.

Yet, from our observations, many experienced private equity managers have factored Brexit in to their deal-making processes. It is often during periods of uncertainty that investors, with the courage to act, reap the most attractive investment returns. Therefore, we expect these managers will continue to find strong value despite potential economic headwinds.

**"THE UK PRIVATE EQUITY MARKET HAS BEEN RESILIENT SINCE THE BREXIT VOTE IN JUNE 2016. WE ARE CONFIDENT EXPERIENCED MANAGERS WILL CONTINUE TO FIND STRONG VALUE DESPITE POTENTIAL HEADWINDS."**

## IMPASSE, BUT VARIOUS ALTERNATIVES STILL EXIST

Following the June 2016 Referendum, the plan was to have a 'divorce' deal in place within two years of triggering Article 50 in 2017. This would mean an end to the UK's 40+ year membership in the EU and naturally create some uncertainty for the UK PE market as Britain would have to find its place in a post-Brexit world. Would the country successfully enter into bilateral deals with important trade partners around the world? Would there be a reasonably favorable deal put in place with the EU?

Currently, however, even more uncertainty prevails as the UK Parliament and the EU are deadlocked with no deal on the table that is theoretically acceptable to both sides. Not to mention an ongoing UK leadership contest following Prime Minister Theresa May's resignation in early June. The significant sticking point between the two sides is the UK border with the Republic of Ireland; this may seem odd when considering that neither side wants a 'hard' border, but the so-called 'Backstop' would effectively mean that the UK remains in a customs union with the EU until a way is found to track goods across the border in either direction. While this should only be a problem during the transition period, those opposing such a measure point out that without an adequate mechanism to track goods across the border the customs union will effectively remain in place – in other words, the UK remains a part of the EU in all but name while having no say in EU legislation.

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So where does this leave Brexit? There are still multiple possibilities.

### HARD BREXIT

A 'hard Brexit', whereby the UK ceases to be a member of the EU with no negotiated trading agreement with the EU but falling back on WTO rules. The UK would be free to negotiate trade agreements with other countries, although it is rumoured that only a handful of the 40 or so potential deals are ready to be signed. Legally, this is the *de facto* outcome if no agreement has been reached by October 31st and Article 50 has not been rescinded. A number of candidates for the leadership of the Conservative Party (and therefore the next Prime Minister) have stated that they consider this a theoretically acceptable outcome.

### A SECOND REFERENDUM?

In recent weeks, the likelihood of a second Referendum has increased marginally as the UK Government seeks to break the impasse. In fact, the Labour Party, the main opposition in Parliament, is considering making a second Referendum its official policy. Having said that, a marginal majority in the House of Commons still opposes a second Referendum. This is due in great part to the fact that for many, even including some 'leave' voters, a second Referendum would be seen as a subversion of democracy – when one vote has already decided the issue. For example, what if the outcome of a second Referendum is to remain in the EU but by a similarly small majority as decided the last Referendum? Does the UK then hold a third and decisive Referendum?

Hindsight is always perfect, but this ambiguity could have been avoided by requiring a more significant majority, perhaps 55 or 60 percent (legally permissible) between 'remain' and 'leave' votes that would have enabled the government to take the decisive action to leave the EU as part of the first vote. Given where we are, however, a second Referendum may very well lead to more confusion.

### OTHER POSSIBILITIES

Continued impasse remains a very real possibility. In the absence of an election, MPs' views are unlikely to have altered significantly following the UK's European Election results in May 2019, where the Brexit Party won the highest number of seats.

With Theresa May stepping down, it is conceivable that another General Election will be called by the new Prime Minister – possibly seeking a mandate to rip up her agreement and enforce a 'hard Brexit'. The difficulty for the new Conservative leader is that the Brexit Party has said its election platform will be solely focused on the single issue of Brexit. This could polarize the parties, resulting in a 'hung Parliament' or split the Conservative vote and let Labour in.

## IMPACT ON PRIVATE EQUITY

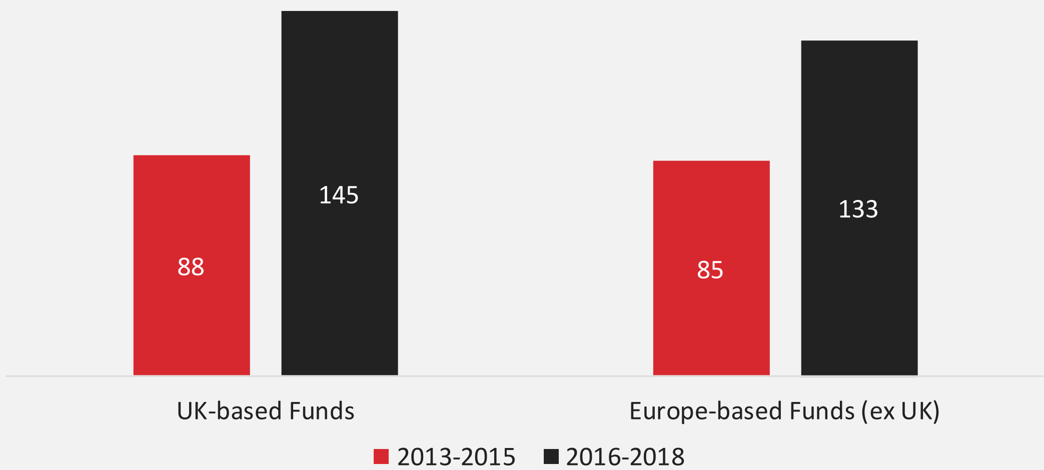
Despite the political, trade, and broader economic uncertainty, the UK has and will remain a critically important market for private equity. Europe itself has an incredibly significant and diverse private equity market with over 2,500 private equity and venture capital firms managing almost EUR 700 billion of assets. While only 20% of these European managers are headquartered in the UK, almost half of their assets are domiciled there (47%). So what have been the effects of the Brexit vote on the UK versus the rest of Europe in terms of fundraising, investing and exits?

### FUNDRAISING

As has been well-reported, private equity has experienced record levels of fundraising over the past several years driven by high levels of re-investment from strong distributions, increasing portfolio allocations from institutional investors, and the entry of new investors seeking higher returns in a low-yielding environment.

While it is difficult to draw a correlation between fundraising and the impact of Brexit, data suggests that fundraising in the UK has remained robust since the Brexit vote in June 2016. **Figure 1**, comparing the pre- and post- vote years, shows that commitments to UK-based funds have increased by two thirds over that period of time – representing a similar increase in commitments to Europe-based funds (ex UK) over that same period of time.

**FIGURE 1: PRIVATE EQUITY FUNDRAISING – PRE- AND POST-BREXIT VOTE, EUR BILLION**



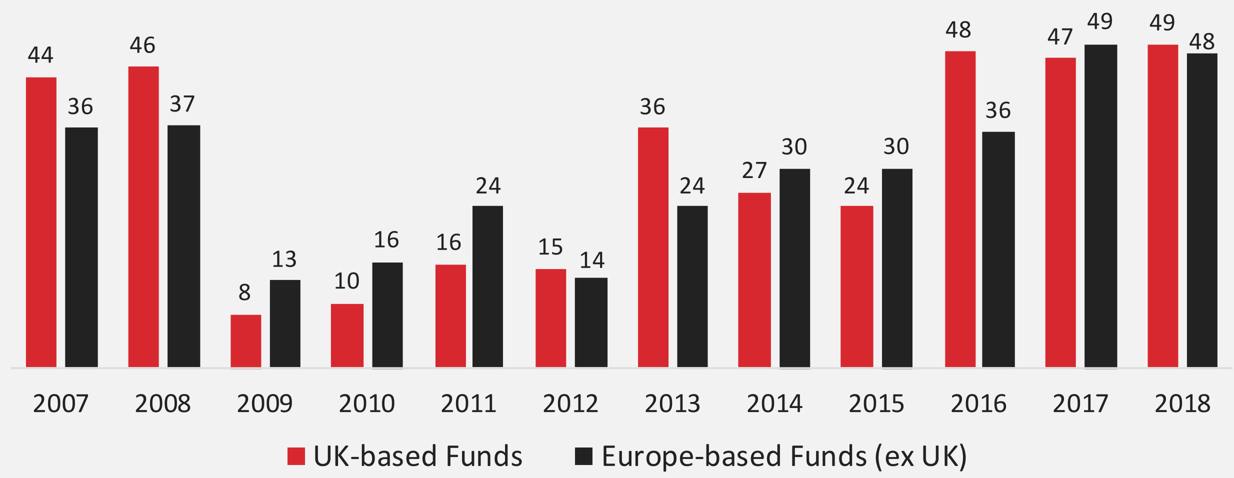

Source: Capital Dynamics based on Invest Europe data.

**Figure 2** shows that since 2007, fundraising for both the UK and Europe (ex UK) have hit record highs in the past two years. Furthermore, according to Invest Europe, only a small proportion of UK managers have relocated operations to non-UK jurisdictions (e.g. Luxembourg) since the vote. This is probably because under the Alternative Investment Fund Managers Directive (AIFMD) UK-domiciled managers with an EU passport can continue to market unimpeded to investors across Europe.

Nevertheless, anecdotally we have observed that some global investors, who typically put capital to work in the UK, have expressed more caution after the Brexit vote than usual. Part of this hesitance is driven by perceived risks about the potential further depreciation of the GBP vis-à-vis the investor's base currency, along with concerns that the exit environment for UK investing may be impaired if the uncertainty around Brexit is not resolved soon.

It is worth noting that Capital Dynamics is also mindful of these risks. When we consider an investment in the UK (in an asset or manager) we actively model currency depreciation and extended holding-period duration into our base and downside case scenarios. Overall, however, these perceived risks have had only a minor impact on the geographical distribution of fundraising since the Brexit vote.

**FIGURE 2: PRIVATE EQUITY FUNDRAISING – BY YEAR, EUR BILLION**

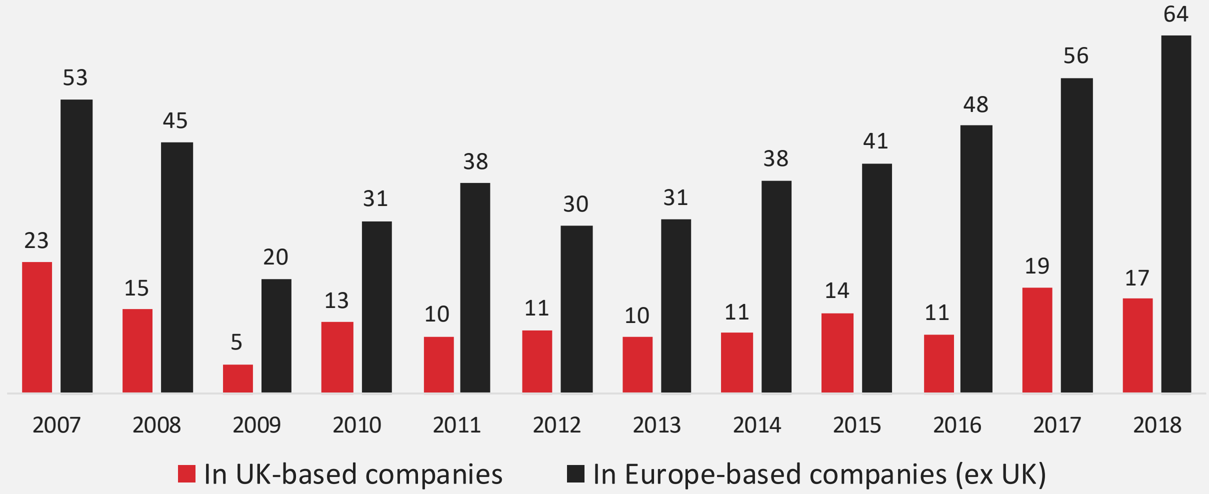



Source: Capital Dynamics based on Invest Europe data.

## INVESTMENTS

Investment data for the UK appears to reflect some of the uncertainty in the wake of the 2016 Brexit Referendum. While UK companies attracted EUR 14 billion in private equity capital in 2015, this figure dropped to EUR 11 billion the following year, as shown in **Figure 3**. Deal activity bounced back in 2017 once private equity managers, lenders and vendors adjusted to the new environment, and remained relatively high in 2018. By contrast, investments in Europe-based companies (ex UK) reached an all-time high of EUR 64 billion in 2018, following six years of successive growth.

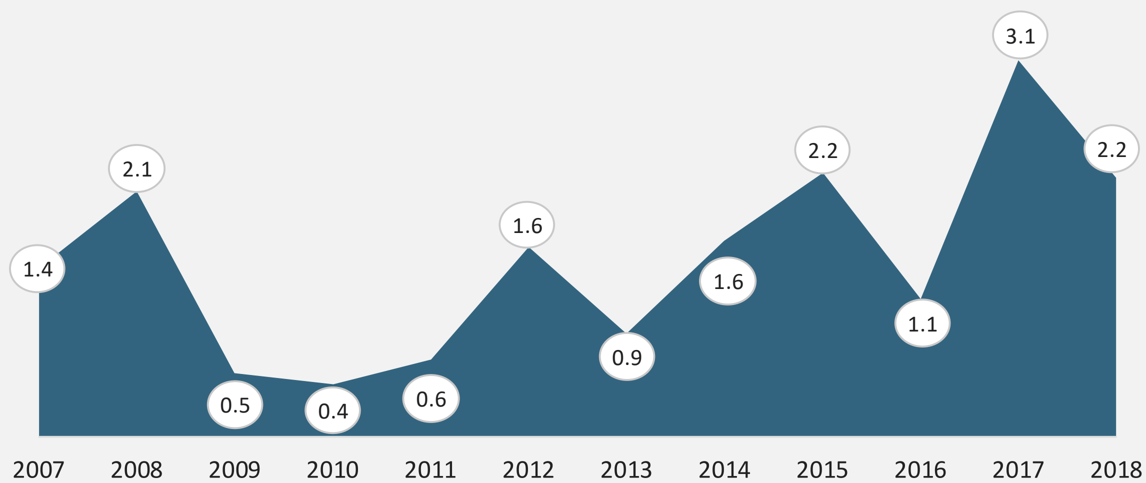
**FIGURE 3: PRIVATE EQUITY INVESTMENTS – BY YEAR, EUR BILLION**




Source: Capital Dynamics based on Invest Europe data.

We have also noticed that non-UK managers continue to find attractive investments in the UK, with some managers even increasing their deal activity following the vote. **Figure 4** shows that investments in the UK by non-UK managers picked up after the Brexit vote, with 2017 proving the strongest inflow on record. On the surface, this may seem contrary to what we described earlier – given the perception of heightened currency and investment holding-period risk. In reality, however, uncertainty often leads to the most attractive and under-valued investment opportunities. Professional investors with the determination and conviction to act in spite of this uncertainty often reap the most attractive and differentiated returns for their investors over the medium and long term.

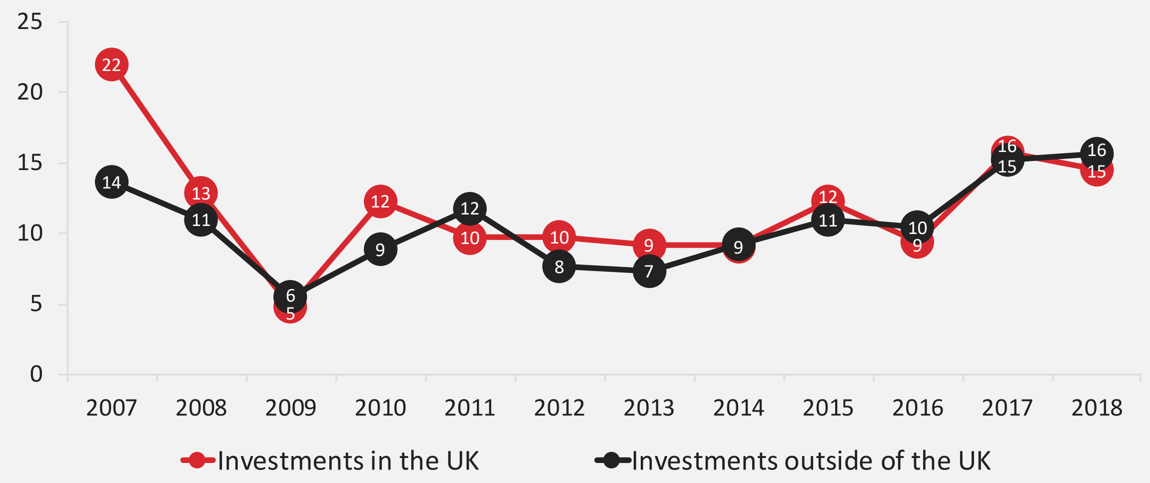
**FIGURE 4: PRIVATE EQUITY INVESTMENTS IN THE UK BY NON-UK MANAGERS, EUR BILLION**




Source: Capital Dynamics based on Invest Europe data.

The data on UK managers investing both domestically and overseas also shows a strong increase since the vote. In fact, the amount invested overseas by UK managers reached a record high in 2018, as seen in **Figure 5**.

**FIGURE 5: PRIVATE EQUITY INVESTMENTS BY UK MANAGERS, EUR BILLION**

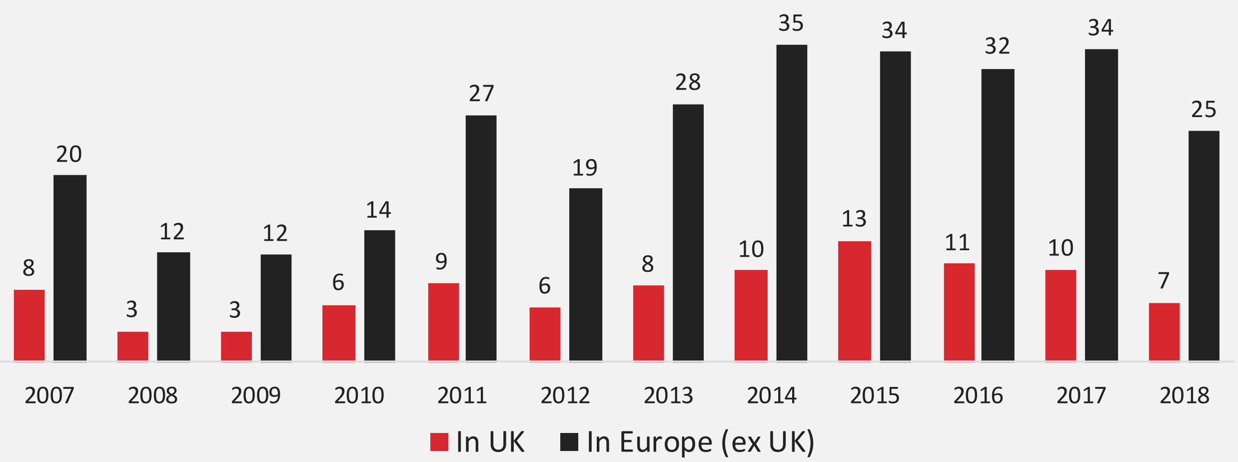



Source: Capital Dynamics based on Invest Europe data.

**EXITS**

The value of exits in the UK has fallen each year since the high of 2015, as shown in **Figure 6**. It is likely that this has less to do with the "Brexit effect" and more to do with the decline in 'mega-deal' divestments beginning in 2015. The current impasse, however, will probably exacerbate the decline in the value and timing of exits as acquirers (especially trade buyers) will likely delay M&A activity until after Brexit is resolved. By contrast, the value of exits in Europe (ex UK) has remained relatively steady since 2015. The only decrease observed was in 2018, which we believe was driven by increased market volatility.

**FIGURE 6: PRIVATE EQUITY EXITS – BY YEAR, EUR BILLION**




Source: Capital Dynamics based on Invest Europe data.

## IMPACT ON PRIVATE EQUITY-BACKED COMPANIES

### UK COMPANIES

The effects on UK companies are legion. Even in the lead up to the Referendum, companies were scenario testing in case the ‘leave’ vote prevailed. Since the triggering of Article 50, UK companies have had, in theory, at least two years to plan for the exit from the EU. But most have taken little if any action because there is no agreement about what an eventual deal might look like. Management teams and their shareholders feel paralyzed. In fact, many whom we have spoken to are, at this point, more concerned with when a deal is done than on what terms.

> **"The sorts of issues UK companies are grappling with include labor force management, pressure on wages, currency impact, capital expenditure decisions and where to locate themselves.”**

Key areas of confusion include: labor force management (particularly in terms of the impact of Brexit on migrant workers), pressure on wages, currency (the Brexit vote has been a positive for exporters but not for importers), capital expenditure decisions and location (where to locate operations to optimize trading with the EU).

According to the UK Government’s own figures, it is expected that the economy will slow-down post-Brexit both in the short-term and the longer-term. Nevertheless, the UK has been surprisingly robust and has been showing reasonably strong GDP figures. A possible explanation for this resilience recently is the level of stockpiling ahead of the end-March deadline; if this is correct, the likelihood of a drop in growth will be high as stockpiling unwinds – a common cause of recessions or muted GDP growth. UK unemployment is already at historically low levels and the anecdotal evidence of EU nationals leaving the UK could lead to wage growth pressure in some sectors, which would also put pressure on corporate profits.

### EU COMPANIES

The UK population represents approximately 12.5% of the EU. As such, the UK is a significant market for EU companies and many of the issues described above apply to Continental Europe – but in reverse and probably on a lesser scale. In addition, Europe may see some benefits from businesses or subsidiaries relocating from the UK, particularly in the finance industry. Having said that, there has been limited movement to date.

Within the EU trading bloc, the UK is undeniably one of the key markets for exporters. Any tariffs on trade would be damaging to both sides. As a major exporter to the UK, this is part of the reason that Germany is particularly focused on limiting the disruption to trade between the EU and the UK. Growth forecasts are already down for the major European economies and would almost certainly be further impacted in a ‘no-deal’ scenario.

### NON-EU COMPANIES

Perhaps the biggest constituent of potential beneficiaries are larger non-EU companies which have had limited success breaking into the European markets. For this group, Brexit may be an opportunity to increase market share in the UK. But, if a 'hard Brexit' occurs, these same non-EU companies may be unable to use the UK as a base entry point into the EU – likely delaying any decisions on relocating operations for now.

Furthermore, there seem to be many countries outside of Europe eager to negotiate new trade deals with the UK. The one which has grabbed the most headlines is the United States, which is particularly keen to export its agricultural products to the UK. However, with different regulatory standards and influential lobby groups on both sides, no new trade deal on mutually acceptable terms has emerged – reinforcing the difficulties of attempting to negotiate dozens if not hundreds of bilateral trade deals.

## THE FUTURE - IT'S ALL IN THE PREPARATION

'It is an ill-wind that blows nobody any good' as the saying goes. The general expectation is that Brexit will be bad for the UK, at least in the short-term and probably over the medium-term as well. Some winners will naturally emerge, particularly those companies which experience reduced competition due to tariffs or other trade agreements.

Longer term, however, it is difficult to say what the impact will be from Brexit. It is certainly possible that the UK may be able to move and innovate more quickly from a political perspective compared to the sometimes onerous regulatory environment of the EU. But this may very well be some way off. Even Jacob Rees-Mogg, a leading pro-Brexiteer, believes it could take 50 years before these benefits become apparent.

During this time of continued uncertainty, Capital Dynamics sees the advantages of accessing UK investment opportunities with managers who have capabilities in both the UK and Continental Europe. These managers are positioned to take advantage of the opportunities they see in the UK but are not pigeon-holed to investing in the UK if the opportunity set does not materialize.

In the wake of the Brexit vote, Capital Dynamics has also increased the attention it pays to the geographical location of portfolio company headquarters, revenues and costs, and sector selection (e.g. certain sectors, such as financials, may be more impacted due to Brexit implications than others).

Most importantly, however, Capital Dynamics believes that the UK will continue to be a vibrant market for private equity with a strong workforce and consistent rule of law. As with all of our strategies, we take an all-weather approach. While the current uncertainty gives rise to caution, we do not believe this is a time to stop investing in UK-focused private equity markets and funds – doing so may result in missing out on some of the very best investments when we look back on this period of time.

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Capital Dynamics is an independent global asset management firm focusing on private assets including private equity, private credit, clean energy infrastructure and clean energy infrastructure credit. Capital Dynamics offers a diversified range of tailored offerings and customized solutions for a broad, global client base, including corporations, family offices, foundations and endowments, high net worth individuals, pension funds and others. The firm oversees more than USD 16 billion in assets under management and advisement[1]. Capital Dynamics is distinguished by its deep and sustained partnerships with clients, a culture that attracts entrepreneurial thought leaders and a commitment to providing innovative ideas and solutions for its clients. Founded in 1999 and headquartered in Zug, Switzerland, Capital Dynamics employs approximately 150 professionals globally and maintains offices in New York, London, Tokyo, Hong Kong, San Francisco, Munich, Milan, Birmingham, Dubai and Seoul.

[1]As of March 31, 2019.

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