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UK capital markets: Everything must go? Part 2

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In Part 1 of this article (https://reut.rs/3W3ymDd), we gave our insights into takeover opportunities in the UK and issues that may arise for international bidders. In this Part 2, we 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, the current rush to take UK companies private is really a threat to the UK listed market.

In focus: sector by sector

Whilst some of the factors identified in Part 1 will apply to all UK (or indeed, all international) issuers, certain sectors are likely to be impacted more than others:

Technology, media and telecommunications

Technology, media and telecommunications ("TMT") stocks have been particularly affected by falling valuations over the last 12 months, largely due to increased interest rates reducing the present value of future growth and cashflows. Additionally, many traditional industries are finally embracing technological change, with online adoption accelerating rapidly due to COVID-19, allowing for real growth opportunities.

Given the dramatic fall in TMT (technology, media and telecommunications) valuations during 2022, we expect to see more takeover activity in this sector, particularly from private equity and financial sponsors.

Whilst valuation of TMT companies can be particularly difficult, given the larger-than-average valuation multiples and the fact that many listed TMT issuers are pre-profit (or even pre-revenue), TMT is expected to continue to grow strongly over the medium term, with the potential for certain companies to accelerate once they reach a critical mass within their chosen niche.

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However, buyers should be aware of the deal risk posed by the National Security and Infrastructure Act ("NS&I Act") where a TMT target's offering crosses over into infrastructure-type projects, as recent controversy over the sale of semiconductor producer Newport Water Fab has demonstrated.

Infrastructure

From an investment perspective, "infrastructure" is no longer limited to traditional infrastructure assets such as utilities and transport — it includes other businesses providing an essential service (such as data centres, waste management and motorway service areas) with stable cashflows largely unaffected by the economic cycle and having high barriers to entry. More and more funds are focussing on infrastructure investments, leading to strong demand (and competition) for valuable infrastructure assets.

The UK has many well-regarded infrastructure businesses listed on the Main Market and AIM. Although the NS&I Act is likely to present the greatest risk on these types of transactions, we anticipate increased public M&A activity in this sector.

Consumer

In light of the deteriorating economic conditions in the UK and tightening consumer spending, consumer-facing businesses are likely to find trading conditions very difficult in the short-to-medium term. Valuation will be difficult given the risk that consumer sales remain depressed for quite some time. Public company acquisitions in the consumer sector are likely to be limited.

However, there will be opportunities for financial sponsors with a greater risk appetite to acquire companies out of distressed scenarios (perhaps even out of insolvency). Corporate buyers may also seek opportunistic acquisitions, hoping to solidify their market position and realise cost-saving synergies through the combination.

On the defensive: What can a UK issuer do to rebuff a takeover bid?

Unlike in the US, where poison pill defences are commonplace, Rule 21 of the UK Takeover Code (the "Code") contains express restrictions on "*frustrating action*," being "*any action which may result in any offer or possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits.*"

As well as complying with the Code, directors of a target company should ensure that they comply with their duties as directors. This

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includes their duty under section 172 of the UK Companies Act 2006 to promote the success of the company for the benefit of its members as a whole, which includes having regard to, amongst other things, the company's employees (and, by implication, its pension scheme), suppliers, customers, and its impact on the broader community and environment.

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Actions that the board of a target may consider taking in respect of an unwelcome bid include asking shareholders to reject an offer on the basis of value, providing additional disclosure to the market, and trying to find a competing bidder which the Board considers to be a more favourable buyer for the company (a so-called "white knight"). In general, these actions would not be considered a 'frustrating action' for the purposes of the Code, but specific legal advice should be taken on the facts before any such action is taken, including consulting with the Takeover Panel.

Whilst directors' duties will always be relevant in assessing a takeover bid, they are particularly relevant in the context of a P2P, where an executive director may be involved in discussions with a private equity or financial sponsor bidder and intending to take equity in the target, and so will be wearing 'two hats'. It is particularly important in this scenario to closely follow rules relating to conflicts of interest and disclosure of confidential information, and directors should obtain specific legal advice on these issues.

Thinking globally: Is the UK really so special?

Whilst some have argued that the NS&I Act adds greater uncertainty to an M&A process in the UK, the UK Government's practice to date indicates that the call-in powers will be used sparingly; in the first three months of the NS&I Act coming into effect, out of a total of 222 notifications received under the NS&I Act just 17 were 'called-in' by the UK Government for further review.

The rise in UK protectionism is also not a unique phenomenon — the EU adopted similar regulations in 2019 (with further regulation expected to come into effect in 2023). Many European jurisdictions have had similar legislation for a long time, and the US CFIUS (Committee on Foreign Investment in the United States) notification requirements also impose a similar regime on foreign investment. Whilst the UK Government's position is less than clear given recent political instability, in our view it is likely that the more liberal approach will continue in respect of US-domiciled buyers, with perhaps a more hawkish stance towards Chinese buyers, particularly in respect of critical infrastructure.

Although the pound has devalued significantly in recent times relative to the US dollar, it is important to see the FX (foreign exchange) rate changes in context. The Euro has declined by a similar amount to the US dollar over the same period; the pound is trading roughly flat against the Euro over that time and has significantly increased in value relative to the Euro over the past five years. Nevertheless, this represents a real opportunity for US (or US dollar-denominated) buyers.

Many commentators are questioning the quality of UK-listed companies whilst simultaneously forecasting a splurge of takeovers of UK issuers. Many of the factors impacting UK issuers are also relevant for other European and, to a lesser extent, US markets.

What is clear from the fact that commentary and public M&A activity is focussed on the acquisition of UK-listed businesses is that international markets still see obvious value in UK-listed issuers, particularly those with a clear strategy and focus on a target market. For all the well-rehearsed drawbacks of UK plc, rumours of its demise have been greatly exaggerated.

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