



Brexit Monitor A European view

5



Looking forward, M&A and valuations

So far it is mainly survey data regarding sentiment, confidence or intentions that can indicate any impact on the economy as a result of the UK's vote to leave the EU. While giving some indication about the status of the economy, these 'soft indicators' tend to be volatile and do not always accurately predict the course of economic developments. We reported on German data released last week. This week's PwC Europe Brexit Monitor takes a closer look at Belgian indicators. In addition, the second part on the Monitor provides an overview of legal implications of Brexit on M&A activity and the impact on valuation of companies.

Mid-July VOKA, the Belgian Chamber of Commerce and Industry, surveyed 600 local companies about the foreseen impact of the UK leaving the EU. At this time 86% percent stated that Brexit has led to insecurity, and that because of this investments will be suspended until there is more clarity. More than half of those surveyed expect a negative impact on economic growth, and 15% expects that revenues will decline due to the Brexit vote. Despite this somewhat gloomy picture, the National Bank of Belgium (NBB) reported on July the 26th, a mere 0.3 point increase in its business confidence indicator for July, after a 3.5 point increase in June. These were the only two months since May 2011 that the index showed a positive number, indicating that more entrepreneurs were optimistic than pessimistic (see the figure below).

The governor of the NBB, Jan Smets, recently informed the federal government that he does not expect the referendum outcome to have a significant impact on the Belgian economy, despite the initial shock after the result was published. The NBB still expects 1.3% economic growth this year and approximately 1.5% in the following two years. In the period 2016-2018 also 140.000 additional jobs are forecast to be created. A looming Brexit will hardly change this according to Smets. However, in the longer term some uncertainty will persist related to the future trade relationship between the UK and the EU, and any potential effects of a UK economic growth decline.

In the rest of the EU some important sentiment indicators, like the purchase manager index for the period directly after the UK referendum, still show resilience and even positive developments. Obviously businesses are not only influenced by developments in the UK, and other factors such as a resilient US economy and progressing recovery in some European countries, still offer companies reasons to be positive about the future. Now we need to wait for the hard indicators to get a better idea of state of the economies. This will in many cases concern data for the third quarter of this year, that will be released during the fourth quarter.

Belgium business confidence, 2011-2016



Source: National Bank of Belgium.

The European political context

In Europe the holiday mood has set in with the Parliament closed for most of August and no Council meetings taking place until the first days of September. The European Commission is also operating at reduced capacity, but one man who has yet to take his holidays is Commission President Jean-Claude Juncker. The resignation of Jonathan Hill, the former UK Commissioner, following the UK's vote to leave the EU, left a key vacancy to be filled in Brussels. This week the Commission president appointed Sir Julian King to fulfil that role, albeit with an altogether different portfolio under his watch. King will oversee the implementation of the European Security Agenda, which was unveiled last year and include priorities such as improved intelligence sharing, de-radicalisation, stemming terror funding and fighting cybercrime.¹

While highly important to the UK, this choice proves much less controversial than the responsibilities of his predecessor who oversaw financial services. Any portfolio too closely linked to trade and economics would have ran the risk of creating a conflict of interest in the negotiations ahead. Continued security co-operation with the EU will remain fundamental to UK security regardless of Brexit, and there may be a need for special arrangements to be set up for example around Europol, which only became the EU's formal law enforcement agency in 2007,² and which is led by a Briton³. Experts agree that Sir Julian King will bring many relevant skills to the newly created role, through his experience as ambassador to Paris and through his past roles at the EU political and security committee, as well as director-general of the Northern Ireland Office and as ambassador to Dublin.



- 1 The Financial Stability, Financial Services and the Capital Markets Union portfolio was transferred to Vice-President Valdis Dombrovskis with effect from 16 July 2016.
- 2 Prior to this it was set up as an international organisation with its own legal acquis.
- 3 Rob Wainwright is the Director of Europol since 2009.



M&A and
valuations

Legal implications of Brexit for Merger & Acquisition activity

Brexit is likely to have substantial implications for businesses from a legal perspective. The scope of the legal implications will, to a large extent, depend on the manner in which Brexit will be implemented. Because of uncertainty surrounding the future relationship with the EU, there is still considerable uncertainty about the legal implications as well. Despite (or maybe because of) the lack of clarity, companies should already start assessing the risks and opportunities that Brexit may bring for their businesses from a legal perspective. The following preliminary observations, that pertain to certain areas of law, with a focus on Merger & Acquisition (M&A) activity, may be of help.

Firstly, it is important to understand that the UK will no longer 'participate' in the harmonisation of legislation in EU member states if it leaves the EU. This means that the EU laws and regulations on the one hand and the UK laws and regulations on the other hand, may increasingly diverge over time, depending on future agreements between the UK and EU. This will affect all sectors and industries.

Implications for M&A activity

The referendum outcome is expected to reduce M&A activity in the UK, as well as in other regions. For example, in the central scenario of a Baker &

McKenzie study, the 'leave' vote can cost the UK up to USD 240 billion in lost M&A activity in the next five years, while M&A levels may fall with 8% in Europe in both 2017 and 2018. These forecasts are mainly based on the uncertainty for companies regarding the (legal) implications of Brexit. Potential buyers postpone deals as they are cautious of the impact on exchange rates, questioning what they are actually buying into and being unaware of the effect of future negotiations about Brexit.

A 'disorderly' Brexit, marked by difficult negotiations, would cause more ambiguity and could result in an even bigger decrease in M&A activity than described above. However, should Brexit take place in an 'orderly' manner, M&A activity should recover quicker as this will boost confidence of potential buyers. On the other hand, the significant fluctuations in exchange rates and share prices may encourage both opportunistic as well as defensive M&A transactions. In the past month we have seen a handful of strategic acquisitions sparked by foreign interest in British businesses. Analysts suggest that the current exchange rate of the pound gives prospective buyers a reason to act now.





M&A and
valuations

Below we provide a concise overview of various legal topics, related to the broader M&A scope, that could be affected by Brexit. The effect of Brexit on these topics is both the uncertainty as described above, as well as more time and costs spent due to a duplication of legal requirements that may become applicable to companies and transactions which have both an EU and a UK angle.

Merger control and competition supervising authorities

In the situation the UK has left the EU, there may very well be separate supervising authorities (one for the UK, one for the EU) in the field of merger control and competition, possibly requiring companies to make parallel filings or becoming subject to parallel investigations. In addition, antitrust legislation in the UK is currently based on, and interpreted in line with, EU law and decisions of the European Commission and the European Court of Justice. After withdrawing from the EU, the UK will no longer be obliged to interpret national law in accordance with EU law and companies may have to comply with divergent systems. When withdrawing from the EU, the UK may wish to agree on a protocol to avoid mergers becoming subject to parallel regulations, or it may wish to amend or repeal the related regulations. In the context of a M&A transaction, the above means that it may take longer before certain clearances are obtained.

Due diligence and corporate restructuring
Due diligence investigations related to an envisaged M&A transaction, will become increasingly important in respect of transactions with a UK angle. More detailed investigations during a due diligence are expected to be required in order to create a clear picture of possible issues connected with a transaction that involves a UK entity or other kind of UK dimension. This increases the time taken up by and the costs associated with these transactions. After Brexit, certain types of corporate restructuring may no longer be available between UK and EU legal entities, such as cross-border mergers of legal entities to simplify group structures. This may affect corporate disentanglements and integrations in the context of an M&A transaction.

Share purchase and asset deal agreements

From a pure contractual law point of view, Brexit is not likely to have a major impact in this case, because Sale and Purchase Agreements (SPAs) and asset deal contracts, unless affected by EU antitrust or EU take-over legislation, are governed mainly by national, non-EU harmonised law.

However, a few important elements ought to be noted in this area:

- We expect considerable uncertainty regarding the finalization of UK-EU cross-border deals that are currently not completed.

- Because of probable weaker share prices and higher GBP-EUR currency volatility, so-called ‘Paper Deals’ (i.e. acquisitions of UK stock market quoted shares) will include more and stricter mechanisms to cover risks faced by sellers/ purchasers in such respect.

A looming Brexit may further lead to guarantees or execution provisions in M&A transactions, particularly regarding the triggering of complex post deal key performance indicators in earn-out schemes (e.g. linking a purchase price revision to the evolution of turnover, should a Brexit negatively impact turnover).

Possible implications for intellectual property registrations

Businesses, in particular those that rely heavily on the intellectual property (IP) rights they own, should be aware that EU registrations of IP may no longer cover both the UK and EU. A registration with the European Trademark Office or the European Patent Office may, after Brexit, no longer cover registration in the UK. As a result, parallel registrations (in the UK and in the EU) of IP may be necessary after Brexit. This will increase the administrative burden for businesses operating and seeking protection of their IP in both the EU and UK. In the context of a due diligence for a transaction, the geographical scope of IP rights should receive increased attention.



Working and living permits for employees on international assignments

Similarly, businesses that regularly send employees on international assignments, should be aware that working and living permits may be required when the UK's exit from the EU has taken effect. Furthermore, European Social Security Regulation ensures that individual taxpayers working abroad pay contributions to social security rights only in the country where they are working in, in order to avoid double contributions. If this regulation would not apply to the UK after Brexit, employees from EU member states on international assignments in the UK, or vice versa, may be confronted with double social security contributions. This topic should also be considered

with greater attention during the due diligence for an M&A transaction.

Provisions regarding 'material adverse effect' in business agreements to be negotiated

Another important legal topic to consider in the context of Brexit, is whether the legal agreements that are of material importance to a business (e.g. commercial contracts, joint ventures, financing documentation) contain provisions which may be triggered by an UK exit from the EU. For example, many contracts contain so-called 'material adverse change' clauses, which allows one or both of the parties to terminate the contract or to not fulfil certain obligations, if the circumstances that are

relevant to the contract have changed dramatically. Depending on the definition used in the relevant contract, Brexit may constitute such a dramatic change in circumstances, and may create a risk of the counterparty walking away from the agreement.

Be prepared

A looming Brexit is expected to cause a decrease in M&A activity as a result of uncertainty surrounding the future relationship of the UK with the EU and the (legal) implications. However, this situation may also encourage strategic and opportunistic transactions resulting from significant fluctuations in exchange rates and share prices. Instead of M&A, companies may also consider to reallocate their activities geographically. Although it will still take some time before there is more clarity, businesses should already start preparing and include legal aspects in their 'Brexit impact assessment'. Reviewing relevant contracts, the IP portfolio, human resources policies, the regulatory landscape and other key legal areas can provide valuable insights, reduce risk and may even expose opportunities.





M&A and
valuations

The referendum outcome and valuation of companies

Did the outcome of the UK referendum about EU membership lead to a decline in the value of companies? This is a question that emerged after financial market volatility, currency movements and increased uncertainty that followed the referendum. Below we will briefly touch upon several relevant aspects regarding valuation.

In general the referendum outcome does have a negative impact on company valuations, but the extent of this impact very much depends on the company and, on the longer-term, the ultimate Brexit scenario play-out. The negative impact on company valuations is mainly caused by a reduction of global economic growth forecasts (leading to lower cash flows for companies and investors) as well as a greater degree of uncertainty among investors (leading to higher risk premiums as compensation) as to how the future relationship between the UK and EU will affect the revenues and cost structures of the sectors in which they are active. It is important to note, that the referendum outcome is certainly not the only factor of significance, and needs to be considered in conjunction with other aspects, such as the relatively low economic growth in China and selected European countries.

The impact on valuations further depends on the sector and geographic location of a company. A company located in the UK, with costs predominantly nominated in pounds and exporting its products, can potentially benefit

from the devaluation of the pound versus currencies like the US dollar and euro. However, for companies located in the Eurozone and exporting much of their produce to the UK, the situation could be the reverse. This currency impact is immediate, leading to changes in revenues, profit and the value of a firm. It can however also be a short-term impact, as companies can adapt to the new conditions, for example by expanding business in other currency areas, and as governments can use fiscal policies to mitigate movements in investment flows. The ultimate effect on a company, its activities and valuation will for an important part depend on the future relationship between the UK and EU.

A sector that is currently strongly impacted by the referendum outcome and market conditions is financial services. This is partly due to the decline in interest rates, resulting from a loose monetary policy in many regions, and a 'flight to safety' leading to lower yields on sovereign bonds that are used as reference interest rates⁴. The interest rate reduction by the Bank of England of 0.25 percentage points and a postponement of an interest rate increase in the US, lead to additional pressure on interest rates. As a consequence, interest margins decline further, with a negative influence on the income of banks. Insurers have greater difficulty meeting future obligations due to the lower interest rates or higher value of liabilities. As a result of these developments, the share valuations of financial service companies have declined significantly in the past weeks.

Although other factors, such as the recent outcome of the European Banking Association (EBA) stress test, has also put pressure on the market value of some banks.

A noticeable development after the UK referendum, is that the yield on various sovereign and even corporate bonds has turned negative⁵. This can be attributed to diminished economic growth prospects and very loose monetary policy. This decline in interest rates has supported share prices, in many cases completely reversing the price declines that followed the referendum outcome, as shares have become relatively more attractive compared to bonds, despite uncertainty surrounding e.g. the negotiation outcomes. Negative yields at the current scale are a new phenomenon and a challenge for those involved in the valuation of assets. After all, how should these monetary conditions be incorporated in the discount values used for valuation? In this case it is essential to keep a close eye on the relationship between the interest rate used for discounting, chosen growth estimates and applied assumptions.

⁴ When the prices of bonds increase due to higher demand, the return or yield on these bonds decline. In case of sovereign bonds, yields are often used as an equivalent of a 'risk free rate' to which a risk premium can be added.

⁵ This basically means that someone who lends money by buying a bond, is expected to get somewhat less back in nominal terms at the end of the term. Normally one is expected to get more in return (in the form of interest and principal) as a reward for lending the money.

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