UK Special Situations Investor Survey and M&A Outlook

ANALYSING CURRENT AND FUTURE TRENDS

FTI CONSULTING

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Despite the challenges faced by the UK economy in 2021, mainstream M&A markets boomed with deal value and volume rising by 159% and 70% respectively in the 12 months to the end of September.[1] However, special situations M&A failed to take flight as challenged businesses leveraged government financial support and protection from creditor action alongside favourable capital markets conditions to prevent the need to find a new owner via special situations M&A processes.

In this context, we set out key considerations for the next 12 months of distressed deal activity, leveraging the results from the inaugural **FTI Consulting Special Situations M&A Investor Survey** ("the Survey") that we conducted in late 2021. The Survey aggregates views from UK based investors focused primarily on alternative investments in the lower to upper mid-market, with a typical equity cheque size anywhere from £10 million to over £100 million per transaction.

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1. Source: Mergermarket

2021 Year in Review

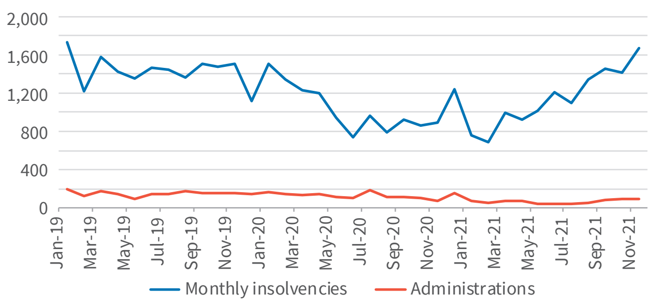
Whilst the year began with a bang following the Arcadia administration in December 2020 and subsequent break-up sales of the portfolio brands to ASOS, Boohoo and CityChic, special situations M&A activity was unexpectedly quieter for the remainder of 2021.

Many legal, financial and insolvency practitioners braced themselves for high levels of special situations M&A in 2021 following a strong 2020 which produced a large number of special situations M&A transactions emanating primarily from the hardest hit sectors including retail, travel and leisure. This was despite the material drop in insolvencies, with the period from March 2020 to December 2020 being 31% down on the previous corresponding period in 2019[2].

However, what transpired in 2021 fell materially short of expectations as companies continued to leverage unparalleled government support in the form of the Coronavirus Job Retention Scheme, grants, tax deferrals and VAT reductions whilst additional new money needs were often either met by incumbent stakeholders or new capital providers eager to deploy funds. Certain businesses turned to formal restructuring procedures in the form of the new Restructuring Plan along with Schemes of Arrangement and CVAs. Additionally, businesses and directors were also protected under various moratoriums including a stay on the eviction of commercial tenants and winding up petitions, together with protections for directors from insolvent trading claims. Businesses also benefited from a sharp V shaped recovery driven by pent-up consumer demand as the lockdown and restrictions were unwound from April 2021 onwards.

Unsurprisingly, as the UK Government support tailed off in the second half of 2021 there was a notable uptick in insolvencies with the figures for November 2021 being 88% up on November 2020 and 11% up on November 2019. However, importantly administrations (directly linked to rescue sales) were still down 38% on November 2019 with the primary driver of the increase in insolvencies being compulsory and creditors' voluntary liquidations for smaller businesses.

Monthly Insolvencies (January 2019 – November 2021)[1]

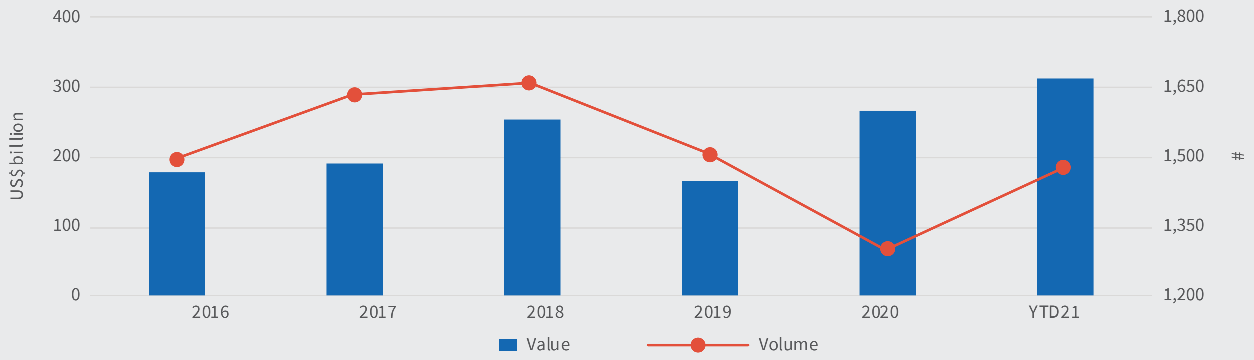


Outside of a hotspot of activity in the energy market (more than 25 failures in 2021) where the majority of processes ended without a sale of the business, special situations M&A activity was limited. However, further signs of stress continued to build in the form of supply chain challenges, inflation, soaring energy costs and rising COVID-19 infections and restrictions driven by the Omicron variant.

How does this compare with mainstream M&A?

The outbreak of COVID-19 in March 2020 instantly slowed M&A activity as markets and investors took stock of the unfolding situation, however, this pause was short-lived with global deal values reaching an all-time high in Q2 2021. In the UK alone, US$309 billion was invested across 1,477 deals in the first three quarters of 2021, already more than the US$215 billion trailing average over the previous 5 years.

M&A DEAL VALUE AND VOLUME (2015 – Q3 2021)[3]



2. Insolvency Service Official Statistics — https://www.gov.uk/government/collections/insolvency-service-official-statistics

3. MergerMarket

Outlook for the UK Economy and Impact on Special Situations M&A

The economic landscape is uncertain with corporates required to carefully navigate debt maturities, the reinstatement of maintenance covenants and reducing Government support, along with macroeconomic pressures (inflation, supply chain challenges, Brexit and more). We therefore expect a pick up in restructuring and special situations M&A activity within the next 12 months.

Unlike in 2020 and 2021, the ability and appetite of the UK Government to mask the damage of the pandemic and Brexit through government support will be significantly reduced. The latest package, revealed by the Chancellor in December 2021, indicates that the appetite for continued financial support is dwindling outside of limited sector specific support such as the directive to HMRC to be lenient and flexible when it comes to negotiating time to pay arrangements for businesses in the hospitality and leisure sectors.

1 INFLATIONARY PRESSURE — HERE TO STAY?

Inflation rose to 5.1% in the winter of 2021 (the largest driver being energy costs) and the Bank of England expects it will reach a peak of 6% in Spring 2022 before falling in the second half of the year.

6%

2022 peak inflation forecast[4]

2 CLIMBING LEVERAGE — LENDER APPROACH?

Many businesses have been forced to take on additional debt to survive, despite their worsening trading performance. Lenders' approach to waiver requests are likely to harden which may result in the need for more restructurings.

+£47 bn

Net corporate debt increase from Q4 2019 to Q2 2021[5]

4. Bank of England — https://www.bankofengland.co.uk/knowledgebank/will-inflation-in-the-uk-keep-rising
5. Bank of England — Financial Stability Report, December 2021

As a result, UK businesses will face much of 2022 and the challenges it presents on their own. Some of these challenges are highlighted below although importantly, many sectors are also facing additional industry specific issues and pressure points.

A Bank of England survey of 3,000 UK CFOs conducted in December 2021[8] demonstrated the current state of business confidence, with sales for the first three months of 2022 expected to be 7.4% lower than previously predicted (hospitality and transport being the worst impacted with a 11% decline). With the above in mind, economists generally agree that UK living standards will worsen in the next 12 months and businesses will face increasing financial and operational pressure. These factors should push a number of stressed businesses and their stakeholders to consider operational and financial restructurings, fundraisings or sale processes. Directors will need to take earlier and more decisive action as creditors will have more leverage in negotiations, shifting the dynamic that has been in place for the last 21 months.

Whilst the tsunami of activity that special situations investors and advisors were predicting back in 2020 may not transpire, we can expect an uptick in restructuring opportunities within the next three years, a significant number of which will involve some form of special situations M&A solution.

3 OTHER PRESSURE — CREDITOR PATIENCE?

The 'hidden' leverage impact of tax, landlord and other deferrals remain. Zombie companies may be forced into taking action as and when residual protections from creditor action come to an end.

£33.5 bn

VAT Deferrals relating to 20 March 2020 — 30 June 2020[6]

4 SUPPLY CHAIN — LONG TERM DISRUPTION?

Over 2021, universal disruption to supply chains in the UK and globally have caused a drag on the economic recovery. Brexit has exacerbated these challenges in the UK. Many expect this to continue in 2022.

17%

Of UK businesses unable to source goods from the EU[7]

6. House of Commons Library — Coronavirus business support schemes: Statistics, December 2021
7. Office of National Statistics — Institute for Government Analysis of ONS, Business Impact of COVID-19 Survey, 4 October to 31 October 2021
8. Bank of England — CFO Survey

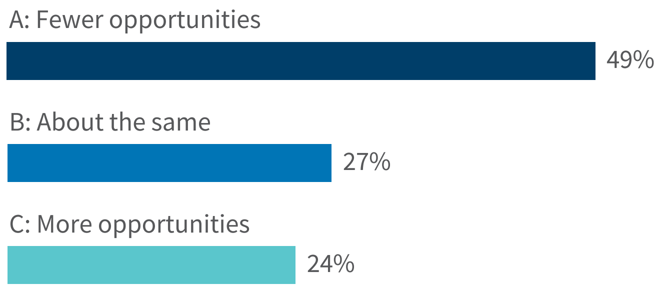
Looking Ahead — Investor View

Whilst it might well be possible that certain challenged UK businesses have successfully and permanently evaded the need to go through a formal restructuring or change of ownership, this won't be the case for many. The more pertinent questions are when will the bubble burst and which sectors will be impacted.

Activity Gauge

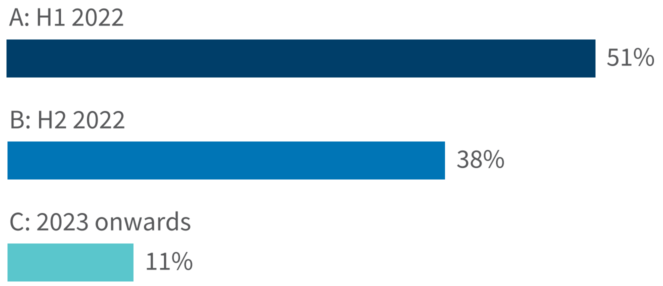
Whilst the largest segment of participants from the inaugural FTI Special Situations M&A Investor Survey ("the Survey") conducted in late December 2021 saw significantly reduced special situations M&A deal activity in 2021 (76% saw less or similar levels), almost a quarter of respondents said they saw more opportunities in 2021, albeit a number of those situations involved debt financing rather than taking controlling stakes.

HOW DOES THE VOLUME OF SPECIAL SITUATIONS INVESTMENT OPPORTUNITIES IN THE UK IN 2021 COMPARE WITH 2020?



Source: FTI Consulting

WHEN DO YOU EXPECT TO SEE INCREASED LEVELS OF SPECIAL SITUATIONS INVESTMENT OPPORTUNITIES IN THE UK?



Source: FTI Consulting

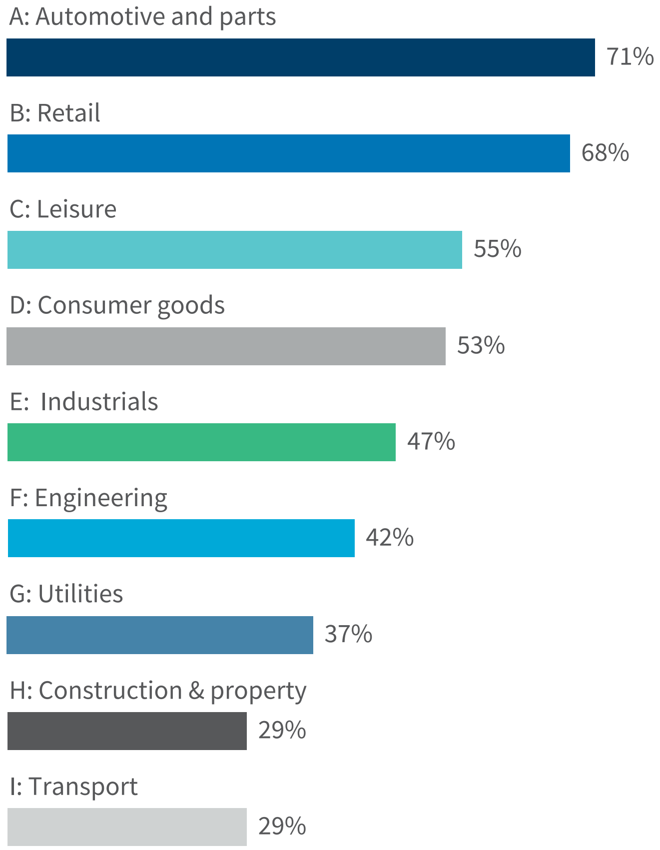
89% of respondents expect increased levels of special situations activity in 2022, with 11% expecting things to pick-up in 2023.

The views of the majority Survey respondents are also echoed by investors and service providers in the mainstream M&A market per the Ansarada "Top Dealmakers' M&A Predictions 2022" survey with 54% of responders believing the number of distressed deals in the UK will rise in the next 12 months[9].

Sector Hotspots

Automotive and parts (71%) followed by the usual suspects including retail, leisure and consumer goods are the sectors where investors expect the most activity. The list is unsurprising given the challenges presented by the pandemic and sector specific structural changes.

WHICH SECTOR(S) DO YOU EXPECT TO SEE INCREASED ACTIVITY LEVELS OF SPECIAL SITUATIONS M&A OPPORTUNITIES IN 2022?



Source: FTI Consulting

9. Atradius — https://atradius.co.uk/reports/economic-research-insolvency-increases-expected-as-support-ends.html
10. Ansarada — Top Dealmakers' M&A Predictions 2022

Investors expect significant activity to be a consequence of rising leverage and failed refinancings. They also anticipate UK corporates will continue to streamline existing operations, leading to increased levels of corporate divestments of non-core or underperforming subsidiaries.

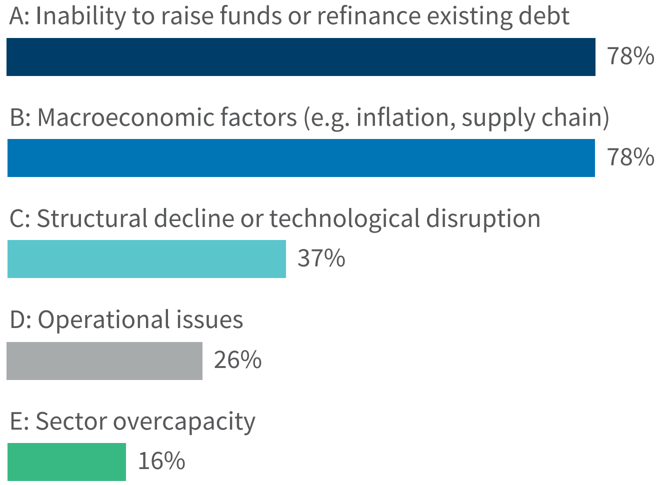
Situational Dynamics

A common theme over 2020 and 2021 was the ability of shareholders and lenders to agree consensual deals involving temporary suspension of covenants (or switch to liquidity focussed covenants), maturity extensions and cash interest being temporarily PIK'd, often at the cost of the shareholder agreeing to provide new money.

However, whilst helpful for many businesses, a number have failed to recover to pre-pandemic levels of profitability and are now facing a cliff edge in respect of a return to normal terms and/or maturity horizon. As a result, we together with the surveyed investors are expecting a significant number of deals to be driven by the inability of businesses to raise funds or refinance existing debt.

Many private equity sponsors will also face a decision point as to whether to continue to support portfolio assets in the face of uncertain performance and lengthened exit horizons.

WHAT FACTOR(S) WILL BE MORE LIKELY TO CONTRIBUTE TO THE INCREASED LEVEL OF OPPORTUNITIES IN 2022?



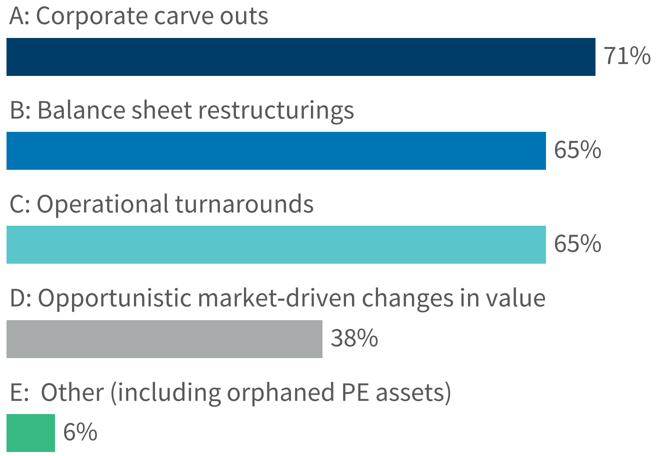
Source: FTI Consulting

Investor Preferences

Whilst special situations investors have a significant amount of flexibility when it comes to sectors, they will usually have a mandate to focus on opportunities aligned to the nature of the turnaround or deal structure required.

In this respect, the Survey results indicated that investors are strongly focused on corporate carve-out opportunities in 2022, as large corporates exit non-core and underperforming divisions (71%), and are equally interested in balance sheet restructurings and operational turnarounds (65% each).

WHICH TYPE(S) OF SPECIAL SITUATION INVESTING OPPORTUNITIES ARE YOU PRIORITISING IN THE UK?



Source: FTI Consulting

Balance sheet restructurings are going to be an inevitable consequence of failed refinancings and liability accruals (e.g. HMRC, landlord and other creditor deferrals/working capital deterioration) whilst operational restructurings will be needed by businesses which have thus far failed to adapt to the changing trading environment and new economic challenges.

Why FTI Consulting?

We provide conflict free M&A solutions for clients facing challenging, complex or business critical issues, where specialist situational M&A expertise and advice (often in accelerated circumstances) is the key to maximising value for business stakeholders.

DIRECT, PRAGMATIC AND SENIOR LED APPROACH TO DEALS

We work in conjunction with key stakeholders such as sponsors, lenders and management teams to deliver pragmatic solutions and outcomes. We operate dedicated senior teams committed to the engagement throughout the whole process to drive progress and deliver results.

ABILITY TO LEVERAGE THE GLOBAL FTI CAPABILITY

We leverage the relevant sector, geographic and situational expertise of FTI Consulting's global network with over 6,600 employees and offices in 86 cities across 28 countries on 6 continents. Our one team approach, ensures we cover all angles, minimise risk and deliver the best outcome for our clients.

ACCESS TO GLOBAL NETWORK OF SPECIAL SITUATIONS CAPITAL

We have excellent access to key decision makers and insights into the most active and credible financial and strategic investors in the UK, Europe and the US. This includes strong active and relevant relationships with special situations investors with significant dry powder to deploy into challenging situations.

Selected experts

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Ben leads our Special Situations M&A team in the UK. He utilises the corporate finance and restructuring skills he has developed in almost two decades of acting as an advisor to guide his clients through disposals, acquisitions and fundraisings. Ben has worked across a range of sectors for a variety of clients.

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Matt leads the UK mid-market and insolvency practice. Matt has over 19 years of experience leading a large number of high-profile and complex restructurings and insolvency cases including leading and delivering a number of special situations M&A transactions. Matt has experience across a wide range of industries.

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Callum is a Senior Director in our Special Situations M&A practice with significant M&A advisory, accelerated funding, restructuring and valuation experience across a range of sectors and for a diverse type of client. Prior to joining FTI Consulting, Callum worked across Corporate Finance and Restructuring teams of a big 4 firm in Australia and the United Kingdom.

A Leader Among Leaders

Every year, FTI Consulting helps more than 6,600+ organisations globally transform the way they anticipate and respond to events, both at critical moments and for the long haul.

NYSE:FCN

Publicly traded

$4.9B

Equity Market Capitalisation*

1982

Year Founded

55

55 of Fortune Global 100 corporations are clients

8/10

Advisor to 8 of the world's top 10 bank holding companies

96/100

Advisor to 96 of world's top 100 law firms

Number of total shares outstanding as of October 21, 2021, times the closing share price as of October 28, 2021.

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EXPERTS WITH IMPACT™

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