Opportunities to invest in UK Plc: Nick Colman discusses Brexit

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In the spotlight

1. Deal activity slows as buyers and sellers pause to re-evaluate – it's not all doom and gloom, but there is a distinct trend towards pushing deals to later in the year when everyone expects we may be ready for a move back towards BAU.
2. Challenger banks are inherently linked to the success and prosperity of the UK economy – will Brexit lead to accelerated consolidation in this sector?
3. Will UK operations change from "core" to "non core" for some banks – with UK Market access uncertain, now is the time to reassess what is non-core.

If your inbox is anything like mine, then it will be overflowing with Brexit emails. Not surprising really. The vote to leave the EU represents the biggest political shock of our generation and probably the second biggest economic shock to the UK which could have more profound medium to long term impacts than the GFC. Before scratching the surface, let's briefly take stock of what we know so far:

- **Deep division:** With less than a 2% majority in favour of leave, the UK is deeply divided. Splits on the basis of age, location and education paint a complicated picture.
- **No immediate change:** At the risk of stating the obvious, the UK hasn't left yet. Until Article 50 is triggered, the UK remains in the EU and we have time to plan for what comes next. However, the political backdrop is far from reassuring with the Tories down to a one-horse race, Corbyn under siege and a challenge being mounted against the legality of triggering article 50 without Parliamentary approval – it is hard to see a clear plan emerging before October.
- **Markets fall:** The FTSE 100 has fallen and recovered strongly (largely on the back of sterling depreciation) and the FTSE 250 has fallen and not fully recovered. Traders are likely to be the only ones enjoying the current volatility.
- **Share prices tumble:** Companies largely dependent on the health of the domestic economy, have seen share prices drop dramatically – Barratt down 40%, RBS down 40%, Barclays down 25%, Challenger Banks fall harder than high street banks.
- **Bank of England stabilises:** Mark Carney has stated that the BOE stands ready to use macro prudential tools to stabilise the UK economy. The first indication of this is a relaxation of Banks' capital buffers to encourage lending and many economic commentators expecting rates could be cut before the summer break.
- **This is not 2008:** Government and business borrowing costs remain stable in the short term, even for battered banks, and even after the UK has lost its AAA rating. There is no liquidity crisis and banks are much better capitalised than during the GFC.

In the immediate aftermath of the vote, the most common reaction from our City contacts was shock and disbelief. Many of us living in London and working in banking barely knew anyone who was planning to vote "Leave" and couldn't understand the quantitative rationale for wanting to leave. With hindsight this was part of the problem and perhaps we shouldn't have been so surprised. The populist tides have been rising around the globe with particular traction where real GDP growth has stagnated, unemployment rates are high and rising, migration policies are perceived to be outside the control of sovereigns and continuing austerity measures are handed down "from the outside". This has left many UK voters feeling that their country's sovereignty has been diluted and that Brussels is to blame.

From the macro perspective, Brexit certainly feels more like a Bear Stearns moment than a Lehman moment. But what are we seeing down in the trenches and what is attention turning to now? What can we look forward to as the dust settles?

- **Immediate impact on banking deal activity:** We have seen that big deals are stalling and small deals carry on. Unless vendors can step in to provide competitive vendor finance packages, the big PE houses will need more time to pull together binding bids. That's not to say that all deals will fail, but immediately post the voting we have seen the pause button being pushed or timelines extended. So far it looks like small and mid-sized deals are less effected. Deals early in the process are likely to continue as vendors seek to preserve optionality for transacting in Q4 2016.
- **View from the buy side:** The views are wide and varying with some buyers saying that they currently have an investment freeze for Europe and others stating that they are open for business but see pricing for predominantly UK based assets reducing by 10 to 20%.
- **View from the sell side:** Again, the experience to date in Banking has varied with the sale of Propertize to JPM and Lone Star (Source: Reuters) proceeding on the one hand and whispers in the market that the sale process for MBNA may be delayed until Q4 (Source: Financial Times). The key determinant so far is how much exposure the assets have to the UK both in terms of operations and financing.
- **View from the financing side:** Recent financing packages contained Brexit MAC clauses and we understand that a number of these have been triggered. In addition, we are hearing that lenders have both reduced advance rates and increased pricing which have had direct and immediate impacts on buyer pricing.
- **Challenger banks future uncertain:** With initial estimates pointing to reduced demand for credit, the Bank of England flagging a rate reduction by Christmas and a negative economic outlook pointing to higher costs of risk, the market has hit challenger bank share prices even harder than high street banks. Much attention is now focussed on the challenger sector with off-shore investors seeing the current situation as an opportunity to invest in UK plc. However, with many of the challengers having anchor shareholders, we believe that mergers and consolidation could be a more palatable option for the sector.
- **More "non-core" sales:** Foreign banks with subscale or non-core operations in the UK may decide that opportunities to grow their portfolios in the UK will now be reduced leading them to consider exiting in the short term. This will create opportunities for challengers and those lenders who remain to make up growth budget shortfalls through acquisition.
- **Relocation, relocation, relocation:** With single market access uncertain at best, attention is turning to EU banking licences and continental hubs in addition to London operations or even replacing London. While London remains a unique centre of excellence for "getting things done", with a swift and predicable legal system, more employer friendly labour laws and the most diverse mix of skilled professionals located in one space, Paris, Dublin and Frankfurt will push hard for a share of London's business. When the final exit occurs there will be no time for re-orientation. This is going to drive business, at a minimum, to put in place some optionality to deliver continued market access.

The Leave campaign never presented a plan for what happens following a "Leave" vote. While this is being scoped and clarified and negotiation progresses behind closed doors, we expect buyers and sellers to continue to pursue small to medium sized transactions in Germany, Ireland, France, the Netherlands and in CEE while a more "wait and see" approach will be taken for UK and Italian assets.

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