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Higher interest rate environment could provide opportunities for UK PLCs and reverse de-equitisation trend in public markets

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The seismic shift in base rates since the start of 2022 has increased the cost of capital across all asset classes, but the relative size of these increases has profound implications for investor allocations. This could provide a significant tailwind to public markets and impact the competitive dynamics of M&A processes and the attractiveness of IPOs as an exit route as volatility begins to settle.

Simultaneously, momentum is building around structural and regulatory reform in the UK capital markets, with investors, advisers and regulators all aligned on the need to improve the competitiveness of London's listed markets to drive growth and innovation. The FCA's recent consultation has been broadly welcomed and, if these changes are embedded, they could be transformative for the City. Nervousness around the short-term economic outlook is suppressing M&A and ECM transaction volumes, but this has masked a sea change in the investing environment, which could also be a catalyst to revive public market activity.

Impact on private equity

Rising base rates have significantly increased the cost of high yield debt, which is typically used by private equity investors to finance take-privates and to fund expansion of their portfolio companies. In January 2022, single B-rated companies borrowed at approximately 5%[1] and today the same companies are paying 10%+[2] for their debt. Assuming that private equity's target equity returns have stayed flat at 20%, then a 50:50 debt to equity funded business will have a cost of capital approaching 15% compared to approximately 12.5% at the start of 2022. In simple terms, private equity's funding costs have gone up materially.

Public market appeal

For comparison, UK boards and investors, scarred by rescue equity issuance in the global financial crisis, have shied away from debt and have run very conservative balance sheets throughout the past 15 years, and particularly coming out of the covid period. These largely equity financed capital structures have a low double-digit cost of capital, which has not changed significantly since rates began to rise. Critically, many lowly levered UK PLCs and investors now have a lower overall cost of capital than their private equity peers. This may make UK listed markets more attractive in a number of ways if higher base rates become the new normal.

Firstly, IPOs may become significantly more attractive as an exit option compared to a secondary sale to new private equity buyers. Public markets' lower cost of capital should allow investors to price companies' earnings at higher multiples than private equity buyers once confidence returns. This could reverse the de-equitisation we have seen since the start of the ultra-low interest rate environment began in 2009.

[1] Numis analysis
[2] Numis analysis

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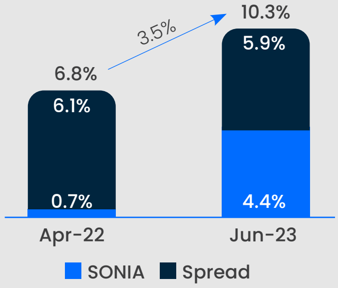
Cost of capital has risen significantly since 2022

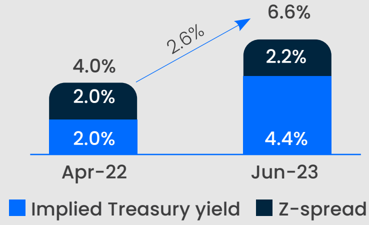
Corporate buyers are now at a relative advantage to their private equity counterparts

Since 2022, cost of debt has increased materially …

Cost of debt

Private equity



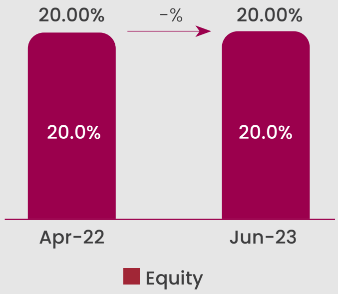


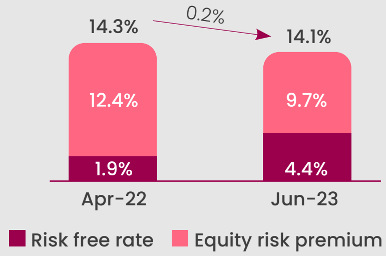
UK PLC

… whilst cost of equity has remained broadly similar …

Cost of equity

Private equity



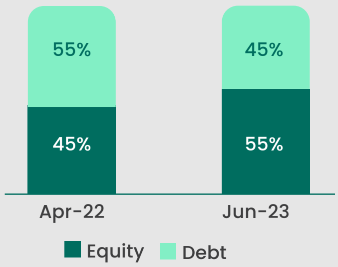


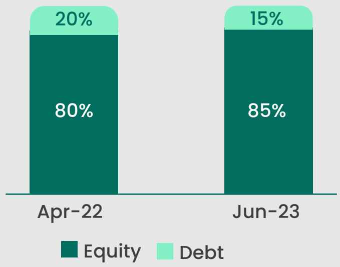
UK PLC

… combined with lower leverage puts UK-listed corporate buyers at an advantage to their private equity bidder counterparts

Indicative capital structure

Private equity

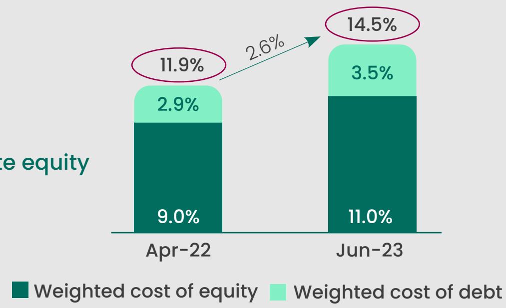


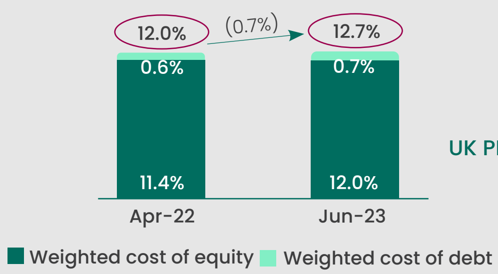


UK PLC

Implied WACC

Private equity





UK PLC

Source: Numis analysis

Notes: Private equity credit spread proxied by Pan-European High Yield Bond (B grade). UK PLC credit spread implied from UK corporate BBB 10+year bonds Z-spread over the implied treasury yield. Risk-free rate proxied by the 10-year UK gilt. UK PLC equity risk premium assumes a beta of 1.3. WACC calculation assumes UK tax rates of 22.5% and 25% in April 2022 and April 2023, respectively.

Secondly, currently listed companies will likely be a lot more competitive in M&A, as they should be able to pay more than competing private equity bidders. In combination with the proposed regulatory changes, which will allow them to execute deals far more quickly due to reduced requirements for shareholder approval and raising new equity, listed company bids will be much more attractive to sellers. Our M&A survey in January[3] suggested PLCs were expecting an uptick in front-footed M&A. This should hold them in good stead. The US regional banking issues have slowed this down, but strong balance sheets mean corporates remain well placed.

Thirdly, new 'platform assets' may increasingly see listed markets as their natural home. As stated above, private equity management teams used to be able to fund bolt-ons with debt at approximately 5% interest, and use the acquired earnings to pay down debt. Financing these at 10%+ makes reducing debt much more challenging, there is less cash flow available to fund future acquisitions, and there is much more scope for covenant and liquidity issues. Executives at these fast-growing, ambitious companies may sleep much easier at night in the listed markets without these pressures in a volatile environment.

Finally, higher rates and lower leverage levels will catalyse more exits for private assets. Very few companies have had to refinance since rates began to rise and the economy began to soften; however, as 2024 progresses, many companies that refinanced in 2020 will need to come to market. Persistently higher base rates could double interest costs in many cases, and drive companies towards lower leverage capital structures. Private equity sponsors that are unable to inject new equity may seek IPOs or a sale to a PLC to de-lever their assets while maintaining exposure in a listed vehicle.

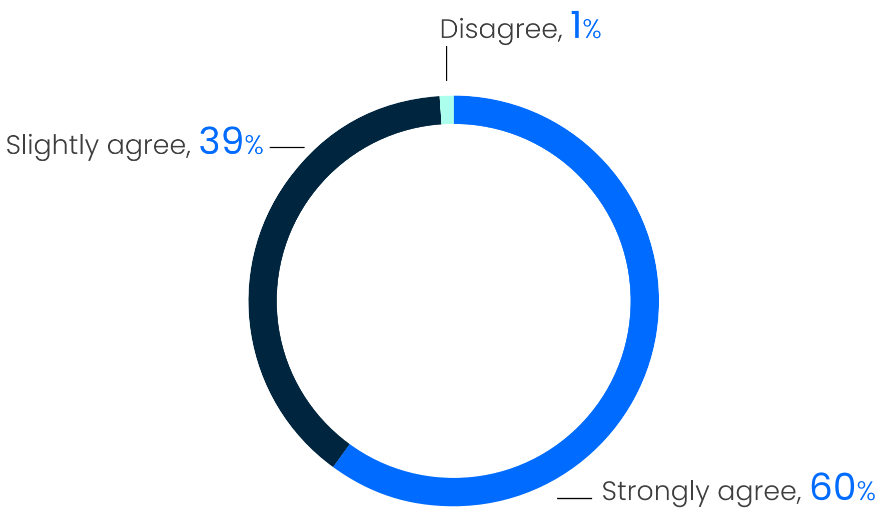
Public markets likely to benefit

The changing environment will provide significant opportunities, and public markets seem well placed to benefit from this. However, it is early days. Higher base rates are new, but not yet the norm.

Private equity will continue to be competitive and value-added owners of many businesses. Nonetheless, their 'right-to-win' will revert to the advantages they can bring to companies through full control, and their ability to drive operational improvements in both the growth and cost where businesses are undermanaged, rather than simply a structural advantage on relative cost of capital.

In Numis' soon-to-be-published survey of 150 FTSE C-suite executives and chairpersons[4], almost all (99%) respondents felt that the current dynamics would favour public markets, perhaps unsurprising given the flow of UK take-privates has continued to slow since H1 2022[5]. Despite some larger leaked situations, there has not been a firm offer for a UK listed company of >£1.5bn so far in 2023, which is in stark contrast to private equity bidders being the first movers following covid. This could be the first sign that UK public markets are increasingly well set for a renaissance.

Private equity groups used to be able to raise capital cheaply to fund their acquisitions when interest rates were very low. It is now a lot more expensive to borrow in the form of bonds and bank debt. This will favour listing on the stock market when conditions improve as equity valuations are in some cases more attractive than borrowing. How strongly do you agree or disagree with this?



[3] Numis Focus: *An inside-out study of UK mid-market M&A* (March 2023)

[4] During May 2023, Numis surveyed 150 UK listed company executives (chairpersons, CEOs, CFOs, and heads of investor relations and senior independent directors) to capture their views on the London IPO/fundraising market.

[5] M&A Insight

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