



# SteelBridge Insights

*A management consulting view  
of private capital's evolution*

**BrexitWatch**

Special Edition

*Building a better Private Capital marketplace*





### Key Highlights:

- Political and regulatory fallout from Brexit will be a 2-4 year process.
- Valuations of Private Capital portfolio companies with international interests may be affected.
- Fund raises in process will likely continue, but new fundraises will be sensitive to currency fluctuations.
- While risky, significant opportunity may arise for investments in the U.K.

## Introduction

Financial markets and investors are still coming to grips with the outcome of last week's referendum vote. Britain's departure from the European Union (EU), more commonly known as "Brexit," quickly caused massive market upheaval and a veritable nosedive in the value of the British Pound. It has introduced a myriad of questions and uncertainty in the global economy. While the end of the week saw markets stabilizing, there is anxiety permeating through the markets not seen since 2008.

Fund managers and investors in private capital wonder: How will this affect our investments? How will this affect the flow of capital, our ability to raise funds, deploy capital, and source deals? For funds with large investments in the U.K. or funds with portfolio companies reliant on international trade, the Brexit effects may be more pronounced.

In the following pages, the SteelBridge team provides a synopsis of the week's events. Additionally, we offer some commentary on the potential impact of Brexit as it pertains to private capital. As events unfold, we will follow this special edition of SteelBridge Insights with ongoing BrexitWatch commentary specific to our unique marketplace.



## Brexit: 2013 – Present and Beyond

2016	January 2013	British Prime Minister David Cameron announces the renegotiation of UK/EU relations and proposes an advisory in-or-out referendum
	June - December 2015	UK representatives and a special EU Task Force iron out a deal
	02 February	Draft deal is published, receiving much negative press in Britain for failing to accomplish PM Cameron's stated goals
	18-19 February	After 24-hours of nonstop negotiations, the EU ratifies a "watered down" UK deal, which receives mixed reviews in Britain
	20 February	UK's in-or-out referendum date is announced, and campaigning for Leave and Remain camps commences
	23-24 June	<b>Referendum vote and announcement of a surprise victory by Leave voters. PM Cameron announces his resignation after campaigning fervently for Remain. Global markets go into shock</b>
	28-29 June	EU holds a summit to discuss future political and economic relations with the UK - the UK is not present
	30 September	UK's Article 50, formally stating its intention to leave, is due to the EU
	May 2017	French presidential elections
	September 2017	German parliamentary elections
	September 2018	Deadline for UK exit
	May 2020	UK general elections



## Political Uncertainty

While there is always some level of uncertainty with regards to financial markets and the global economy, Brexit exacerbates that uncertainty to uncomfortably high levels. There are still many months of negotiation before an official exit is finalized. A lot can, and will, happen.

A new government will emerge upon the resignation of Prime Minister David Cameron, who made his announcement hours after the vote. The make-up of that new government remains to be seen. That said, Conservatives will continue to be the dominant political force until the next general elections. Barring a victory of Labour in that year, private capital will likely continue to benefit from Conservative policies as well as a strong desire to attract investors and investments to the British Isles.

There is also the outside chance Parliament members ignore the will of the voters and choose to remain in the EU. There is also speculation that a re-vote could occur as many voters have already expressed voter's remorse. Assuming the exit occurs, it could have a ripple effect across Britain, Europe, and the global economy.

A further possibility is that other countries follow Britain's lead and depart from the EU. Among those countries frequently mentioned are Sweden who, like the U.K., refused to introduce the Euro as a currency; Denmark, a close U.K. ally in the EU; the Netherlands; France; and Hungary. Greece, whose ongoing debt crisis has long been a source of agitation among EU members, may be forced out in an effort to placate other members and salvage the union. Further shake up in the EU could occur, threatening the largest integrated market in the world.

Then there is the issue of Scotland. Scotland's 2014 referendum to leave the U.K. failed. However, First Minister Nicole Sturgeon has indicated a second referendum on the same issue may occur in the near future. Scotland voted overwhelmingly to remain in the EU, and FM Sturgeon has suggested they could block Brexit entirely. The EU has expressed a desire to have Scotland as a member should they declare their independence.

## Global Economic Concerns

In the short term investors must brace themselves for currency and market volatility, low interest rates, and capital outflow. Widespread panic and sell-offs occurred moments after the results were announced. Trillions of dollars of book value were wiped away. The British Pound plunged to its lowest point since 1985 and the Euro dropped as risk-averse investors hoarded their money, opting to purchase gold and U.S. Dollars. Later in the same week, markets have recovered much of their losses, but the possibility of similar dramatic swings runs high with each Brexit milestone.





The long-term outlook depends largely on how the U.K. and the E.U. negotiates and manages the exit. Given the central role immigration played in the Brexit vote, it's logical to assume a curtailment of immigration into the U.K. The U.S. will maintain strong ties and trade relations with both the U.K. and E.U.

It's hard to imagine a scenario where the U.K.'s economy does not undergo significant fluctuation. How substantial and long-lasting that state of flux will be remains to be seen. Both Moody's and the S&P have already downgraded the U.K.'s credit rating. Economists have speculated reduced GDP growth by over 1% and a rise in unemployment.

The same concerns apply to EU member states, which have been hampered by sluggish growth for several years. The spillover effect of Brexit and the lack of confidence in the EU will likely reduce GDP further. Moreover, the interconnected nature of the modern economy dictates that the U.S. may also experience some strains on economic growth. Any downturn in the economy will affect private capital firms, even those with limited global exposure. Indeed, a receding tide lowers all boats.

### Trade Issues and Investment Valuations

The most direct way the Brexit could impact the U.S. is through trade. The U.K. is the U.S.'s 7<sup>th</sup> largest trading partner. A stronger U.S. Dollar does not bode well for U.S. companies exporting goods. Their products become less competitive. For private equity funds with portfolio companies who rely on international trade, this will affect their earnings and thus, reduce their valuation.

A major area of concern for private equity funds with international exposure is the valuations of their portfolio companies. Valuations are largely based on operating income (EBITDA). Transaction gains and losses are a result of the effect of exchange rate changes on transactions denominated in currencies other than the functional currency. Gains and losses on those foreign currency transactions are generally included in determining net income for the period in which exchange rates change.



### Transaction Adjustments

	Export	Import
Dollar Weakens	Gain	Loss
Dollar Strengthens	Loss	Gain

Depressed values of debt and equity will negatively impact enterprise value, thereby reducing valuations. Moreover, paralysis and risk-aversion among business and investors will hinder the liquidity of investments, further reducing valuations and reducing potential exit opportunities.

At the fund and/or portfolio level, translation adjustments may affect foreign currency denominated loans from financial institutions and investments in debt and equity securities denominated in foreign currency. Translation adjustments arise from converting foreign currency financial statements into U.S. Dollars using different rates. Translation adjustments are not included in determining net income for the period but are disclosed and accumulated in a separate component of consolidated equity until sale or until complete or substantially complete liquidation of the net investment in the foreign entity takes place. Though unlikely, there is an increased risk of LP defaults or the inability to fund capital calls. There may also be an increase in LPs selling or transferring their investments in the fund.

### Translation Adjustments

	Net Asset Position	Net Liability Position
Dollar Weakens	Gain	Loss
Dollar Strengthens	Loss	Gain

The silver lining is that monetary policy easing will persist. The Bank of England, the European Central Bank, and the Bank of Japan will likely ease policy. The U.S. Federal Reserve also indicated that it would hold off on raising rates in the near future. Private equity funds rely heavily on low cost debt and the tax advantages of interest. This will benefit all funds, particularly LBO funds.

A strong dollar means that foreign assets are comparatively cheaper. With depressed valuations and a risk-averse environment, this may be an ideal time for U.S. funds to diversify geographically. Bold, prudent investors with foresight and the wherewithal to withstand short-term fluctuations may find opportunities where others see challenges.

### Fund Operations and the Regulatory Landscape

By ceding from the EU, the U.K. is no longer bound by the rules and regulations of the member states. One advantage to this is that the UK will have the freedom to regulate its own financial sector. That said, London must include in its negotiations with the EU language identifying how British firms may freely do business with the Continent and vice versa. The U.K. must create a new regulatory environment that conforms to EU standards, while being careful not to add additional layers of forms, rules, and regulations that unduly burden fund managers and increase costs.



For Private Capital, SteelBridge believes the negotiations between the U.K. and EU will heavily focus on the EU's disclosure and reporting requirements, particularly those in the tables below. Data protection requirements – recently released in an EU directive – are also critical. Any new U.K. regulatory scheme must meet the EU's standards for managing investor data. The remaining question is whether the U.K. will attempt to mirror her EU counterparts or take more of a U.S.-based approach to regulation.

Markets in Financial Instruments Directive (MiFID)		Alternative Investment Fund Managers Directive (AIFMD)	
Regulates trading and advisory practices among member states	Possibly replace with a FINRA-like agency	Disclosure requirements for private funds doing business in the EU	"Copy-paste" a U.K. version, or simplify to mirror U.S. Form PF

## The Road Ahead

Fund managers and investors can expect increased volatility in the market, currency exchange rates, and portfolio company valuations. London's position as the premier financial hub in Europe may diminish or at least be dramatically altered. It will likely mean the loss of jobs for those in the banking sector, posing a large threat to the U.K. economy, which will undoubtedly affect the world economy and its EU neighbors in particular.

The geopolitical uncertainty will be problematic. Whether new norms place new limitations on the flow of capital or expand opportunities remain to be seen. In all likelihood, smaller fund managers will be hesitant to inject dollars into a Britain in such flux for the coming two years. Simultaneously, those two years may present significant opportunities for larger fund managers to make strategic purchases in the U.K. It will be months before negotiations are finalized and new rules are established. Navigating through the new environment will require an increased investment of time, money, and energy.

With the credit rating of the U.K. having been downgraded and a banking sector deeply impacted, the cost of borrowing may increase. Startups, in particular, are sensitive to the flow of credit. London is a European hub for startups, particularly in Fintech. A credit crisis or reduction in borrowing poses an existential threat to startups. Furthermore, the free flow of human capital, which businesses and workers consider a benefit to EU membership may be limited. Additional barriers to entrepreneurship and worker mobility will reduce economic growth, innovation and job creation.



## Summary

Brexit will continue to present challenges for the investment community and financial services industry. While private capital has not yet been a focal point of discussions, the impacts of Brexit will inevitably be felt in our sector. SteelBridge is monitoring the situation and is prepared to assist our clients in navigating through the changes.

---

## About SteelBridge

SteelBridge is a boutique advisory services firm with deep expertise in private capital. We have a passion for helping our clients identify and affect change to improve process and technology for more effective organizations. We help general partners, limited partners, third party administrators, software vendors, and portfolio companies. At SteelBridge, we hold ourselves to the highest standards by providing exemplary services for our clients.

To learn more call us at 646.737.7960 x1008, visit us at [www.steelbridgeconsulting.com](http://www.steelbridgeconsulting.com), or join us on our Facebook and LinkedIn pages for more information:



***Let us show you why we are the leading boutique advisory services firm in the Private Capital space.***

### Contact:

p: 646.737.7960 ext. 1008

e: [info@steelbridgeconsulting.com](mailto:info@steelbridgeconsulting.com)

#### **Pittsburgh:**

1725 Washington Road  
Suite 305  
Pittsburgh, PA  
15241

#### **New York:**

14 Wall Street  
20<sup>th</sup> Floor  
New York, NY  
10005

#### **Los Angeles**

7711 Center Avenue  
Suite 200  
Huntington Beach, CA  
92647

#### **Miami:**

7990 SW 117<sup>th</sup> Avenue  
Suite 203  
Miami, FL  
33183