howden M&A

Arrowpoint Advisory

Rothschild & Co

Pinsent Masons

PE M&A Report

2021

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Executive Summary

Welcome to the 2021 edition of our annual review examining deal terms and trends in the M&A and private equity markets. For the third year running we are delighted to work alongside Howden M&A and Arrowpoint Advisory to pool our deal data, which we believe provides the most comprehensive analysis of UK mid-market transactions available for review by buyers and sellers alike. We hope it proves a useful benchmarking tool for your transactions.

In our 2020 report we commented on the strong sellers' market and whether this would continue given the darkening economic forecast at that time and increasingly uncertain business environment – little did we anticipate what an extraordinary year we would experience!

When the UK first entered lockdown in Spring 2020 we feared a sharp decline in deal activity and, while there was an undoubted pause as investors took stock, there was a relatively swift resumption of deal making in the second half of the year – albeit this activity was going ahead in completely new circumstances. During the year we worked on transactions which completed despite investors (or their advisers) being unable to physically meet with management teams and where deals were finalised over Zoom calls with family life often clearly evident in the background.

In several areas we saw a continuation of the trends in our 2020 survey and this is reflected in little change in many of the charts in this report. Changes we did note centre on an acceleration of deal activity in the latter half, partly at least driven by fears of an increase in capital gains tax rates.

We have also noticed a subtle hardening of buyers' negotiating positions – with private equity investors being less generous with equity allocations to management teams. It is worth noting that from a seller's perspective, where transactions have included an element of deferred consideration, management are being given longer to achieve targets in recognition that post lockdown trading may take a bit longer to recover.

As we reach the midpoint in the second quarter of 2021 – we are seeing a continuation of last year's themes. With, what is hopefully an ease in lockdown restrictions and a return of more normal trading conditions, we are cautiously optimistic about prospects for the remainder of 2021.

Ed Stead
Head of Private Equity
Pinsent Masons

Caroline Rowlands
Head of Private Equity
Howden M&A

Simon Cope-Thompson
Managing Director
Head of Management Advisory
Arrowpoint Advisory

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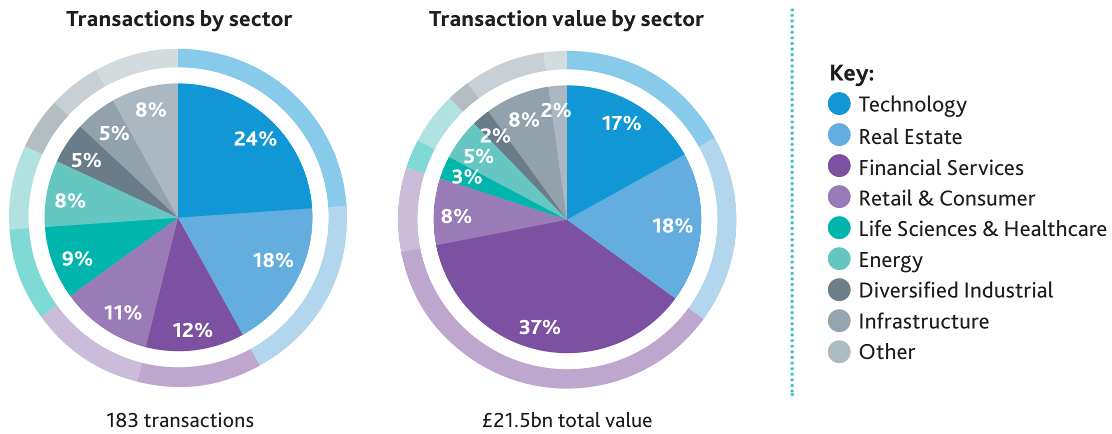
Survey Methodology

Our survey analysed the combined deal data for Pinsent Masons, Howden M&A and Arrowpoint Advisory for transactions completed in 2020. Data was extracted from **183** (down from 190 surveyed deals in 2019) completed transactions with a total value (where disclosed) of **£21.5 billion** (72% up on 2019). The average transaction value across all deals (where disclosed) was £137 million (double that of the deals analysed in 2019).

The transactions we advised on were from a representative mix of sectors with unsurprisingly Technology (24%), followed by Real Estate (18%) and Financial Services (12%) contributing the highest volume of transactions. The Financial Services sector accounted for the highest value contribution, representing 37% of the total value followed by Real Estate 18% and Technology 17%.

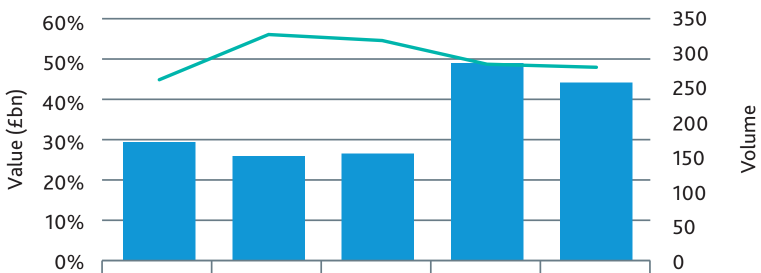


UK mid-market private equity deals 'resilient despite lockdowns'

Mid-market M&A transactions in the UK did not appear to suffer serious coronavirus setbacks in 2020 in terms of the number of deals concluded.

This is in spite of a brief halt to deals at the start of the first UK lockdown in March. Deal activity advised on by the three firms accelerated in the latter part of 2020, showing that unlike prior economic shocks, the disruptions in 2020 did not lead to a fire sale of assets and prices for good businesses held up.

UK Private Equity Volume & Value



	2016	2017	2018	2019	2020
Value (£bn)	29.5	26.4	26.8	48.8	44
Volume	263	329	320	285	277

Source: Mergermarket: All UK PE acquisitions (excluding bolt-ons)

We noticed that the number of deals being done accelerated significantly towards the the end of 2020, with 45% of all deals closed in the final quarter (compared to only 14% in Q2 2020). This could have had a number of causes, most significant among them a proposed rise in capital gains tax (CGT). A report commissioned by Chancellor Rishi Sunak that was leaked in the autumn indicated that CGT would rise in spring 2021, prompting entrepreneurs to more urgently seek deals that could complete at the lower rates.

It is also likely that some deals were informally postponed as coronavirus lockdowns swept the world. By autumn people had got used to working remotely and were more comfortable progressing deals without the usual amount of face-to-face time. The ongoing availability of funds and funders' appetite for deals was also a factor.

Of our surveyed deals, private equity deals were lower in number and higher in value than sales to trade acquirers. Private equity accounted for 38% of deal numbers and 62% of deal values; it was the exact opposite for trade, which accounted for 62% by number and 38% by value.

Some may have feared a 'fire sale' of assets as Covid-19 hit, but this did not materialise. Instead, as confidence returned into the market in the second half of the year, there was a marked shift towards investment in companies and sectors which had proven to be more resilient and were seen to be less impacted by the immediate (and predicted) aftermath of the pandemic. As a result, investors turned their focus to competing for higher quality assets, even if this meant having to pay relatively full prices.

Statistics suggesting a prevalence of trade buyer activity do not necessarily tell the full story though, as many of the 'trade' acquirers captured by our M&A survey are themselves actually backed by private equity. Deploying capital through existing platforms (and behind proven management teams) has provided a de-risked means of investment in more volatile and troubled times.

Ed Stead partner at Pinsent Masons comments: "Another area of growth for private equity has been 'continuation fund' transactions, where instead of being sold at the end of an investment period, an asset is moved from one fund to another within the same private equity house. This allows investors in the original fund to be paid back on time, but lets the private equity firm keep hold of an attractive asset rather than have to go looking for a new one at a time of stiff competition for well-performing assets."

Another area of growth for private equity has been 'continuation fund' transactions, where instead of being sold at the end of an investment period, an asset is moved from one fund to another within the same private equity house.

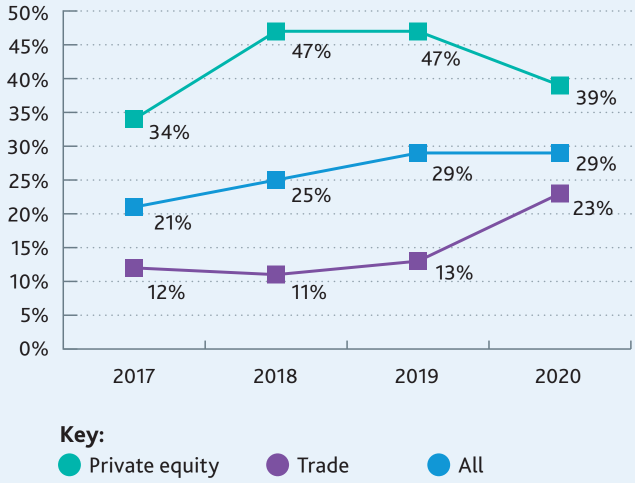
This technique has long existed but has come into its own in the year of coronavirus restrictions as opportunities for new deals slowed. Asset manager Lazard has estimated that US$7 billion of these deals were done four years ago, but that US$35 billion-worth were done in 2020. Our surveyed deals for 2020 includes a growing number of deals of this type and it will be interesting to see if this trend continues in future years or is a reflection on a temporary lack of new supply in the market.

Again possibly due to the effect lockdowns have had on traditional deal making processes, we have also seen an increase in the number of sales from one private equity firm to another, rather than exits for investors through trade sales or stock market flotations.

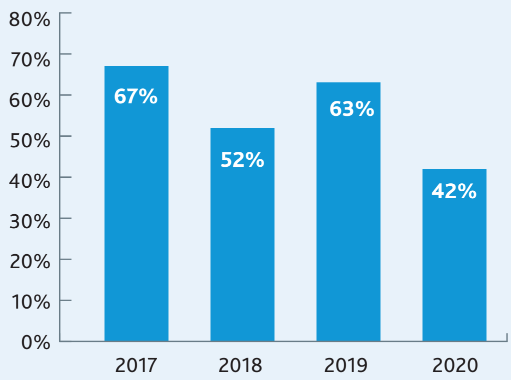
There has also been a shortening of the investment cycle, with some private equity houses 'flipping' businesses more quickly than was the case in the past. Kieran Toal partner at Pinsent Masons reflects: "We do not necessarily think there has been a shift in anticipated hold periods for investors – there have always been certain assets that have a stellar period of rapid growth which creates a quick exit opportunity. We just think that there were probably more examples in 2020 where the meteoric success of certain businesses in some sectors (both in absolute terms and relative to more challenged companies in other sectors) meant that buyers were prepared to pay up to secure the assets they wanted and weren't prepared to wait and risk facing a highly competitive auction. Sellers able to get tomorrow's price today have definitely taken the opportunity to exit early."

Where more traditional sales have occurred, the use of auctions by private equity has declined in recent years. Auctions were used in 47% of our surveyed private equity transactions in 2019 but in just 39% of them in 2020.

Transactions via an auction process



Share of total transaction value generated via an auction process

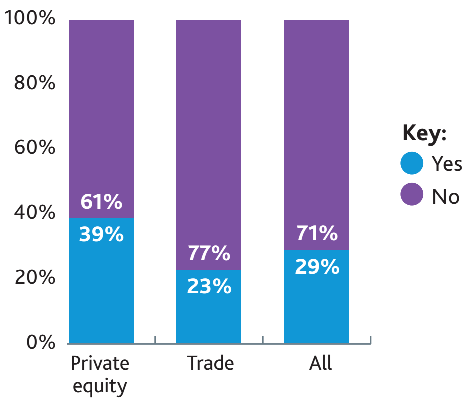


Arrowpoint Advisory managing director Simon Cope-Thompson comments: "This trend has carried into the start of 2021. Even when deals have started out as auctions they now tend to quite quickly get down to smaller groups or even bilateral negotiations. There is less of an appetite from private equity to chase lots of deals and compete in heavily contested processes. This could be a result of becoming more selective over the last 12 months as a result of the pandemic, or because there is a sense that some of the best 'auction' deals were probably done in 2019 and 2020. Some of the deals we would normally have expected to see in the first half of 2021 were done on a more accelerated basis in 2020, partly because of the threat of capital gains tax rate change."

"This means that private equity are not putting the resources into running hard on so many deals, so fewer go to full auction. Also, where they have been tracking an asset pre-Covid and have real conviction about the management team and the opportunity, investors have frequently decided to pre-empt a future process and look to do a bilateral off-market deal," he said.

The most notable changes to last year's trends were the percentage of trade transactions subject to an auction process, which saw a big jump from 13% in 2019 to 23% in 2020. Auctions are typically used in higher value transactions (average value £172m), accounting for 42% of total deal value but just 29% of volume. However, the statistics need to be seen in light of the comments above as many of the 'trade' acquirers captured by our M&A survey are themselves actually backed by private equity.

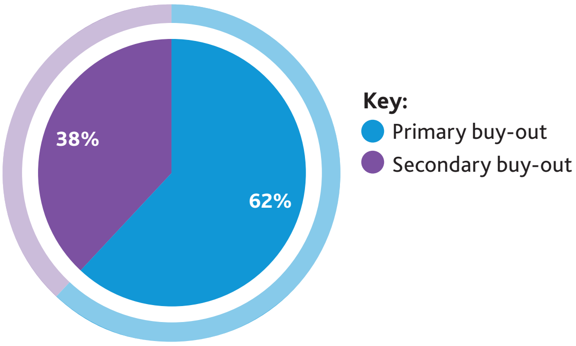
Was the sale via an auction process?



Deal Process Trends

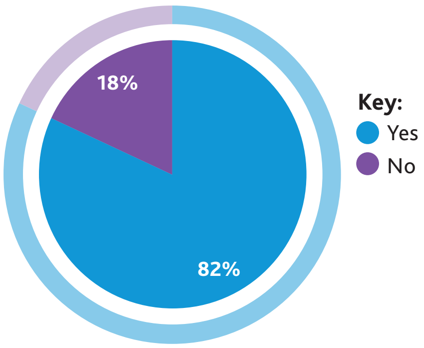
One of the big shifts last year was the increase in the proportion of private equity deals that were secondary buy-outs, where volume increased from 14% in 2019 to 38% in 2020, though this may be reflective of the smaller sample size of private equity transactions.

Was the deal a primary or secondary buy-out?



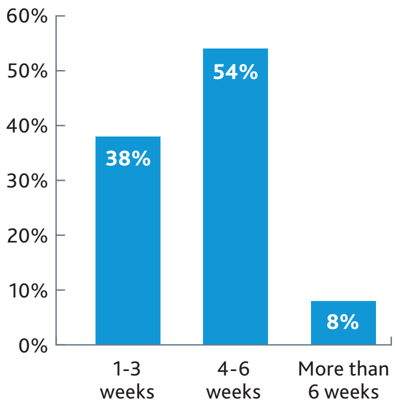
Consistent with previous years, essentially when there is an auction process, exclusivity will be granted in around 80% of transactions.

Was a period of exclusivity granted?

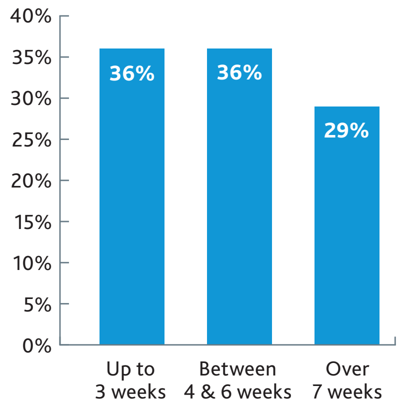


Although there is an indication that the exclusivity period granted has shortened (32% over 6 weeks in 2019 compared to 8% in 2020), the number of weeks between grant of exclusivity to closing appears to have lengthened in comparison to last year. This could possibly be due to the extraordinary year we had in 2020, with Covid-related factors perhaps slowing down deal processes.

Length of initial exlusivity period



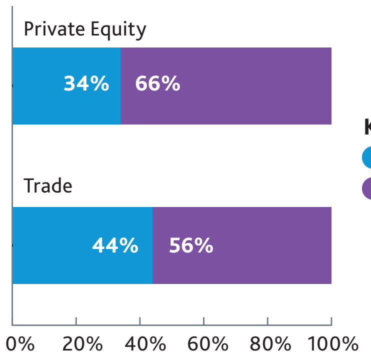
Weeks between granting exclusivity & completion



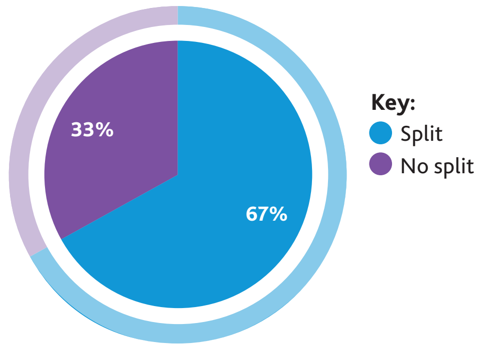
Split between exchange and completion

In terms of transactions subject to a split, the figure for private equity is consistent with prior years. Trade transactions saw a somewhat higher proportion of deals subject to a split at 44% in 2020 compared with 35% in 2019, which may be a result of the higher number of FS deals in this year's survey. In value terms around 67% of the total transaction value of the deals surveyed was subject to a split, down from 77% in 2019.

Was there a split between exchange & completion?

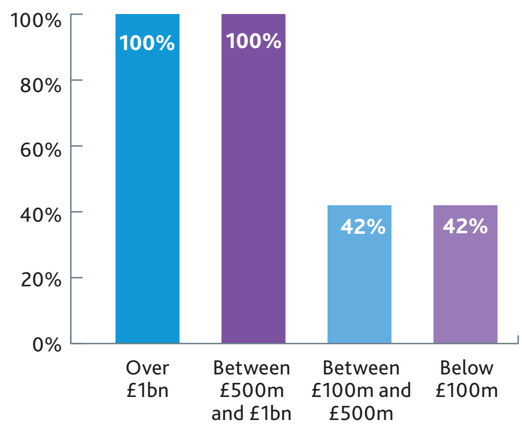


Transactions involving a split (by transaction value)



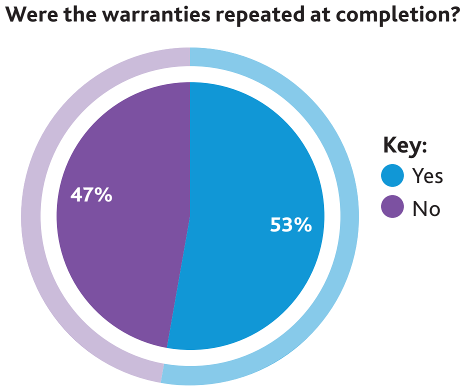
As was the case last year, all transactions valued at more than £500m were subject to a split. However, this year just 42% of transactions between £100m and £500m were subject to a split compared to 92% last year, while those under £100m subject to a split increased from 28% to 42%.

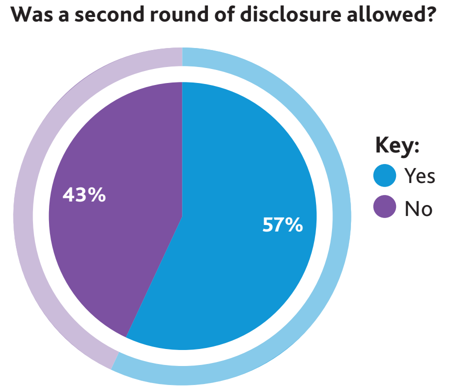
Proportion of transactions subject to a split



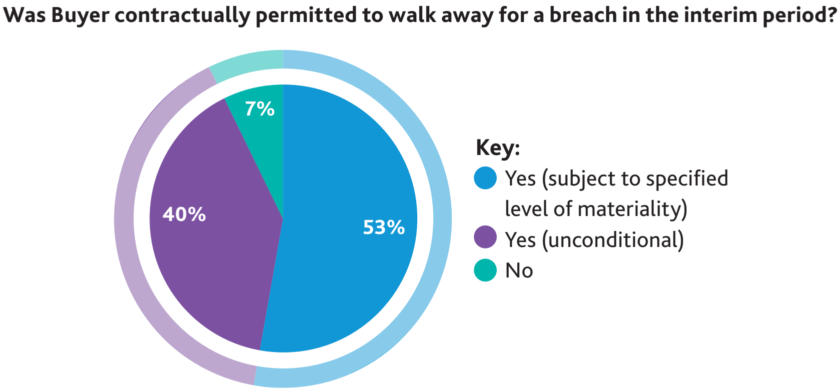
In terms of transactions subject to a split, the figure for private equity is consistent with prior years. Trade transactions saw a somewhat higher proportion of deals subject to a split at 44% in 2020 compared with 35% in 2019, which may be a result of the higher number of FS transactions in this year's survey.

Warranties given by sellers at exchange were repeated at completion in 53% of transactions, down from 82% in 2019 – but reflecting a return to historic norms (55% in 2018). Where warranties were repeated at completion, 57% of split exchange and completion transactions surveyed allowed for updated disclosure against the warranties, down from prior years (71% in 2019 and 67% in 2018).





The proportion of transactions where the buyer could walk away by reason of material warranty or conduct provision breach prior to completion increased compared to last year from around 25% to 40%, perhaps as a reflection of Covid-induced uncertainty.



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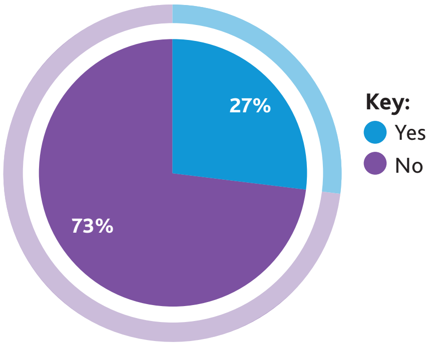
– but reflecting a return to historic norms (55% in 2018).

MAC Clause

Use of more general MAC clauses declined for the fourth year running and only featured in 27% of surveyed transactions involving a split exchange and completion, down from 35% in 2019 and 45% in 2018. We view this to be a reflection of the fact we remain in a seller's market.

Was there a MAC clause?

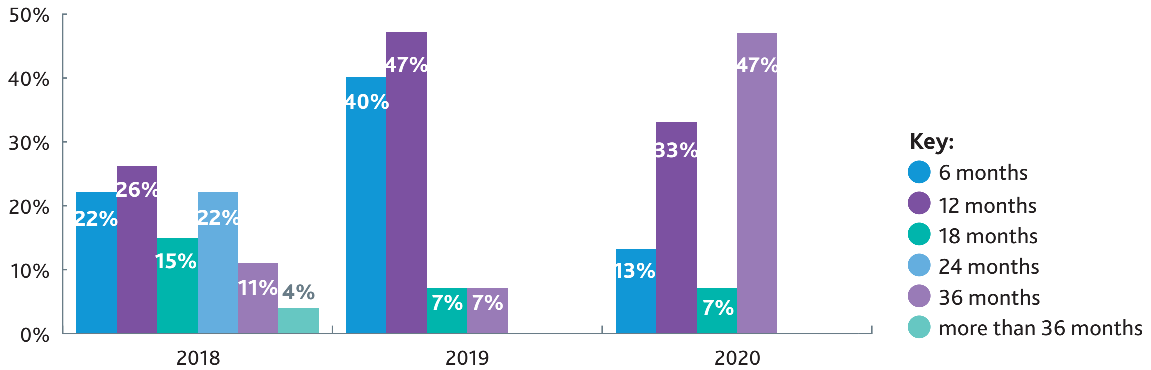


Use of more general MAC clauses
declined for the fourth year running.

UK's mid-market deal terms shaped by Covid-era and market competition

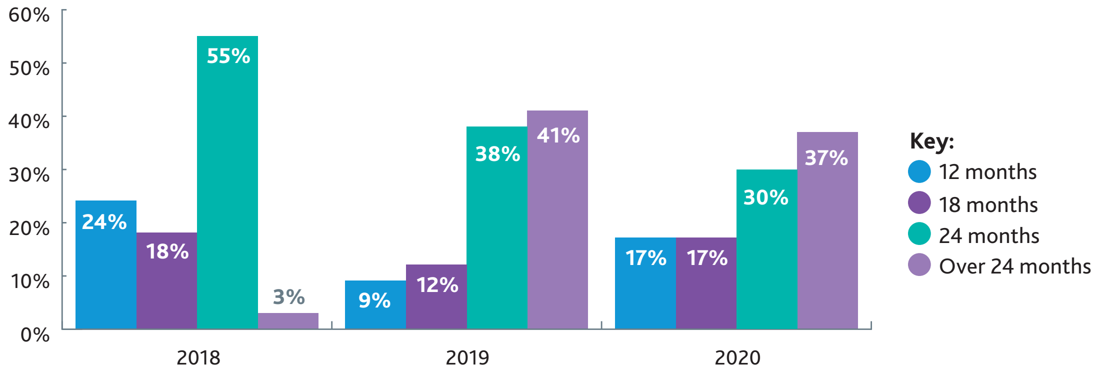
The 2020 deals surveyed by us indicate a growing use of deferred consideration structures as they provided a means of bridging valuation gaps caused by concerns around either the sustainability or recovery of earnings. As we emerge from the pandemic and trading patterns return back to normal, it will be very interesting to see whether deferred consideration or earn out consideration structures remain so prevalent or not.

Deferred consideration periods



Evidence that we still continue to operate in a seller's market is perhaps also provided by our survey results in respect of restrictive covenants, by which a buyer restricts the competing activities of sellers after they have left the company. Their duration in these deals shortened last year, a trend which may need to be considered in parallel with the revisions to consideration structures. Ed Stead partner at Pinsent Masons comments: "It could mean that there is a growing acceptance that there has to be a significant carrot as well as stick to assure the long term success of the business and support from its founders/sellers."

Non compete periods



Sellers are less likely than before to have a large number of buyers lined up as **private equity houses are being more selective about which deals they run hard at and are being more proactive about originating deals.**

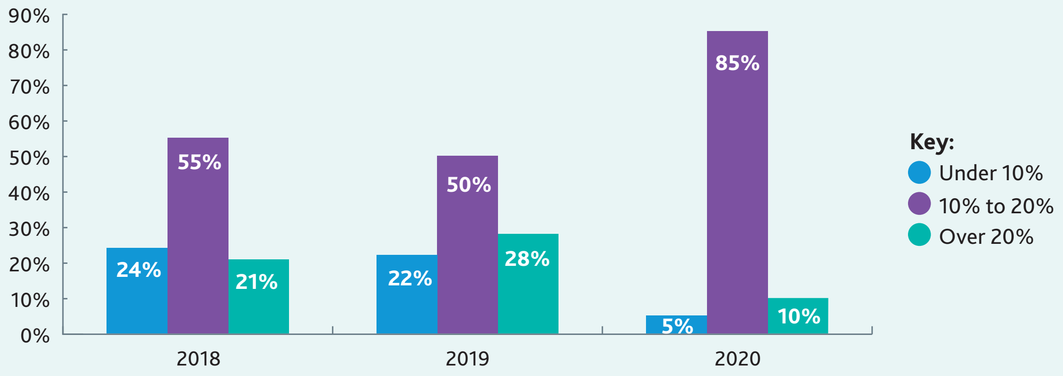
Arrowpoint Advisory managing director Simon Cope-Thompson comments: "Management terms are certainly being squeezed; private equity are cautious about packages that they think may have become over-generous in recent years. Management teams are therefore having to work harder to get the same deals as could be readily secured two years ago."

"Sellers are less likely than before to have a large number of buyers lined up as private equity houses are being more selective about which deals they run hard at and are being more proactive about originating deals," he said. "With lots of funding out there they need to know what their angle on a deal is. Firms have institutional memories about what has worked for them in the past and that guides what they go for."

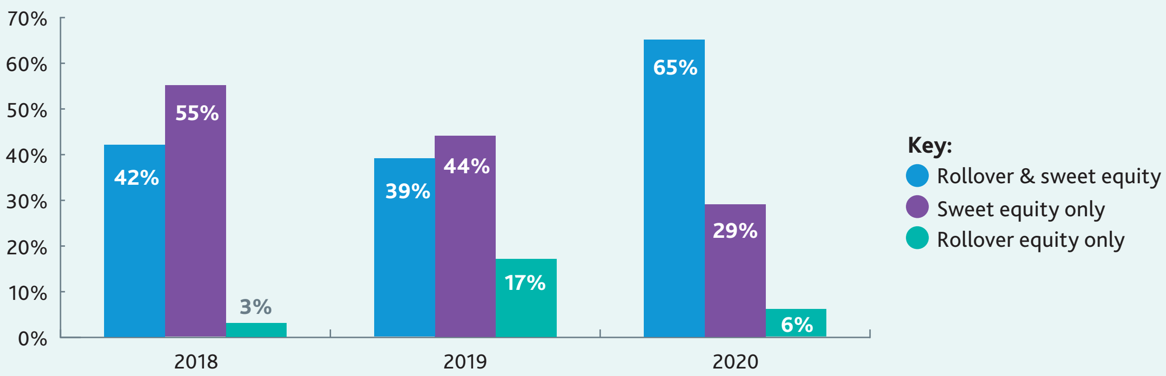
There have been interesting moves in relation to sweet equity, a share of the post-buyout company given to management teams by private equity funders to incentivise high performance. There has been a reduction in the most generous and least generous allocations over the past three years, and an increase in the number of deals offering a mid-range share of 10-20%.

There is however evidence of investors exercising more control over equity. Leaver provisions which strip leavers of equity if they leave in acrimonious circumstances were applied increasingly to rollover equity, up from 39% of deals to 65% between 2019 and 2020. So while investors may be being more generous in many cases, it comes with some element of increased control.

Sweet equity offered to management teams



Which classes of shares do leaver provisions apply to?

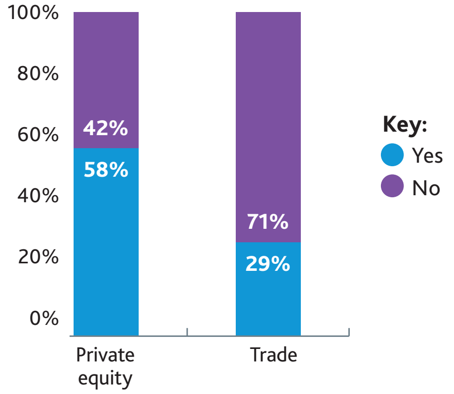


Locked box, completion accounts and deferred consideration

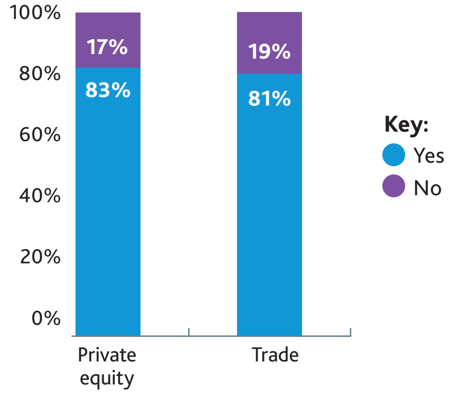
Locked box v completion accounts

Consistent with prior years, the proportion of buy-side private equity transactions employing a locked box mechanism was higher (58% in 2020, up from 51% in 2019 and closer to the 65% in 2018) compared to deals involving a trade buyer (29% in 2020, up from 21% in 2019 and 22% in 2018).

Proportion of transactions using a locked box mechanism

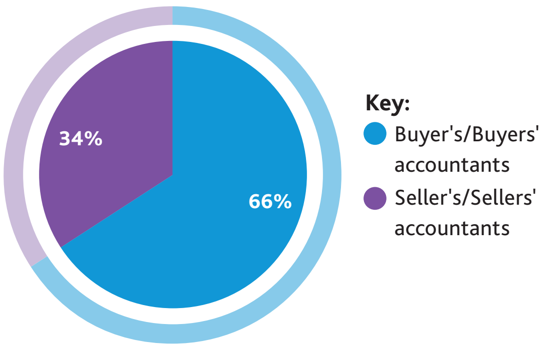


Did the SPA contain a net assets/profit/ working capital adjustment clause?

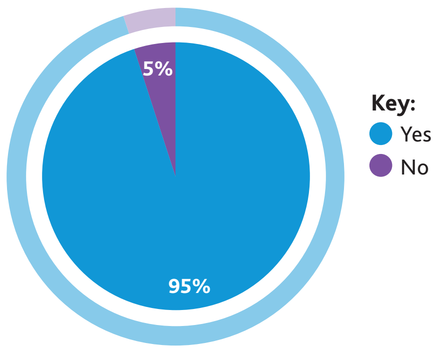


Whether buyers or sellers prepare the first draft of the completion accounts is a common area of debate and the 2020 survey data shows an almost exact reversal of 2019 – with buyers' accountants preparing accounts in 66% of transactions compared to 37% in 2019. This suggests it is very much up for debate on any given transaction as to who should prepare the first cut of any completion accounts. Where completion accounts were used a small proportion (just 5%, which is similar to prior years) of transactions set a cap and collar to exclude immaterial price adjustments within agreed parameters.

Who will prepare the first draft of the completion accounts?



Was a 'cap and collar' set (i.e. no adjustment if within a certain amount)?



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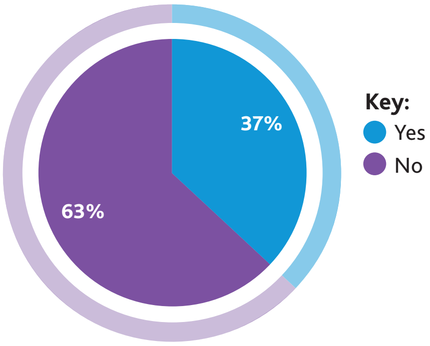
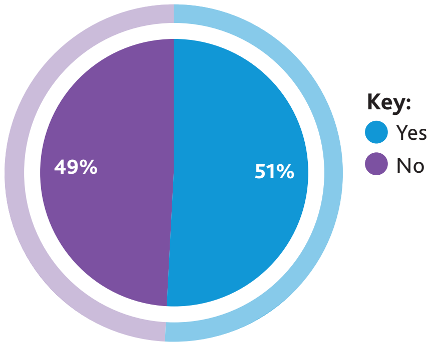
Deferred consideration

Consistent with prior years, private equity transactions saw a lower use of deferred consideration (37% in 2020 and it has hovered around one third of transactions for the prior three years) than trade (51% in 2020 compared to 45% in 2019 and 27% in 2018, showing a steady year-on-year increase).

Did transaction include an element of deferred payment? (private equity)

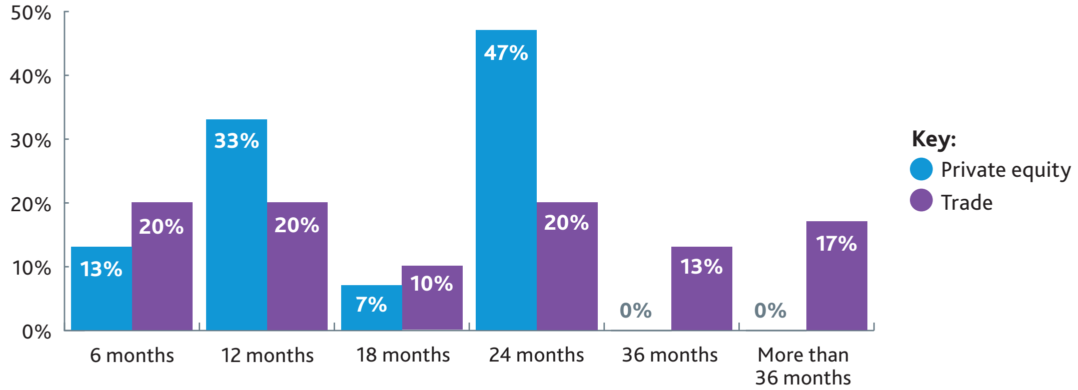


Did transaction include an element of deferred payment? (trade)



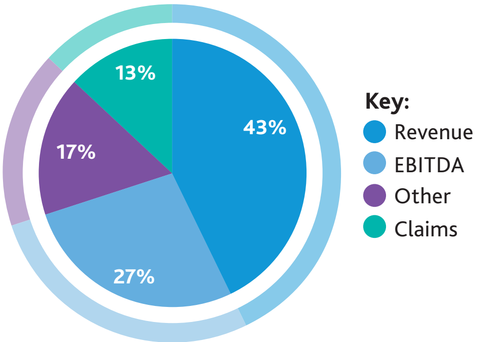
In terms of time periods for deferred consideration, trade transactions remained relatively consistent with a more even spread across the time periods and an equal split of 50% of transactions with a deferred consideration period of 24 months and longer and 50% with a deferred consideration period of less that 24 months. However, private equity transactions showed a significant change: in 2019, 87% of transactions included a deferred consideration measurement period of 12 months or less, but this dropped to just 46% in 2020, which is closer to the 48% level seen in 2018. The preferred deferred consideration measurement period of 24 months, at 47% of private equity transactions, compared to just 7% in 2019 and 25% in 2018.

Time period for deferred consideration

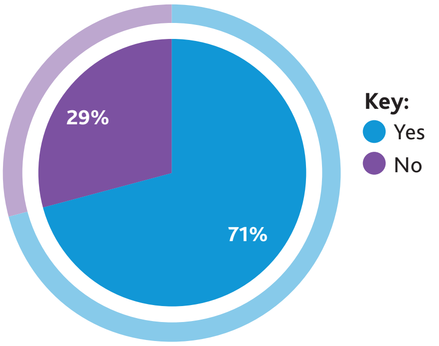


Achievement of EBITDA targets as a measure for calculating the value of deferred consideration continued its downward trend, used in 27% of transactions in 2020, down from 40% in 2019 and 52% in 2018. Conversely, the use of revenue-based targets increased to 43% in 2020, from 23% in 2019 and 28% in 2018. In 13% of the relevant transactions under review, deferred consideration related to the resolution of certain claims in respect of outstanding tax, insurance or litigation issues.

Basis for payment of deferred consideration



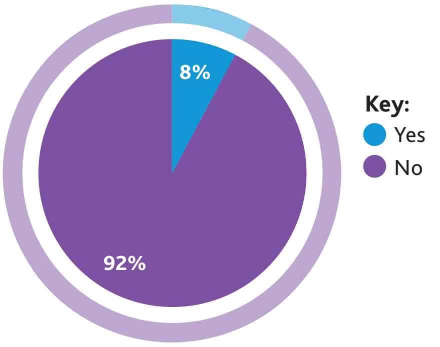
Were any protections in place for the deferred consideration period?



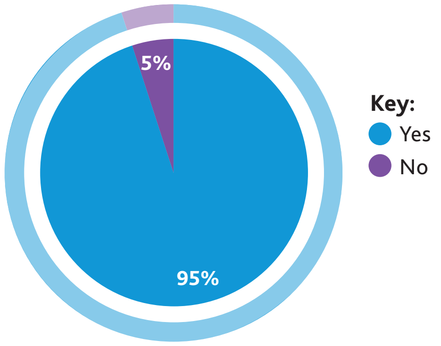
Warranties

The accepted position remains that for M&A transactions it is highly unusual for buyers to be entitled to recover for breach of warranty on an indemnity basis, while a suite of caps on a seller's liability under the warranties remains standard and the survey this year is consistent with prior years.

Was the Buyer entitled to recover for breach of warranty on an indemnity basis?

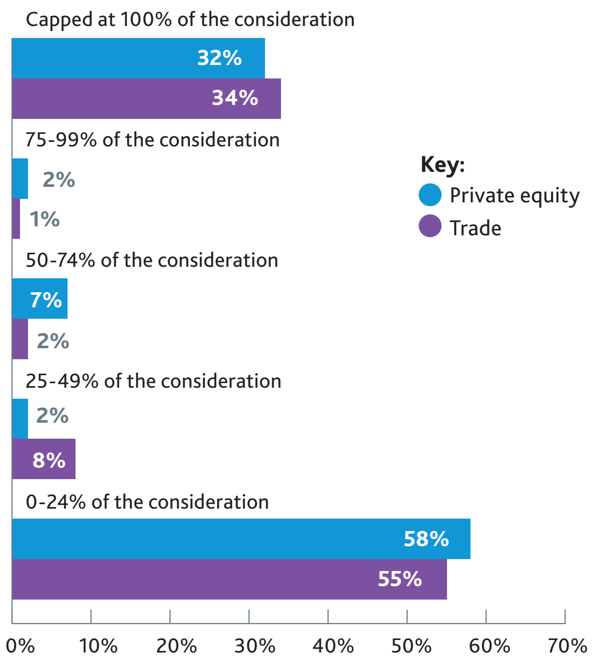


Was there a cap on the Seller's liability under the warranties?

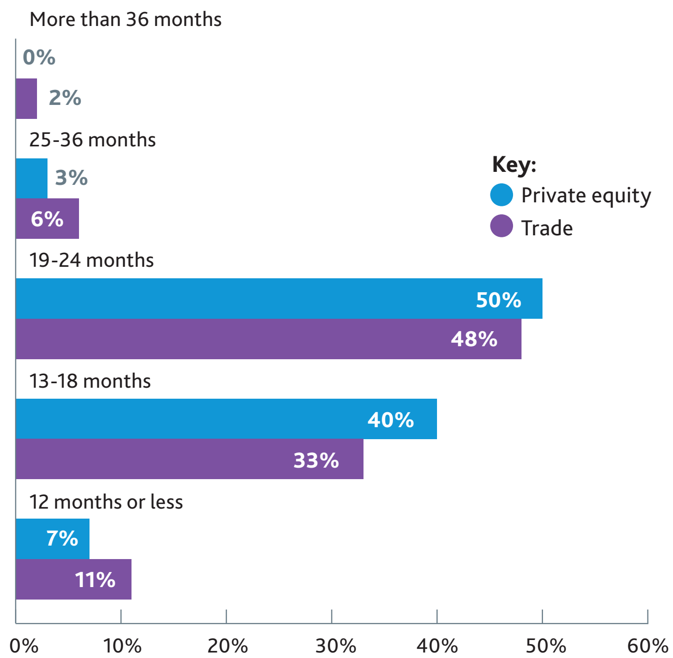


In private equity transactions, the warranty cap continued to be set at a relatively low proportionate amount of the overall consideration, with 58% of those transactions including a warranty cap set at between 0-24% of the consideration, down from 64% in 2018. In relation to trade deals, the proportion of transactions where the cap was set at 100% consideration paid dropped from 56% in 2019 to 34% in 2020, while the proportion of such transactions with a liability cap of between 0-24% of consideration jumped from 28% in 2019 to 55% in 2020. The time limit for claims in respect of surveyed deals is consistent with prior years.

What was the amount of the cap on the Seller's liability under the warranties?

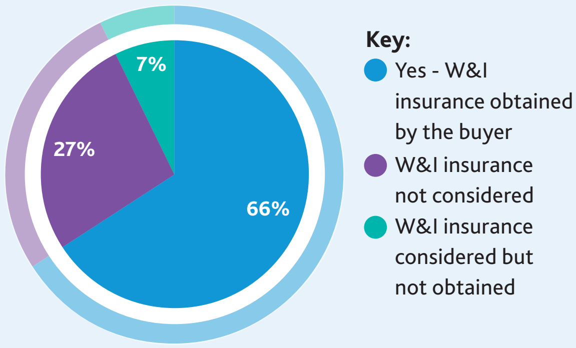


Limitation periods for commercial warranty claims



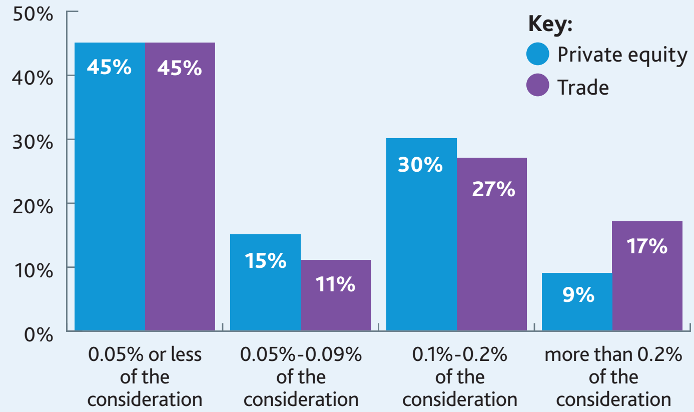
The number of transactions utilising warranty and indemnity insurance continued its year-on-year increase – 66% of surveyed transactions in 2020, up from 51% in 2019 and 41% in 2018. The proportion of transactions where warranty and indemnity insurance was considered but not obtained has remained in the 5-8% range over the past three years, so the transactions where it is not considered at all has continued its year-on-year fall to 27% in 2020, from 44% in 2019 and 51% in 2018.

Was warranty and indemnity insurance obtained in this transaction?



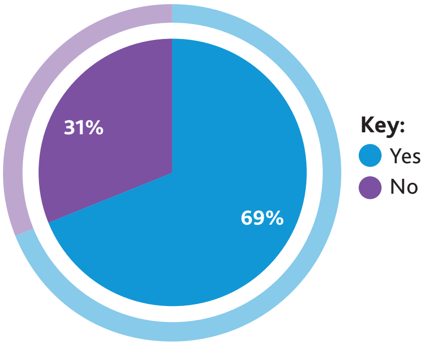
Surveyed deals in 2020 continued to demonstrate consistent use of a low throw away de minimis threshold for warranty claims. In a very significant majority of those deals, that throw away threshold was set at 0.1% of the consideration or lower.

Throwaway de minimis for warranty claims as a % of consideration

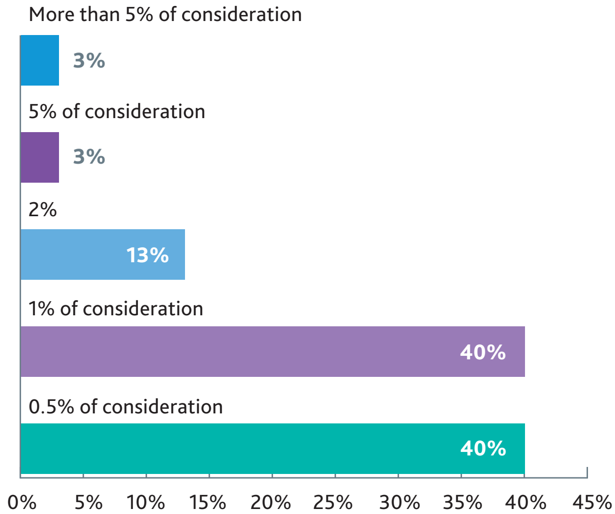


Interestingly the number of surveyed transaction with a warranty claims threshold set at 0.05% increased from 30% in 2019 to 40% in 2020. There is a clear correlation between this and the availability of W&I insurance with a deductible set at this same level. In 2020, the claims threshold was again set at 1% or less which reflects a long standing market norm in this area.

Did the transaction use a basket / threshold for claims?

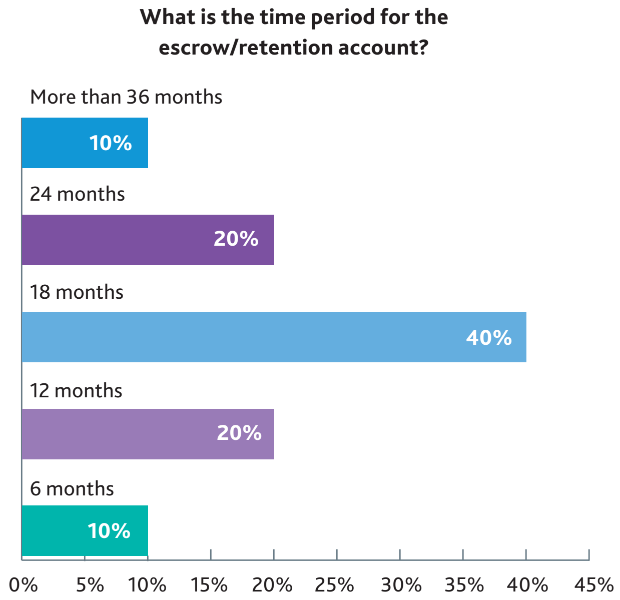


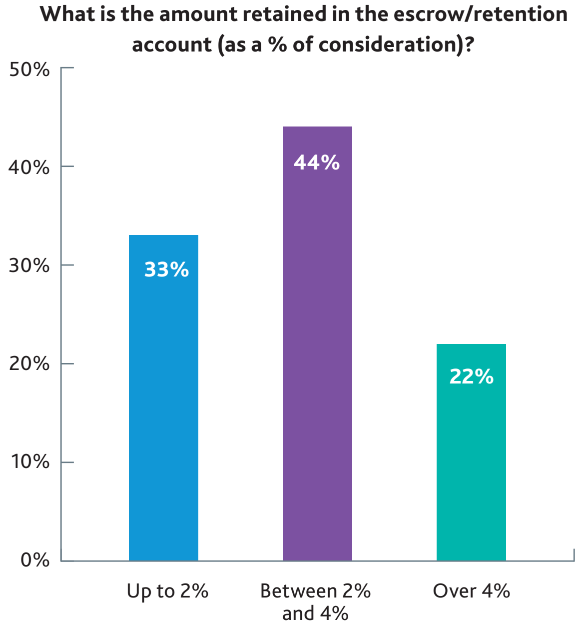
Transaction basket amount as a % of the consideration



Escrow / retention accounts

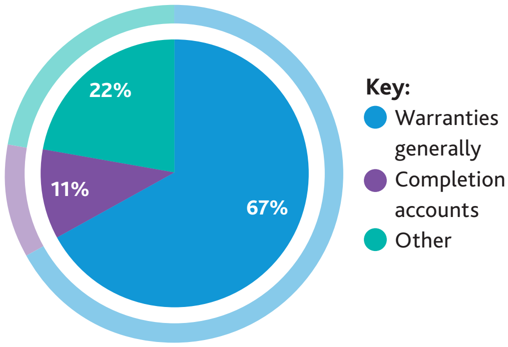
There appears to have been a general lengthening of the time period for retention accounts in respect of surveyed deals, with 6 months the most frequently period in 2019 compared to 18 months in 2020.





In two thirds of surveyed transactions where funds were held in an escrow account, this was to provide general security for warranty claims, up considerably from the 13% in 2019. Security for completion accounts adjustments were cited in just 11% in 2020, compared to 31% in 2019. However, we would sound a note of caution in assuming that these findings on escrow matters point to particular long term trends. 'Specific indemnity provisions' was the top answer (37%) in 2019, but was not mentioned in this year's survey results.

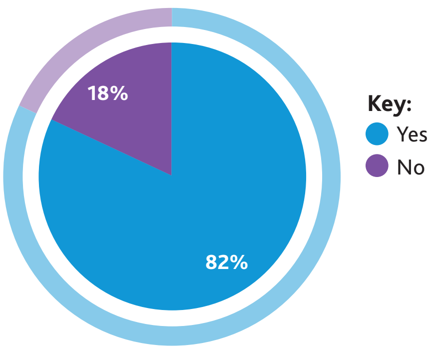
Purpose for which an amount was held in escrow/retention account?



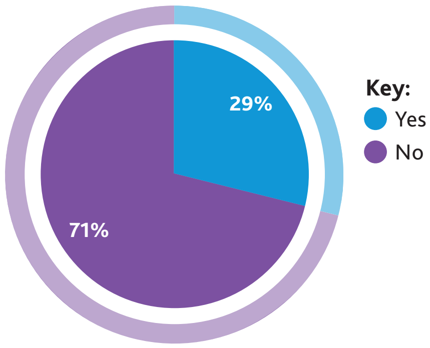
Disclosure

The trends in 2020 are generally in line with prior years. The buyer agreed to general disclosure of the data room in 82% of transactions in 2020, up from 78% in 2019 and 71% in 2018. Separately, the buyer only gave a reverse warranty that it does not have any knowledge of a possible warranty claim at the time it entered the SPA in 29% of transactions, marginally up on the 28% figure seen in 2019.

Did the Buyer agree to general disclosure of the data room?



Did the Buyer give a reverse warranty?



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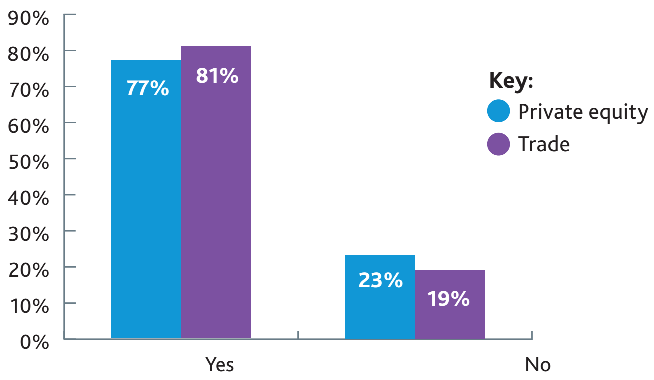
> Tax covenants continue to be a common feature
> **in both private equity and trade transactions.**

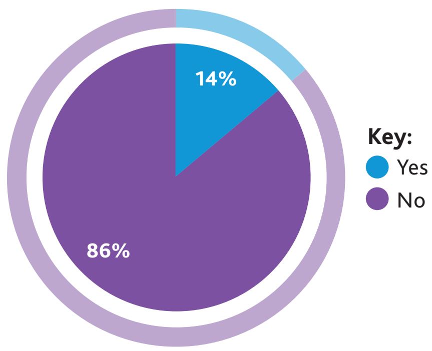
Tax

Tax covenants continue to be a common feature in both private equity and trade transactions, though with a higher proportion seen in trade deals (81%) compared to private equity deals (77%) for the first time over the past few years. As in previous years it remains unusual for there to be a separate cap on liability under the tax covenant.

Was a tax covenant used?

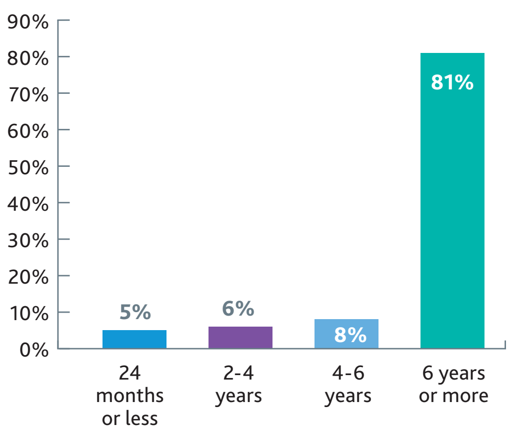


Was there a separate cap on liability under the tax covenant/deed?



The limitation period for tax warranty claims continues to be set at six or more years in the majority of transactions, though this increased slightly in 2020 to 81%, up from 75% in 2019 and 76% in 2018.

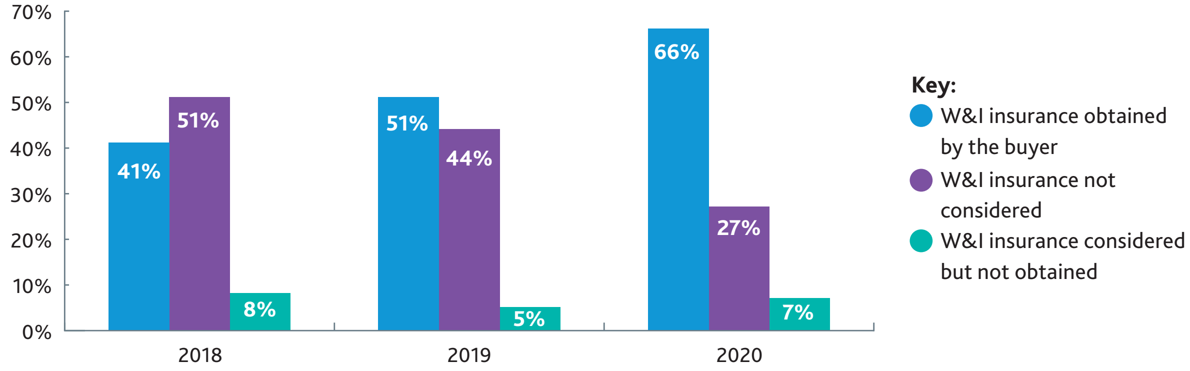
Time period for deferred consideration



'Innovation and sophisticated purchasers' behind continued W&I growth in UK deals

The use of warranty and indemnity (W&I) insurance continues to rise with insureds taking out more policies than ever before. The sustained increase in the use of insurance demonstrates that M&A insurance has simply become part of the infrastructure of deal-making.

Use of warranty and indemnity insurance



While certain private equity houses have been resistant to using W&I insurance on the basis that they have done deals for years without it, this approach is becoming less sustainable in the current market conditions. Given the amount of 'dry powder' available, compared to the relatively limited number of good quality investment opportunities, it is now more important than ever for investors to make their bids as attractive as possible. If all of the competing bidders in an auction process are using W&I insurance, and thereby offering to cap the warrantors' liability at a nominal amount, not using insurance can become a significant disadvantage.

Howden M&A Head of Private Equity Caroline Rowlands comments: "Having insurance streamlines transaction negotiations. Absent insurance, the warranties and indemnities will be negotiated in granular detail: sellers will want them drafted narrowly, while buyers push for as broad a suite of warranties as possible. W&I insurance eases the tension in these negotiations and thereby, makes the deal a little easier to get over the line."

Historically, insurance was not used on lower cap deals or investments. However, with more insurers focusing on this end of the market, minimum premiums are coming down and take-up is on the rise.

Broadly speaking, as insurers chased fewer deals between March and September of last year, we saw average pricing and deductibles drop again in 2020. Deal terms got less competitive in Q4 as deal volume increased significantly but average terms across the whole year were still an improvement when compared to 2019.

Nevertheless, with insurers experiencing large losses on their 'traditional' lines of insurance, there could be an impact on insurer appetite and their pricing of risks. The much-anticipated price rise has not yet materialised but we may start to see insurers being more selective with respect to the transactions they underwrite and the premiums they charge as the year progresses.

Worries have been expressed about whether increased use of W&I insurance will, ultimately, drain time and resources in the event that claiming under the policies becomes difficult or protracted. Experience to date has not borne out such concerns. Having reviewed claims outcomes over the past five years, it is clear that policies are doing what they are supposed to do – protecting policyholders with efficient payments in the event of a valid claim.

While certain private equity houses have been resistant to using W&I insurance on the basis that they have done deals for years without it, this approach is becoming less sustainable in the current market conditions.

Howden M&A Head of Private Equity Caroline Rowlands comments: "There are also encouraging signs of innovation in the market, which has, in part, been driven by lower deal volume in 2020 and insurers having both the time and appetite to consider potential new revenue streams. Two key examples of innovations in 2020 are policies for P2P deals and policies for secondary buy-out deals."

Looking forwards, we expect to see continued innovation in the market, alongside a continued uptick in the use of tax, title, environmental and contingent risk insurance being used more frequently alongside W&I.

Average Premium Rates (% of the Policy Limit)			
Real Estate		Operational	
2019	2020	2019	2020
0.92%	0.78%	1.26%	1.15%

Typical Retentions (% of Enterprise Value)			
Real Estate		Operational	
2019	2020	2019	2020
Nil	Nil	0.25%-0.5% fixed (with certain insurers beginning to offer tipping retentions on private equity backed transactions)	0.25%-0.5% (with most insurers now offering tipping to NIL retentions on private equity transactions)

Looking forwards, we expect to see continued innovation in the market, alongside a continued uptick in the use of tax, title, environmental and contingent risk insurance being used more frequently alongside W&I.

Private Equity

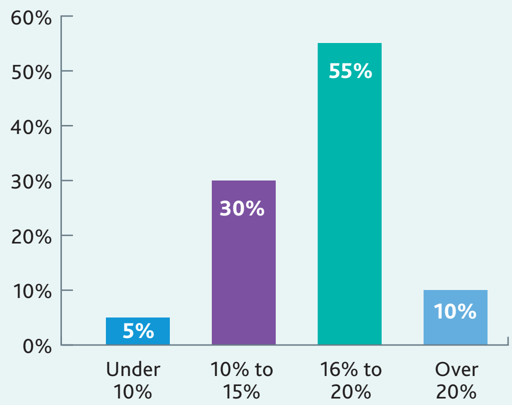
Sweet equity

As in previous years sweet equity typically comprises between 10% and 20% of the overall equity available, and this was even more emphatically the case in 2020, with 85% of relevant transactions having a sweet equity pot of between 10% and 20%, up from 50% in 2019 and 55% in 2018. Of the 85%, 55% had sweet equity pots of 16%-20%. As a result, the proportion of transactions seeing sweet equity pots of more than 20% (which we only saw in 10% of cases, down from 28% in 2019 and 21% in 2018) or less than 10% (which we only saw in 5% of cases, down from 22% in 2019 and 24% in 2018) dropped.

As Jamie Hutton, director at Arrowpoint Advisory explains: "The headline size of the pot available to management can be misleading, as there is often a debate around whether the chairman or non executive director(s) are included or not and also how much of the pot is issued at completion rather than held back. Also, the hurdle rate the investor applies (typically between 8-12%) makes a big difference. 74% of the surveyed deals had a 10% hurdle, with 17% at 12% or more. Where investors have been more generous, this has often come with a higher hurdle rate, which provides greater downside protection to the investor but a higher share of the upside for management.

Management have continued to secure better deals for themselves in secondary or tertiary buyouts than on primary deals, which is a reflection of their relatively stronger negotiation position in the deal scenarios and the fact that they have often learned from their earlier experiences (and more frequently employ specialist legal and corporate finance help)."

What proportion of equity is available as sweet equity (as percentage of total ordinary equity)?

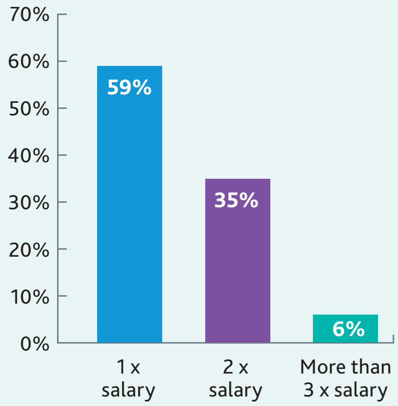


Warranty caps

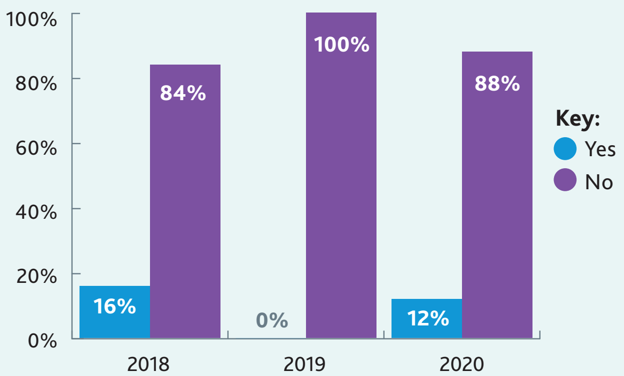
In 2020, we saw a reversal of the trend seen over the past few years of the cap on investment warranties being two times a manager's salary (which peaked at 56% in 2019), with a cap of one times salary now being the more popular approach, appearing in 59% of transactions in 2020 (after previously falling year-on-year from 56% in 2017 right down to 33% in 2019).

As in previous years we have seen a small number of transactions (12%) where the private equity house accepts a different warranty liability cap between managers receiving rollover equity as opposed to those receiving sweet equity, but this still remains far from the norm.

What was the warranty liability cap for managers taking sweet equity?



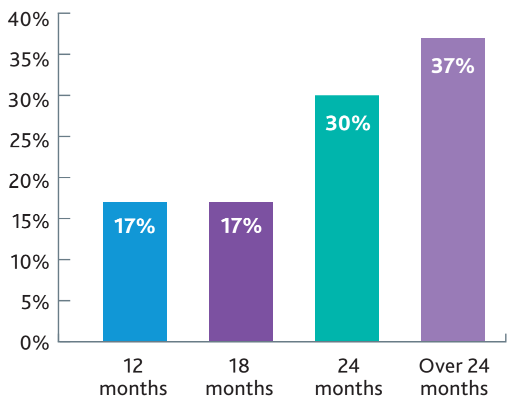
Did warranty liability cap vary for rollover investor?



Restrictive covenants

In last year's survey, investors appeared to be taking a harder line on restrictive covenants, preferring a covenant period of 24 months or more in the majority of cases. However, in 2020 we have seen a slight lessening of non-compete periods, with a willingness to accept 12 months in 17% of cases (up from 9% in 2019) and 18 months in 17% of cases (up from 12% in 2019). This is likely due to the current competitive landscape or perhaps the recognition of the need for different lengths of restriction for those sellers not receiving a significant amount in proceeds as compared to founder or senior management shareholders.

Length of restrictive covenant / non-compete

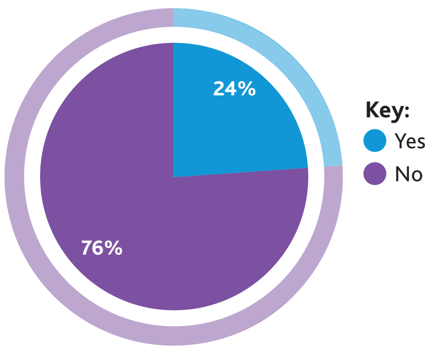


Fees

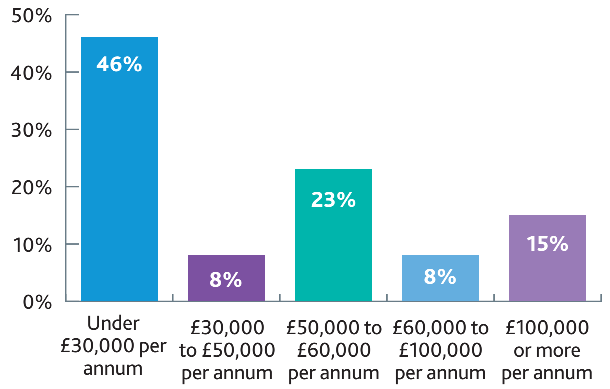
Although there has been some fluctuation in the use of arrangement fees charged by investors over recent years, the results in 2020 were consistent with the previous year.

In 2020, we saw a continuation of the long-term trend towards a lower aggregate package of fees being charged by investors, particularly for competitive auction processes where investors strive to make their investment terms as attractive as possible to capable management teams. We would expect this trend to continue where there is an element of competition. In transactions where investor director annual fees were charged, just under half (46%) received up to £30,000 per investor director, which was almost the same proportion (47%) who received up to £40,000 in 2019. The share of investor director annual fees at the top end fell; fees of between £60,000 to £100,000 of those fell from 13% in 2019 to 8% in 2020 and fees of £100,000 or more fell from 20% in 2019 to 15% in 2020. Slightly fewer transactions in 2020 included a monitoring fee on top of the directors' fee, with a monitoring fee appearing in 24% of transactions, down from 32% in 2019.

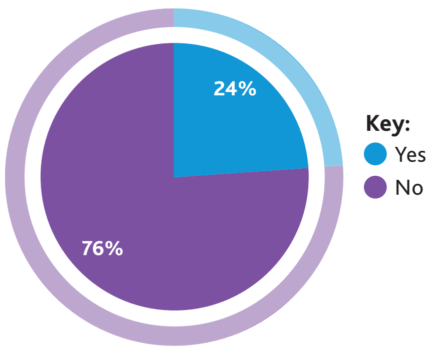
Was there an arrangement fee?



What is investor director's annual fee?



Is there a monitoring fee on top of director's fee?



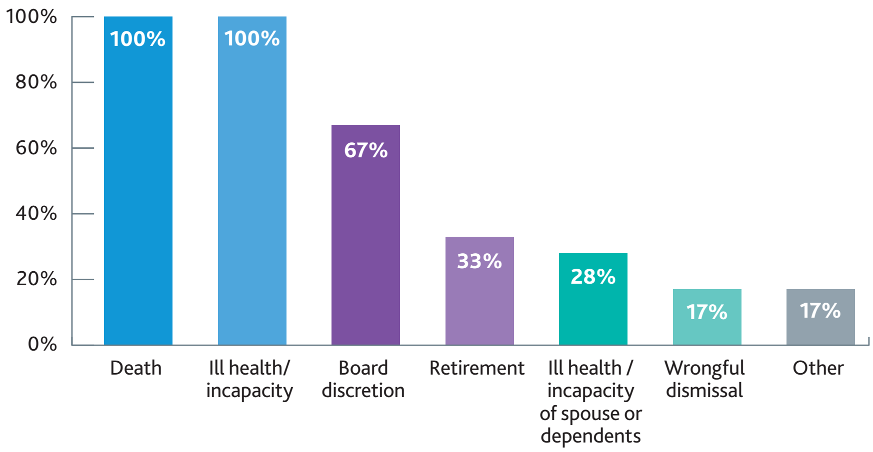
Leaver circumstances

The standard position for good leaver remains consistent with previous years to the point where good leaver circumstances are now fairly settled. Death, ill health/incapacity and categorisation at board discretion remain the most common. We have previously noted that wrongful dismissal fluctuates in usage as a specific good leaver circumstance from year to year and this is once again true, being used in 17% of relevant transactions in 2020, compared to 47% in 2019 and 31% in 2018.

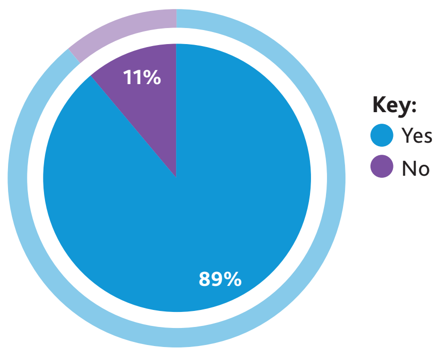
The previous increase in wrongful dismissal as a good leaver event was likely down to investors having confidence that the process of a manager's departure and the risk of wrongful dismissal claims could be sufficiently managed, while the reduction in 2020 may point to investors taking a harder line on management terms in an uncertain environment where previously they were perhaps more inclined to 'take a view'.

A trend emerging over recent years is the increase in the use of intermediate leaver, with investors allowing managers to benefit from value accrued on their shares up to the point of them becoming leavers. As can be seen, the use of intermediate leaver rose in 2020 for the fourth consecutive year, from 28% in 2017, 57% in 2018, 60% in 2019 and 89% in 2020. This change has served to avoid the previously contentious debate on whether unfair dismissal should be a good leaver or bad leaver event. The key debating points around intermediate leaver however are whether voluntary resignation should be included as an intermediate leaver event and whether the vesting of value of an intermediate leaver should reach 100% or be capped at a range of between 80% to 90% (the argument for a lower cap being that some of the leaver's shares should be made available at cost to incentivise a replacement manager).

Good leaver circumstances



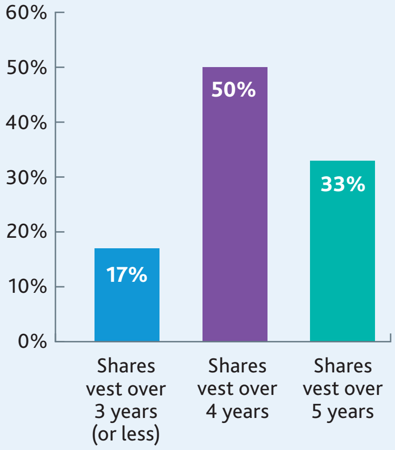
Is intermediate leaver concept included?



> **A trend emerging over recent years is the increase in the use of intermediate leaver,** with investors allowing managers to benefit from value accrued on their shares up to the point of them becoming leavers.

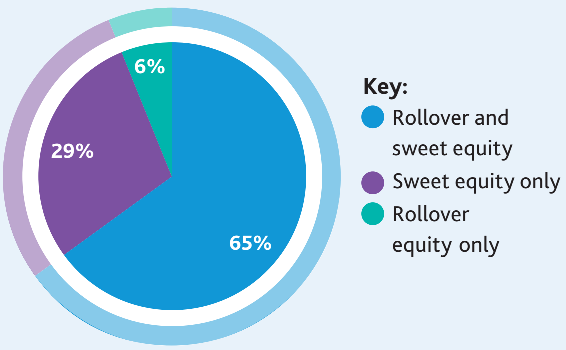
Vesting schedules were similar to those reported in previous years with a straight-line vesting period of four years typical in 50% of deals, up from 46% in 2019.

What are the vesting arrangements?

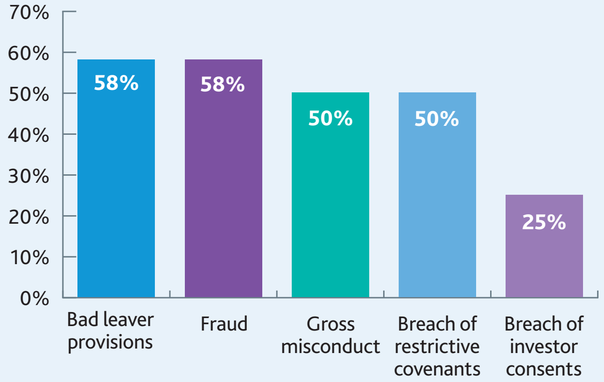


The application of leaver provisions to both rollover and sweet equity increased significantly in 2020, up to 65% from 39% in 2019, with investors looking to increase their suite of downside protections. This reflects a hardening of the position taken by investors, that where serious conduct on the part of a manager is established then this conduct should not be free of consequences for the relevant manager. Far fewer deals saw leaver provisions applying to rollover equity only, down to 6% in 2020 from 17% in 2019, with sweet equity only also falling, down to 29% in 2020 from 39% in 2019. The general position, however, is that investors seem to accept that rollover is historic value created and should only come up for sale in more limited circumstances.

Do Leaver provisions apply to sweet equity/rollover?



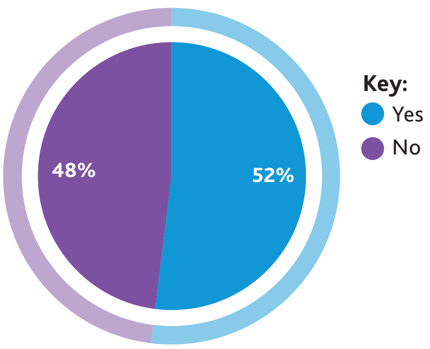
Which Leaver provisions apply to rollover equity?



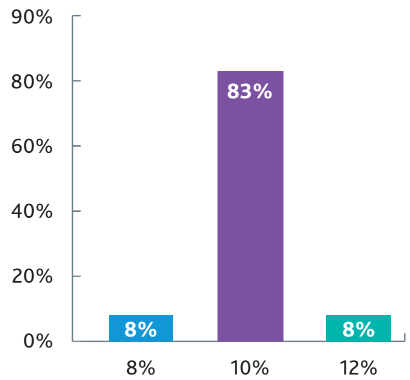
As to the circumstances where leaver provisions apply to rollover equity, as a general observation we tend to see a significantly narrowed range of leaver events applying here, limited to the serious acts of fraud, gross misconduct and breach of restrictive covenants. We also see investors having the ability to switch off interest on the leaver's loan notes in these circumstances.

The use of preference shares increased slightly to 52% in 2020, up from 47% in 2019, continuing the upward trend that had halted in 2019. The coupon on preference shares typically averaged at 10%, which is consistent with prior years.

Were preference shares issued?

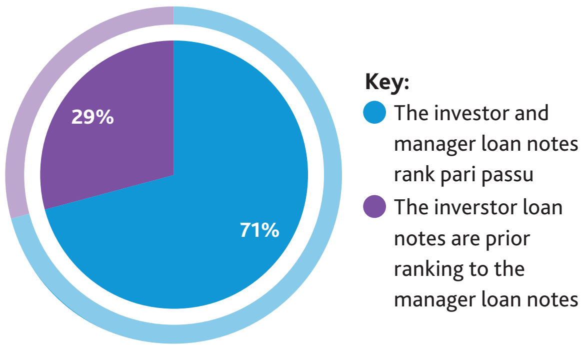


What was interest rate on investor loan notes



Each year our survey has found that loan notes or preference shares held by private equity investors tend to be ranked equally with those held by managers and the latest data is broadly consistent, with this being the case in 71% of transactions in both 2019 and 2020. This tends to be the market norm in competitive auctions with investors more likely to push for prior ranking where the sale process is bilateral.

How do the investor and manager loan notes sit for ranking purposes?



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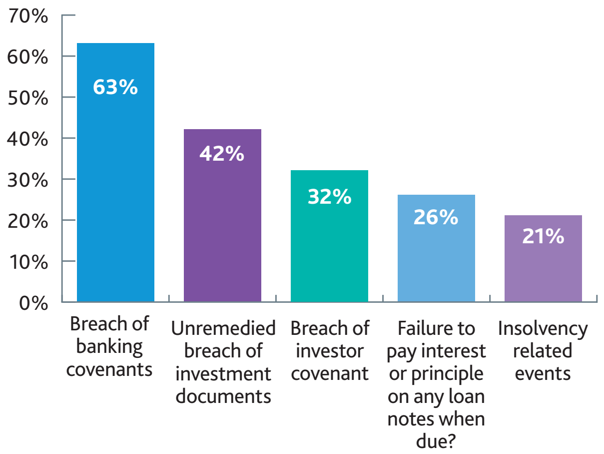
Swamping rights

Swamping rights are an important and generally accepted protection for private equity investors in the event of a material default or downturn in performance and the swamping events that we tend to see have remained consistent over recent years. In our 2019 survey, breach of investor covenant and insolvency-related events were the most common swamping events reported, each applying in 60% of transactions. This year, breach of banking covenants topped the list, applying in 63% of transactions, up from 50% in 2019 but not as high as the 79% seen in 2018 and 100% in 2017. There was a marked decrease in the inclusion of insolvency as a swamping event as against previous years, which at 21% in 2020 was back down to the level last seen in 2017, after increasing to 43% in 2018 and 60% in 2019. We do see private equity bidders opting not to include insolvency as a swamping trigger as breaches of bank or investor covenants are more likely to alert the investor to underperformance issues ahead of insolvency-based triggers and so this may explain the reduction in use.

If the investment agreement contains "swamping rights", in what circumstances can investors invoke these rights



> This year, breach of banking covenants topped the list, **applying in 63% of transactions, up from 50% in 2019**

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