howden M&A

Arrowpoint Advisory

Rothschild & Co

Pinsent Masons

PE M&A Report

2023

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Executive summary

Welcome to the 2023 edition of our annual review examining deal terms and trends in the M&A and private equity markets. For the fifth year running we are delighted to work alongside Howden M&A and Arrowpoint Advisory to pool our deal data, which we believe (as with previous years) provides the most comprehensive analysis of UK mid-market transactions available for review by buyers and sellers alike. We hope it continues to prove insightful in assisting benchmarking on what constitutes 'market practice'.

In 2022 we reflected on a record year of deal activity as global economies re-opened post pandemic, resulting in a backlog of transactions coming to market with deal activity underpinned by abundant liquidity and high demand for quality assets. At the same time we noted the worrying headwinds on the horizon from the war in Ukraine, and the energy and cost of living crisis. While pandemic fears have receded the conflict in Ukraine continues to have negative global economic implications, though a major European energy crisis appears to have been averted thanks to a mild winter. However with inflation running at double digits, leading to high wage demands and industrial action, and with interest rates increasing the cost of debt and further curtailing consumer spending, the outlook continues to be uncertain.

The end of 2022 saw the publication of a number of bleak economic forecasts predicting mild recessions, stubbornly high inflation and low growth. As we approach the end of the first quarter the outlook appears somewhat brighter, and although low growth is still expected in most major economies, recessionary fears have faded and there are optimistic signs that inflation may have or be close to reaching its peak and energy prices moderated. The **OECD** now forecast a fragile recovery with global growth at 2.6% in 2023 and 2.9% in 2024. Any forecasts are of course subject to uncertainty and this fragile recovery is likely to remain subject to periods of volatility – as evidenced by recent challenges in the global banking sector.

Despite economic headwinds the private equity market has maintained its usual resilience, having become adept over recent years at navigating the various curve balls thrown at it which have ranged from Brexit, to the pandemic and the uncertain economic landscape mentioned above. In the UK, private equity deal volume and value were down on a record year in 2021 but proved robust with deal numbers comfortably exceeding those in the years prior to the pandemic. With record funds raised in 2021 and decent inflows in 2022 the industry retains a significant amount of dry powder (approaching US$2 trillion globally) according to recent research (**S&P Global Market Intelligence, 21 December 2022**), which should be supportive of a decent transaction pipeline in 2023 and beyond. There was however a notable slowdown in leveraged buyouts in H2 2022 as the market adjusted to a higher interest rate environment.

In the UK we saw solid transactional demand through 2022, albeit with a noticeable slowdown in the second half, not helped by the turbulence of the short lived Liz Truss government. While there remained plenty of sellers and buyers active in the market we found transactions took a lot longer to close than in 2021, which was perhaps reflective of general economic uncertainty and more nuanced discussions on valuations.

In sector terms, Technology, Media and Telecoms again led in the volume of transactions. Even if the shine appears to have recently come off 'big tech' valuations there was still a keen market for mid-market and growth technology companies. The Life Sciences and Healthcare sector saw the second highest number of transactions and this reflects both a growing appetite for innovative UK life sciences companies as well as for service providers in the healthcare sector. We also saw a notable increase in the volume of Energy and Infrastructure sector deals perhaps driven by a firm pricing environment.

Our 2021 report noted a return to the sellers' market witnessed in pre-pandemic times – shown in a number of areas including a reduction in the use of MAC provisions and deferred consideration and an increase in pari passu ranking in all respects between investor and management loan notes, but over the course of 2022 we began to see a shift back to terms typically seen in a buyers' market and we anticipate terms to slightly favour buyers through the current economic conditions. In other areas, trends seen over recent years continued.

As we experienced somewhat of a year of two halves in 2022 with respect to deal volumes, the M&A insurance market adjusted accordingly. A notable slowdown in deal volumes in the second half of the year, coupled with insurers' sizeable underwriting teams following a period of aggressive investment in preceding years, resulted in a notable expansion in insurer appetite and downwards pressure on pricing and retentions, which has carried through to the first quarter of 2023. The report explores these trends in further detail, together with an analysis of recent claims data and how we expect the insurance market to evolve as we move through the year.

In this year's report we have again taken the opportunity to include commentary from the Pinsent Masons' corporate teams in Germany, Ireland, Luxembourg, Netherlands and Spain for their perspective on deal trends in their jurisdictions, highlighting where these align with, or diverge from, UK trends to provide more of a European view beyond the UK perspective. We hope you find these comments enlightening.

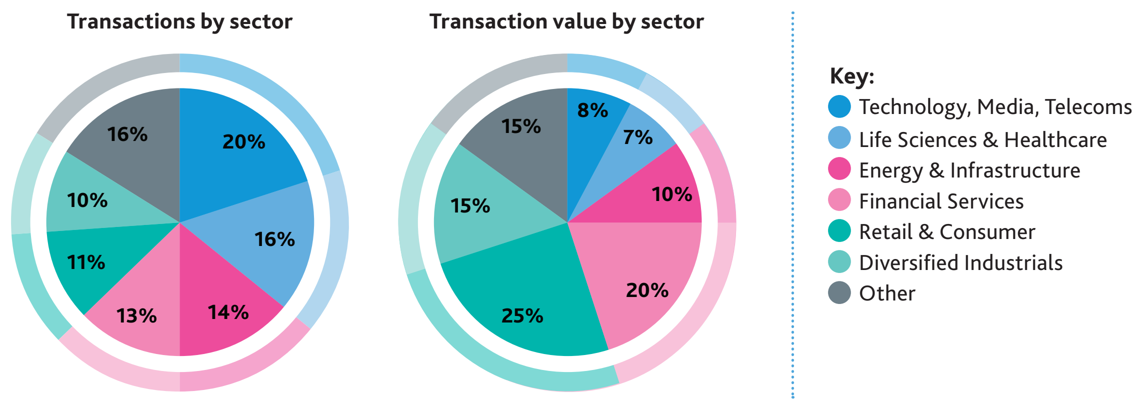
Looking forward over the next 12 months we remain cautiously optimistic for deal activity – where there is disruption there is often opportunity and the UK has certainly not been short of recent disruption! With asset values moderating we believe buyers will continue to see attractive opportunities in the market, though they are more likely to strike a hard bargain – particularly in comparison to transactions concluded over the last two years.

Survey methodology

This report represents our analysis of the pooled transaction data of Pinsent Masons, Arrowpoint Advisory and Howden M&A. We analysed data from 176 transactions (compared to 179 in 2021) with a combined transaction value of £21.5bn, a decline of a third on 2021, a year of record transactional activity and some exceptionally large transactions.

Our data was comprised of 89 private equity backed transactions and 87 trade led transactions, each contributing around 50% of the total transaction value. At £122m the average private equity transaction was approximately half of the average in 2021, but more in the range of our prior surveys – which illustrates what an exceptional year 2021 was.

The Technology, Media and Telecoms sector again accounted for the largest number of transactions at 20% of the total, followed by Life Sciences and Healthcare with 16%. There were fewer Financial Services transactions in our data this year, though they continue to account for a high proportion of transaction value at 20%. By value, the Retail & Consumer sector continued to be attractive, accounting for 25% of total transaction value, compared to 30% in 2021.



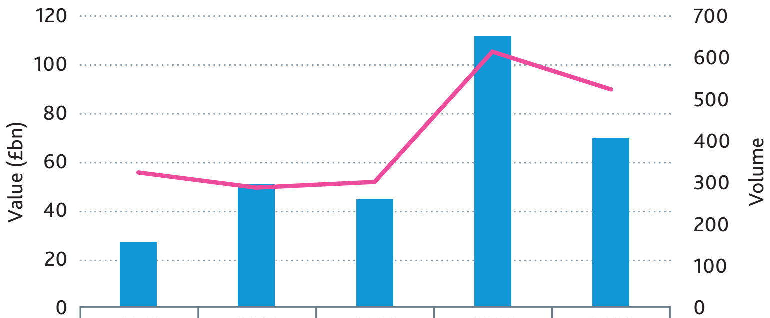
Market view

Following a record 2021 driven by abundant liquidity, a backlog of transactions from a pandemic disrupted 2020 and increased investor confidence, deal activity inevitably declined in 2022. Global mergers and acquisitions totalled US$3.6 trillion according to data from Dealogic, a decline of almost 40% from the prior year. While the year on year decline could be expected, total transaction value in 2022 was lower than each of the previous five years and this was despite a strong start to the year when a continuation of 2021 seemed a strong possibility.

Positive sentiment eroded in the second half of the year as the war in Ukraine became protracted, and with fears of a global energy and cost of living crisis becoming reality. The US market led the decline in deal activity, with Europe and the UK seeing greater weakness towards the tail end of the year.

In the UK private equity market, acquisitions of UK companies declined year on year in both volume and value terms, but on a long term view the market demonstrated resilience. Transaction value declined by 38% to £69bn, with a 15% decline in the number of transactions. But on a five year view both figures were encouraging.

UK private equity transaction volume and value



	2018	2019	2020	2021	2022
Value (£bn)	26.8	48.8	44.3	111.6	69.4
Volume	324	286	300	614	523

Source: MergerMarket

'Snowball effect' will drive PE M&A deal activity in 2023

A quieter period for private equity (PE) merger and acquisition (M&A) deal activity may be coming to an end, with signs that the market is recovering following months of economic and geopolitical turmoil in 2022.

Insurance brokers specialising in warranty and indemnity policies are already reporting around 25 to 30 new transactions involving these types of insurance products coming to market every day in Europe, which is a significant increase in activity compared to the latter part of 2022, when volumed had dropped by over 80%, and comparable to the levels recorded during the boom years of 2020 and 2021.

Differences in the expectations of sellers and buyers over valuations remain a barrier to deal-making in some cases, but high-performing assets remain popular and, with market conditions predicted to stabilise further as 2023 progresses, confidence in deal-making is expected to grow. With significant funds or 'dry powder' ready to be committed, a 'snowball effect' is possible – with a stronger second half of 2023 increasingly likely.

Buyers rediscovering their conviction

Due to the challenging market conditions highlighted above, many prospective buyers dwelled on their due diligence and adopted a 'wait-and-see' approach to target assets and their business performance in 2022. Where deals were done, they were often the product of opportunism – with buyers in some cases successfully encouraging sellers to revisit their valuations after embarking on marketing processes that failed to meet sellers' expectations and striking a deal.

While trading conditions remain challenging, there are positive signs of economic recovery – **the Bank of England is predicting** that inflation will fall to around 4% by the end of 2023 (notwithstanding a surprising increase reported in March) and continue to fall thereafter, while the **FTSE 100 recently hit 8,000 points for the first time**. Interest rate rises may also have reached a peak, which will help provide the debt markets with more stability. The prospect of less external 'noise' to muddy waters is likely to help buyers act with greater conviction as we go deeper into 2023 giving scope for parties to assess the valuation of target companies with more confidence.

Greater stability in the economy and financial markets makes it easier to compare seller valuations against comparable companies which have been sold. Stronger buyer conviction in turn will encourage more sellers to move to full auction processes to complete a sale, rather than bilateral off-market deals, where there is arguably more deal risk or where the risk of a less satisfactory result may increase.

We have already seen a number of £500 million-plus value deals signed in 2023, which indicate that larger deals are progressing and that deal activity is not just restricted to mid or the lower mid-market.

In many cases, however, there remains a gap in valuation between buyers and sellers. In 2023 we expect to see creative deal-making as a means of bridging the valuation gap. We saw different structures used to achieve this in 2022, such as ratchet-based equity incentives for management teams rewarding overperformance – this encourages investors to pay a slightly higher price at the outset but gives the investor more protection where actual performance and returns are not as stellar as management may promise. We expect more of the same this year.

A mixed picture across sectors

With **an estimated US$250 billion of 'dry powder' ready to be deployed into investments in the European market**, private equity houses are primed to act when they identify the right target companies at the right price. Some sectors are likely to be more attractive to these 'conviction investors' than others.

There has been a lot of recent attention on the Technology sector amidst a wave of job losses, with big movements in the valuations in some listed companies. Yet, interest remains high from investors who still see opportunities to get in early in a market that promises high-growth and substantial returns. This sector is one where buyers are showing real appetite and conviction to invest, looking to take advantage of the uncertain economic backdrop, but we do expect to see prospective investors seeking to reduce valuation multiples that they might have had to pay to acquire technology companies only 18 months ago.

The focus of private equity investors has, however, been shifting. Consumer-facing sectors, even within the Technology sector such as e-commerce, are sensitive to pressures on spending. There has been a resultant reduction in the value of some businesses in these sectors and an impact on sale processes and execution where buyer sentiment has been affected.

Investors are likely to remain attracted to the Healthcare sector, where valuations have been more resilient to economic volatility. We are seeing emerging sectors such as Infratech become more popular with investors as they see value growing from the drive to use technology and data to better design, build, operate and maintain infrastructure assets.

Exit strategies

We expect the decline in the number of initial public offerings (IPOs) to continue in the short-to-medium term, but conditions in the capital markets can change quickly – as the recent recovery in value of the FTSE 100 demonstrates. It can take months to prepare for an IPO, so PE investors that are considering that option for exit will want to start preparing now so that they are in a position to benefit when market conditions improve.

In 2023 we also expect to see a continuation of the popularity of secondary or tertiary buy-outs – where PE investors buy existing PE-backed businesses. In addition to the need for PE funds to continue to deploy capital, investors also need to achieve exits to demonstrate returns to their own limited partners. Some investors consider there to be less risk investing in businesses and management teams that have withstood the watchful eye of PE investors and achieved successful growth – though the scope for further growth for a secondary PE investor must exist for these sorts of deals to happen.

ESG

The environmental, social and governance (ESG) agenda is an increasing factor in deal-making for both buyers and sellers.

There are a growing number of impact funds that are focused on investing through the ESG lens, while other buyers are also doing increasing due diligence on the ESG credentials of target businesses amidst growing regulatory and reputational pressures to channel investments to green and ethical projects and businesses. In this environment, the way sellers position and market their business in respect of ESG is becoming increasingly important.

In 2023, we are increasingly seeing investment decisions being shaped by ESG considerations as they have a higher level of importance and weigh heavier with investment committees and in their investment decision making. Demand for specialist ESG due diligence providers is growing as a result, and ESG factors will seep into many aspects of the deal process, including warranties around compliance with environmental laws, governance and anti-bribery.

Merger control

Merger control and public interest regimes have been tightened in a number of jurisdictions in recent years, including in the UK with the National Security and Investment Act 2021 (NS&I).

Last year, sellers and buyers, together with their advisers, were coming to terms with this new regime, seeking to understand what impact it may have on deal processes and transactions. As the regime is drafted widely, potentially capturing businesses that parties may not initially consider to be impacted by it, and requiring notification, advisers have been adopting a cautious approach, choosing to seek a pre-notification and wait for the Secretary of State's response before completing.

We expect this 'safety first' pre-clearance approach to remain prevalent in 2023. However, the approach being taken by parties is far from uniform and no single accepted way of dealing with NS&I where a notification is to be made has, as yet, been blessed by the market.

In some circumstances, parties are notifying the Secretary of State during due diligence, enabling signing and completion to occur simultaneously once a favourable response is received. In other cases, sellers are pushing for contractual certainty from buyers first before notifying, with the sale agreement being conditional on approval being received from the government. However, there may be time pressures to get a deal done in other cases and so – given the risk of deals being unwound if they are found to present a risk to national security – we expect to see a growing number of sellers seeking to pre-empt any issue on NS&I with the aim of achieving a consensus on whether to notify or not earlier in the deal process by commissioning their own analysis and sharing this with potential buyers during the due diligence phase to reduce deal or timetable risk.

Take confidence from the resilience of businesses

Despite challenging trading conditions in recent times, there remain a lot of robust businesses that are doing well. As economic sentiment improves, we expect that to build confidence, particularly in the debt markets, and this will encourage private equity to invest. While the picture differs across sectors, businesses in many parts of the economy will be attractive to investors.

We are quietly confident that 2023 will see momentum back into the market – perhaps not at the multiples witnessed in 2020 and 2021, but there will be less of an emphasis on deals driven by underperformance issues and more deals done involving healthy businesses with good scope for growth and in increasing volume as the year goes on.

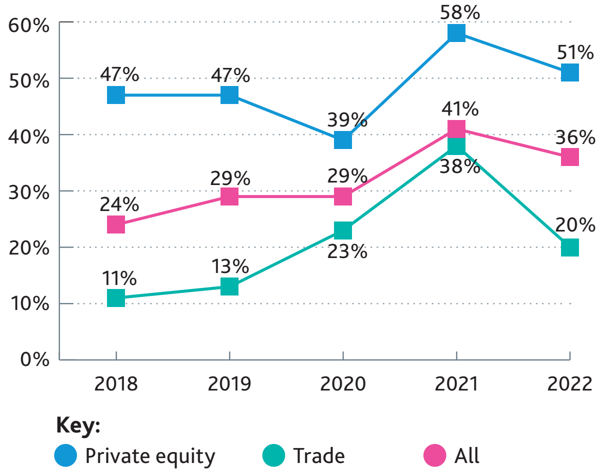
*Co-written by **Kieran Toal** of Pinsent Masons, **Simon Cope-Thompson** and **Jamie Hutton** of Arrowpoint Advisory, and **Ella Shillingford** of Howden M&A.*

Deal process trends

Auctions continued to feature strongly in the transactions under review, accounting for over a third of all transactions, slightly down on the prior year but in line with the long term trend. In private equity transactions, auction processes were used more frequently, again topping the 50% mark. The increasing popularity of auctions in recent years reflects the sellers' market that has prevailed over this period. Given the changing economic dynamics it was perhaps not surprising to see the slight fall in the number of these types of processes. It may also reflect that with the end of Covid restrictions, the importance of networking and relationship building returned for parties with a preference for bilateral deals.

Auction processes continue to generate higher proceeds than non-auction processes, arguably reflecting their competitive dynamic. In total, transactions involving an auction accounted for 62% of the total transaction value and this figure was even higher for private equity transactions at 74%. For private equity owners, auctions continue to work well given the relative speed and certainty embedded in the process.

Transactions via an auction process

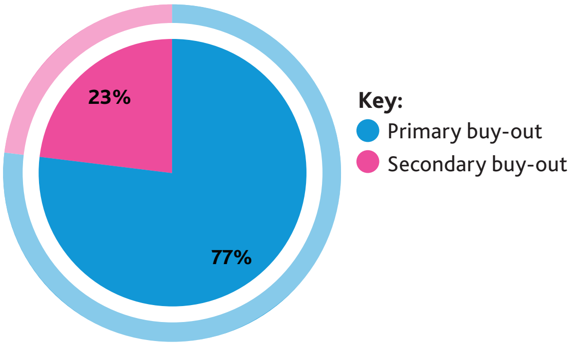


Last year we noted the growing popularity of secondary transactions in private equity, accounting for a third of transactions. This figure was down to just under a quarter in the data for 2022 but the long term trend for secondaries was maintained.

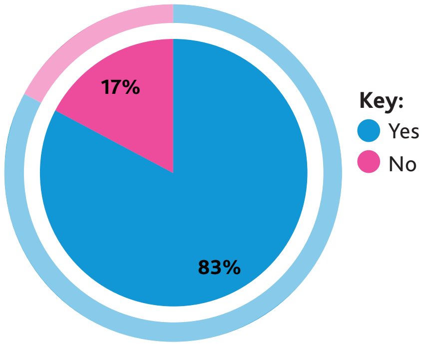
Secondary transactions have attracted greater scrutiny in recent years given the increase in the number of deals where the deal has resulted in the buyout being completed by a different fund managed by the same private equity house and it will be interesting to see if such transactions continue over the next eighteen months. Secondary transactions provide private equity investors with the opportunity to achieve liquidity for their incumbent fund whilst retaining further upside in a newer fund (with the added advantage of backing the management and company they already know). With economic indicators less favourable than prior years we may see private equity houses seeking to hold onto investments for longer periods in order to go to market when conditions have improved, particularly given exit routes via IPO appear closed off in the mid-term.

Where a transaction was completed via an auction process a period of exclusivity was granted in 83% of the transactions. This figure is consistent with prior years.

Was the deal a primary or secondary buy-out?

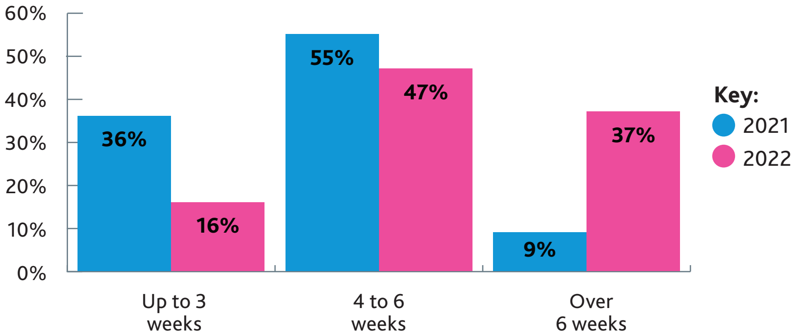


Was a period of exclusivity granted?



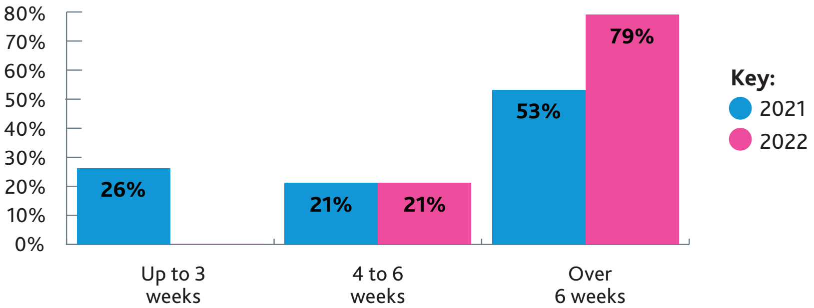
An initial exclusivity period of 4-6 weeks remained standard, with 47% of relevant transactions allowing this in 2022 compared to 55% in 2021. However, we saw stark changes outside of this. In 2021 over a third of transactions had an initial exclusivity period of 3 weeks or less – reflecting a strong sellers' market and a strong dynamic to push on at pace. However, this has reversed in 2022 with far fewer transactions granting the shorter exclusivity period; in fact, over a third of transactions granted an exclusivity period of over 6 weeks. We think this is an inevitable consequence of the increased economic uncertainty, inflation and the rapid increase in interest rates: with more uncertainty buyers want more time for due diligence and reflection and to avoid being railroaded into short transaction deadlines.

What was the length of the initial exclusivity period?



This was also true of the length of time between granting exclusivity and ultimate exchange and completion, with completion typically over 6 weeks in 79% of the transactions under review, up from 53% in 2021. We expect the trend for transactions to take longer, even if utilising an auction process, to continue in the mid-term.

How many weeks were there between granting exclusivity and ultimate exchange & completion?



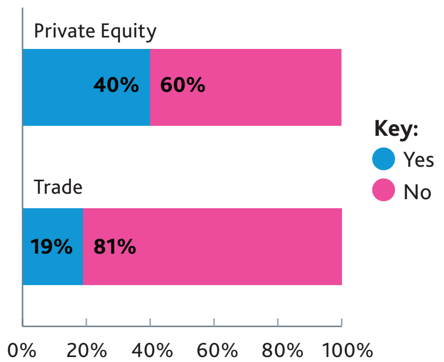
Split between exchange and completion

In private equity transactions there was a split between exchange and completion in 40% of the deals under review – exactly the same as in 2021. A split between exchange and completion remains a tool for financial sponsors to execute quicker than they otherwise would do: debt can be raised and long form equity documentation can be drafted and negotiated in between exchange and completion, leaving less to do before signing. As mentioned last year, it's a tool that the savvy buyer can use to shorten the deal process thereby reducing execution risk for the seller and positioning themselves as a more attractive bidder as a consequence. However, we are also seeing it being used by buyers to reduce execution risk for themselves, making completion conditional upon the satisfaction of matters in the interim period (e.g., change of control consents, regulatory requirements) in circumstances where they previously would have taken the commercial risk.

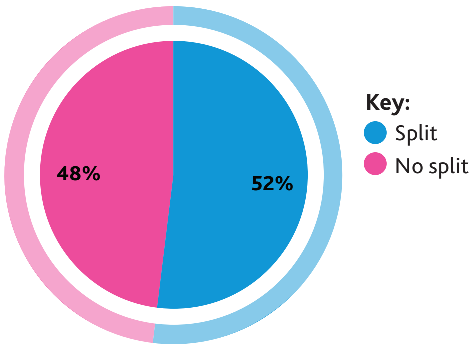
In trade transactions there was a split in 19% of transactions – substantially down on 2021 (45%), which may be partly a result of the lower volume of financial services sector transactions in this year's survey. Financial services transactions are generally subject to a split given the normal requirement for regulatory clearance. However, it might also be a sign of the lessening of competition for assets – giving trade buyers more time to do upfront diligence and not being coerced into the 2021 style competitive auction processes with aggressive timelines.

In terms of total transaction value, 52% of total value was subject to a split which was down from the 82% seen in 2021. Generally the larger the transaction value the more likely there is to be a split between exchange and completion, and despite the apparent decline year on year we think this still holds true. Two of the largest transactions within our pooled data were, unusually, not subject to a split so the apparent decline is likely a quirk of the data rather than a shift in transaction dynamics.

Was there a split between exchange & completion?



Transactions involving a split (by transaction value)



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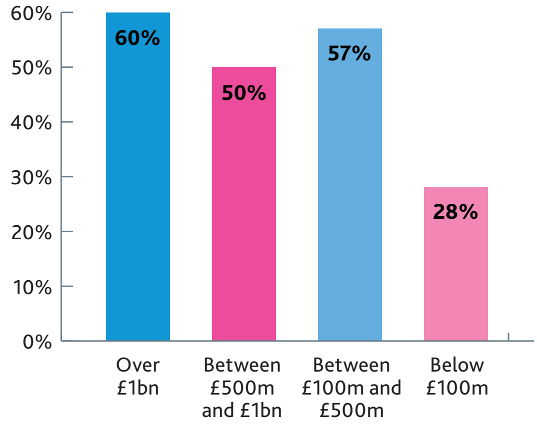
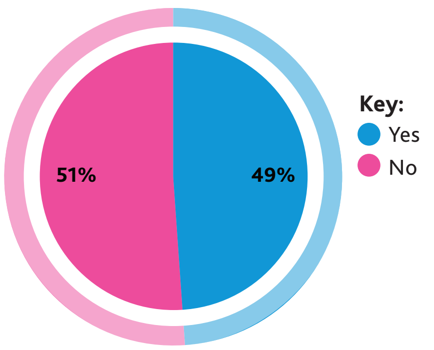
Last year we speculated that the introduction of the National Security and Investment Act had the potential to create further timing issues on a range of transactions, but in our experience this has not transpired. Whilst the wording of the legislation is broad, and therefore brings more deals into its orbit than expected, the government have been responsive and cleared transactions quickly.

Proportion of transactions subject to a split

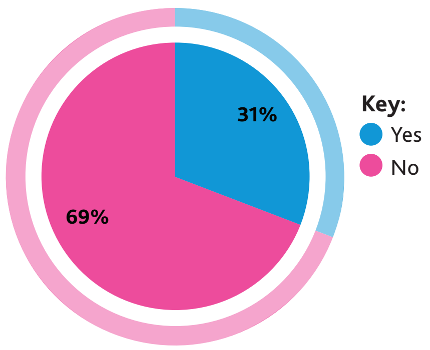


Warranties given by sellers at exchange were repeated at completion in 49% of transactions, slightly below the level seen in the two previous years but not far enough off trend to be an anomaly. Where warranties were repeated at completion a second round of disclosure was allowed in a third of transactions down from half in the prior year, and continuing the long-term decline we have seen in the number of transactions where a second round of disclosure has been allowed.

Were the warranties repeated at completion?



Was a second round of disclosure allowed?

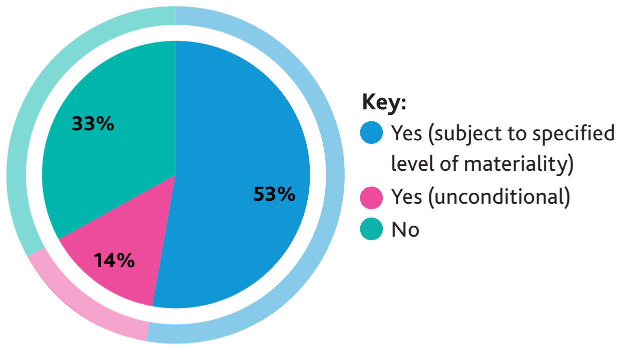


The buyer was contractually permitted to walk away for material breach of warranty or interim covenants during the gap between exchange and completion in 53% of transactions, down from 67% in 2021 but in line with previous years. Previously we had noted that it would be unusual for the buyer to be allowed to walk away regardless of the materiality of the breach and indeed just 14% of transactions permitted this – the lowest level in our survey data yet.

However, the data indicates a third of transactions did not permit the buyer to walk away for a seller breach which was a material change from 2021 when only 8% of transactions allowed this.

The reduction in buyer termination rights reflects the increased uncertainties we face. Sellers are more nervous about a material issue occurring between exchange and closing that might give a buyer second thoughts (e.g., a return of Covid lockdowns or a cyber-attack). As a result, once a price is agreed the contracts are tightly drafted to give the buyer few, if any, opt outs.

Was the buyer contractually permitted to terminate for a breach of warranty/interim covenants during the gap between exchange and completion?

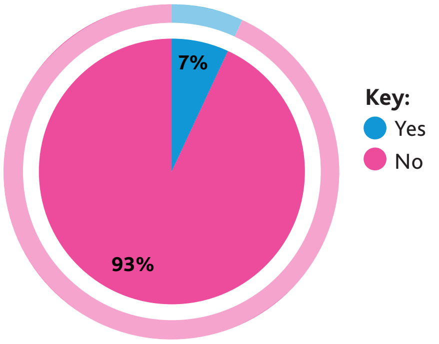


MAC clause

The use of more general material adverse clauses continued to decline with just 7% of transactions employing a MAC in 2022, down from 14% in 2021 and reflecting a long drift down from the 45% seen in 2018.

The decline has arguably been indicative of a strong sellers' market in recent years with sellers having been able to push the risk of material unforeseen circumstances on to the buyer. With the increased uncertainty seen in the second half of the year we may have expected the figure to have been higher. Looking forward we expect buyers to harden their stance over the coming year given some of the economic and pricing volatility we have seen over the last few months – and on that basis we expect 2023 to see the return of the MAC.

Was there a MAC clause?



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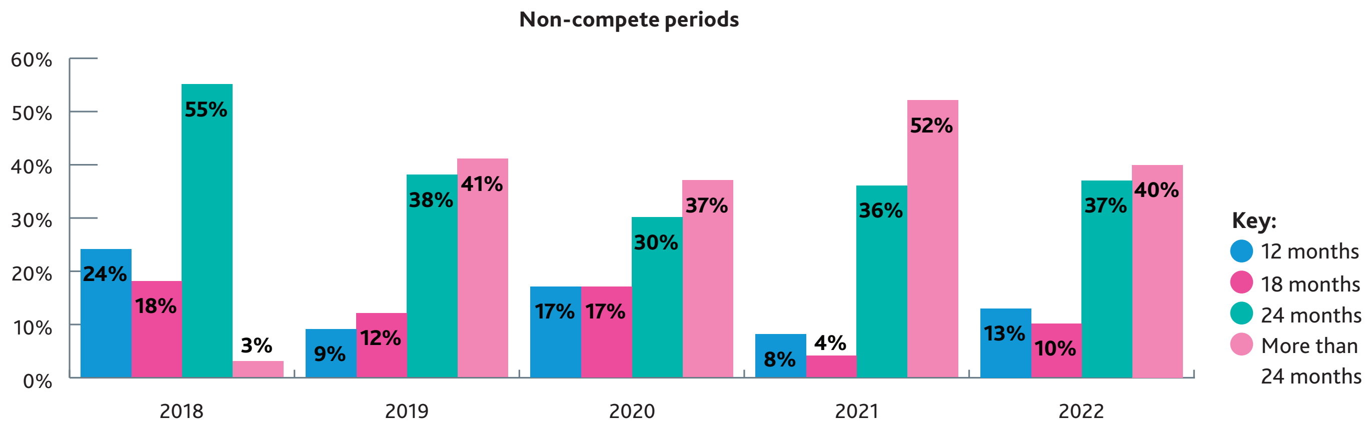
Restrictive covenants – non-compete

In the years that we have been collating this data we have seen a gradual increase in the length of non-compete periods, and while the proportion of transactions specifying a period of more than 24 months fell from 52% to 40% in 2022, this now appears to be the preferred range on mid-market transactions. Transactions setting non-compete periods of 18 months or less remain in the minority.

Previously we had noted that with companies often being acquired at an earlier stage of development than in previous years, and with companies able to scale at pace through the use of digital technologies, there is a greater incentive for buyers to insist on longer non-compete periods to maximise the value of their investment and as a lever to retain key talent within the business. Commercially we can see the demand for long restrictive covenant periods will continue, however, the political direction is more towards free trade and away from covenants that stifle competition. We are expecting movement on the laws governing restrictive covenants in the next few years.



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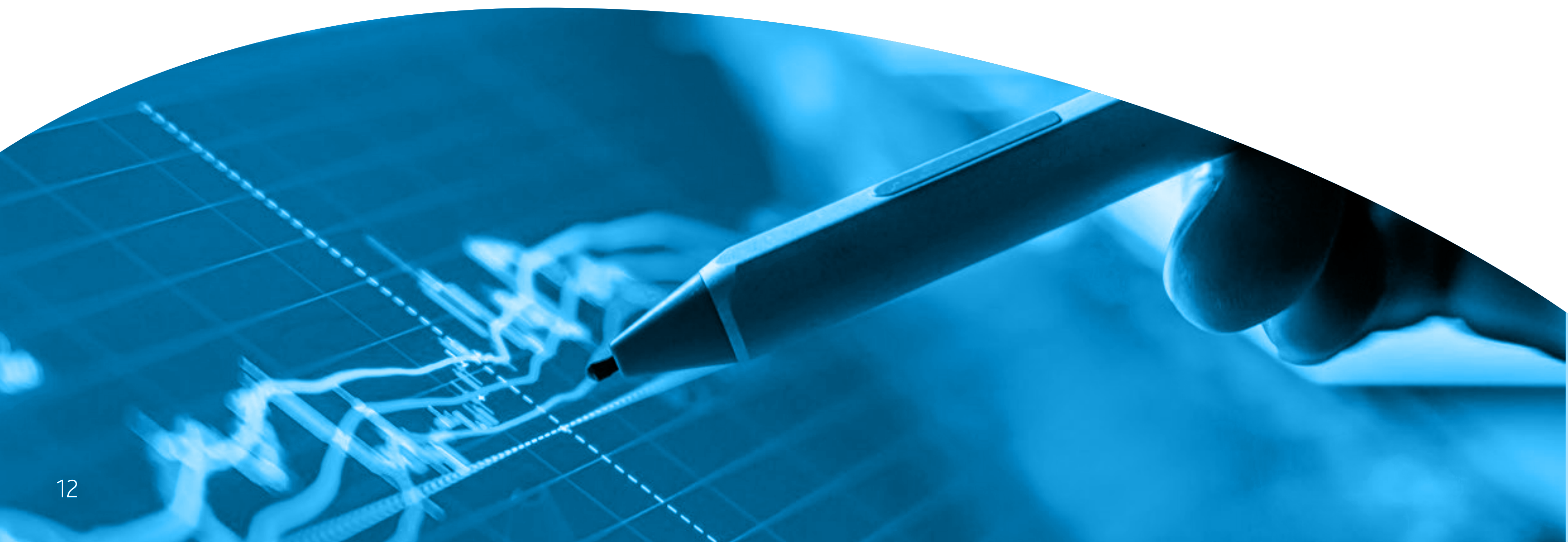
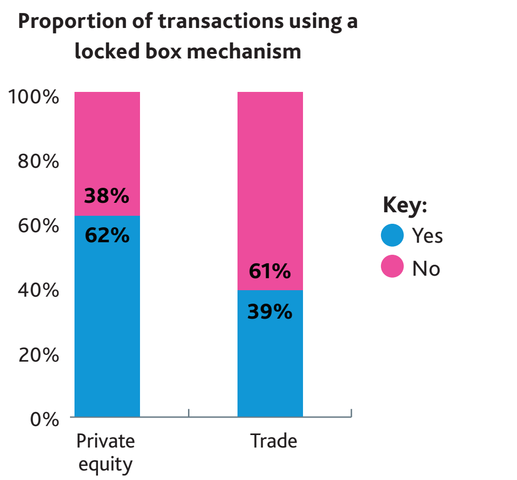
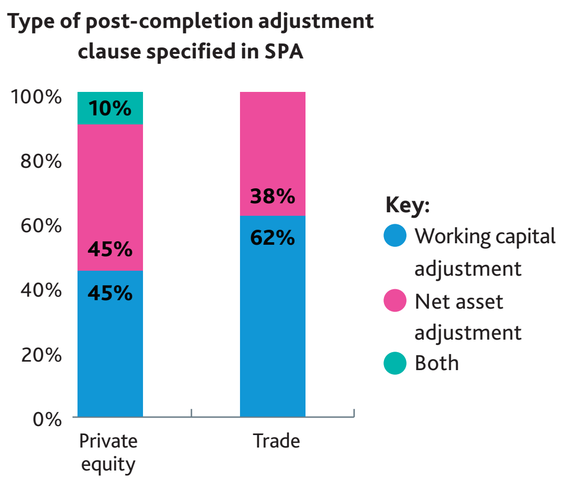


Locked box, completion accounts and deferred consideration

Our latest data confirms the use of the locked box mechanism has become the favoured methodology in private equity transactions and seen in 62% of deals, down from 80% in 2021, but confirming a long term trend. Usage also fell in the share of trade transactions (39% from 54%) but again reflects the long term trend. Whilst a locked box prevents lengthy negotiation of the working capital, cash and debt numbers post deal it is increasing the amount of upfront diligence undertaken on the target balance sheet. A well-advised seller will have in-depth financial vendor due diligence that will prepare the ground for a constructive discussion on the correct levels of working capital. Many buyers are now preferring the more detailed pre-exchange diligence and negotiation process over less pre-exchange information and the potential for a post-completion dispute.

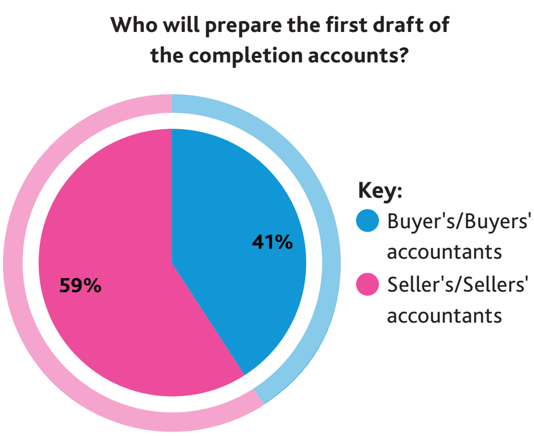
Where a post-completion adjustment clause was specified in the SPA it was split evenly between working capital and net assets in private equity transactions, with trade transactions weighted towards a working capital adjustment.





Whether buyers or sellers prepare the first draft of the completion accounts is a common area of debate and the 2022 data indicates an ongoing shift towards sellers with the task falling to the sellers' accountants in 59% of transactions up from 52% in the previous year.

Where completion accounts were used a small minority of transactions (just 4%) set a cap and collar to exclude immaterial price adjustments within agreed parameters, this is consistent with previous years.



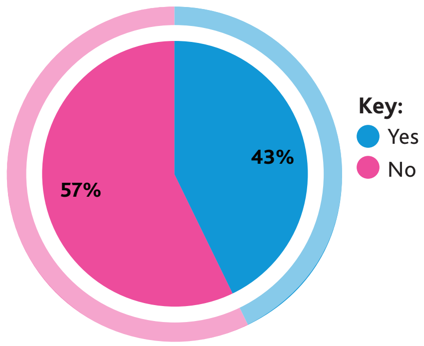
Deferred consideration

We have previously highlighted a trend for the increasing use of deferred consideration as a way of bridging value gaps arising from concerns around either the sustainability or recovery of earnings. Our 2021 data appeared to contradict the long term trend with just under a third of transactions structured to include an element of deferred consideration. We think that reflected the extraordinary conditions prevalent in 2021 in which sellers were emboldened to demand full payment on completion in a highly competitive market.

In 2022 we saw a return to the long term trend with deferred consideration clauses utilised in 43% of transactions – in line with our 2020 data. This is also playing out in Q1 of 2023 with more transactions involving earnouts than previously experienced. This reflects a hardening of buyers' resolve, a lack of confidence in the forward trading outlook for businesses given the uncertain economic outlook and sellers who still have belief in the resilience of their business and, therefore, its value.

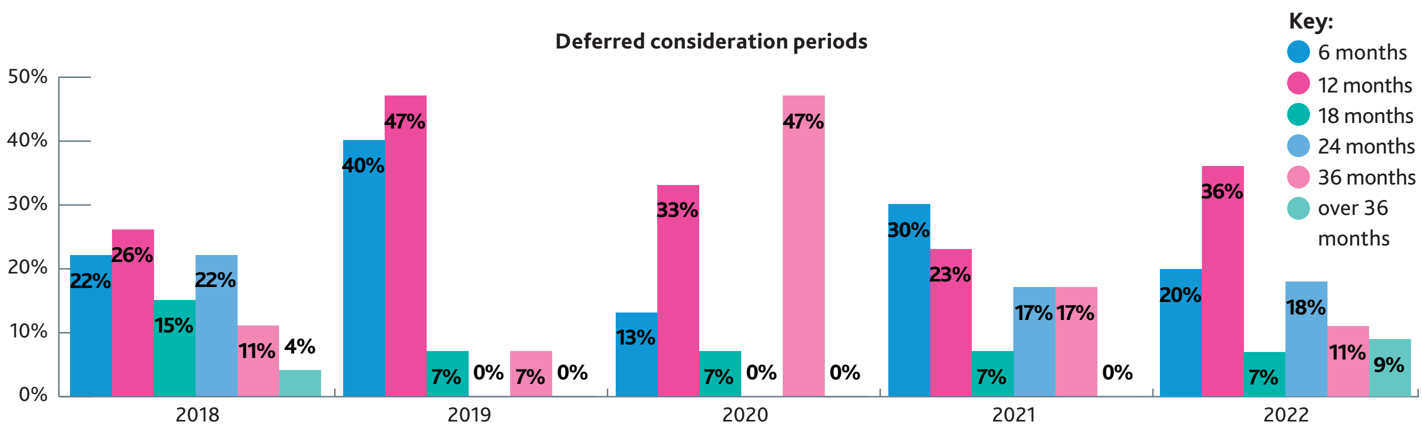
We have also seen earnouts used in circumstances where historical figures are still affected by Covid trading. An earnout is a good way of paying part of the consideration based on a full 12 month trading period outside of Covid lockdowns.

Was payment of the consideration structured to include some or all by deferred payment?



Since 2018, 12 months has usually been the standard deferred consideration period and this was seen again in 2022 with 12 months set in a third of transactions. We did however see a lengthening of the deferred consideration period, with 9% of transactions specifying a period of over 36 months. Again we suspect this reflects greater economic uncertainty and may even suit sellers in sectors particularly exposed to energy and commodity pricing volatility who fear missing out on potential upside should pricing return to more normal levels.

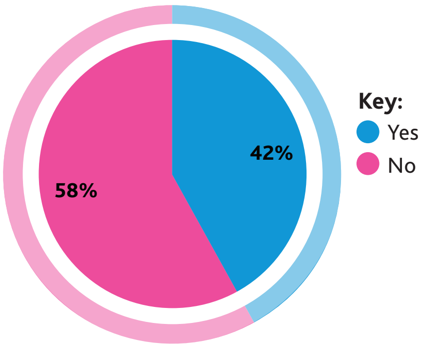
Deferred consideration periods



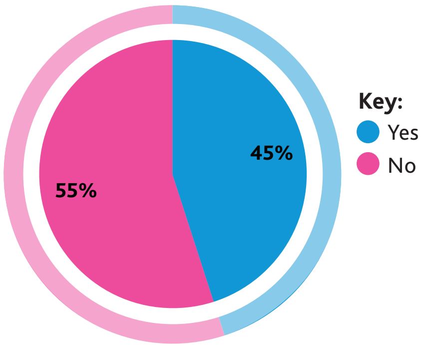
Private equity featured an element of deferred consideration in 42% of transactions, a doubling of the prior year, but as noted above reflecting a return to the levels seen in prior years.

There was less movement in trade transactions where a deferred consideration element featured in 45% of deals compared to 39% in 2021.

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



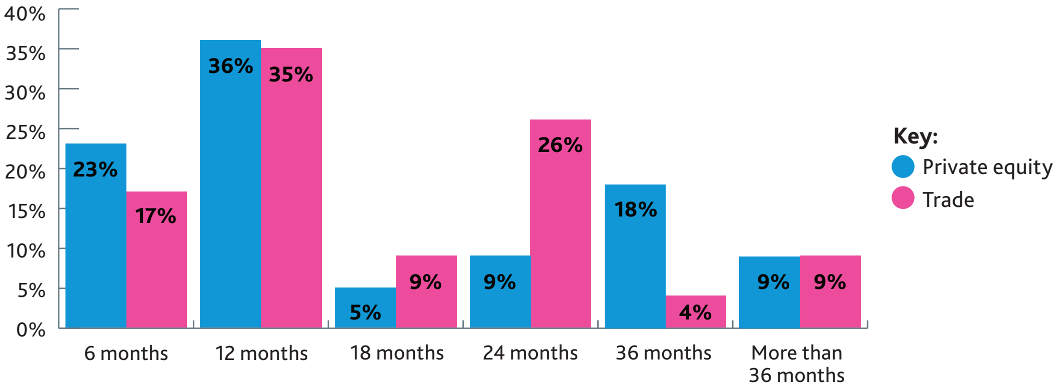
Did transaction include an element of deferred consideration? (trade)



Where we did see movement was in the deferred consideration period specified by private equity. In 2021 all of the relevant transactions featured a deferred consideration period of 18 months or less – but the picture was very different in 2022. While 12 months and under was still preferred in just over half of all private equity transactions, periods of 36 months and over were specified in a quarter of transactions. As mentioned above, we believe this reflects the lack of reliability of historical earnings due to Covid anomalies, a lack of clarity on future earnings due to global economic and political instability and the resulting mismatch in valuations between buyers and sellers.

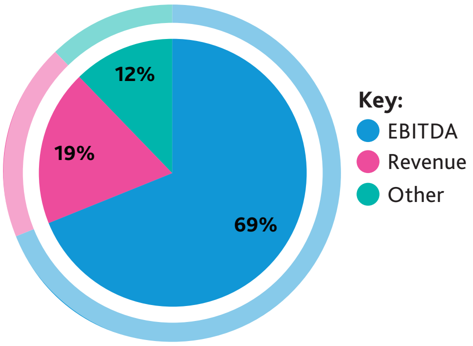
Historically the deferred consideration period in trade transactions has been more evenly spread and this remained the case in 2022.

Deferred consideration periods



As in 2021, EBITDA was the preferred metric on which deferred consideration payments were based. Over the last three years we've seen a gradual shift from revenue to EBITDA as the preferred measure. We think this indicates a shift from a growth to a value strategy and a more holistic approach to setting earnout targets, reflecting the old adage that revenue is vanity and profit is sanity.

Basis for payment of deferred consideration



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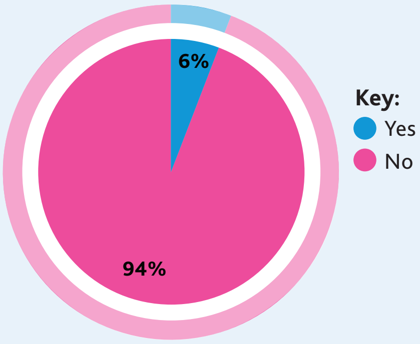
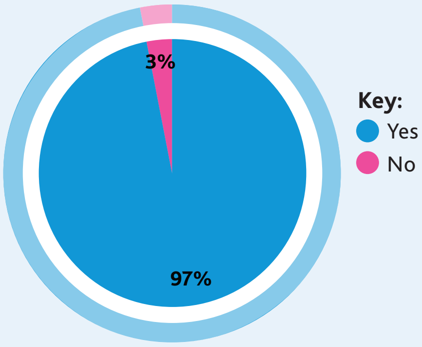
Warranties

The accepted position remains that for M&A transactions it is rather 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/sellers' liability under the warranties remains standard. Our data for 2022 is again 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?



The warranty caps continue to have a "dumbbell" shape to them. Either buyers are comfortable with the use of W&I insurance and live with a low cap on liability for the warrantors (usually around the amount of the excess on the policy) or buyers are not comfortable with W&I insurance and move to traditional protections of 100% warranty cover.

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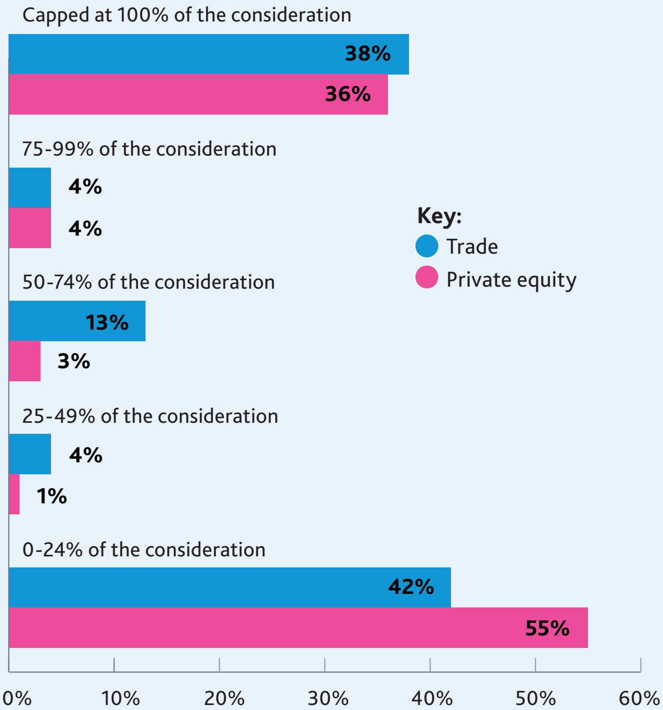
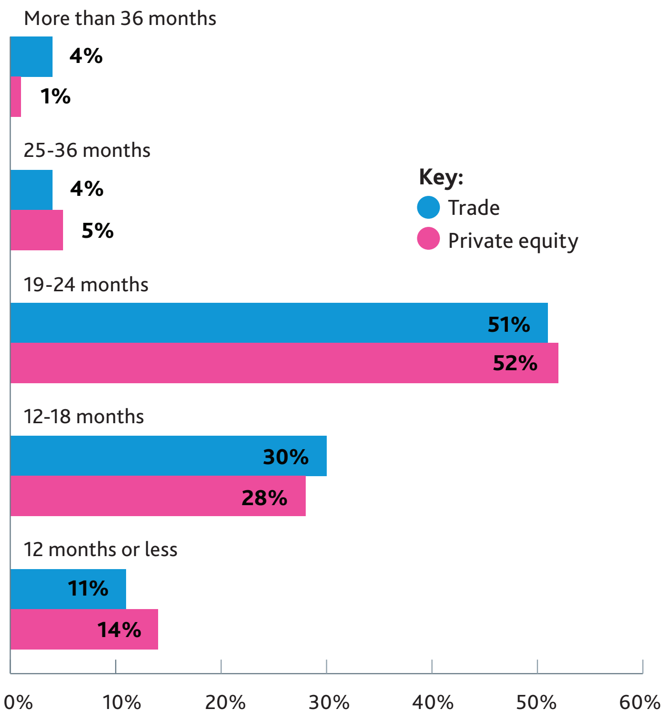
What was the amount of the cap on the seller's liability under the warranties?



The 2022 transaction data on limitation periods for commercial warranty claims is similar to that of 2021, though private equity transactions appear to have increased the length of limitation periods at the lower end. In 2021, 23% of private equity transactions specified a period of 12 months or less but this reduced to 14% in 2022, with a greater use of a 12-18 month limitation period (up to 28% from 14%). Limitation periods in trade transactions have remained broadly similar.

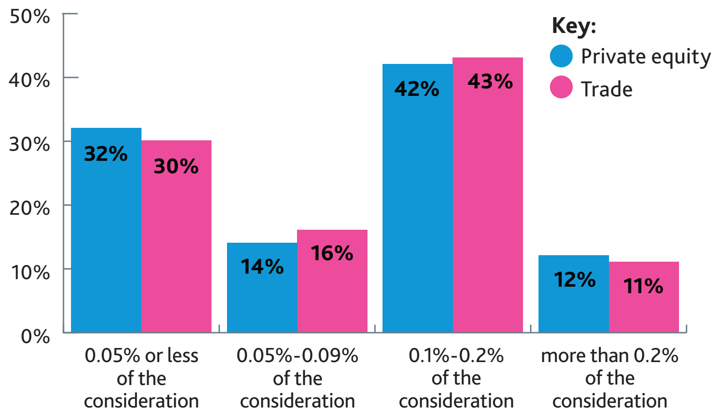
Limitation periods continue to be distorted by (i) the use of W&I insurance - it is possible to purchase policies that have different time limitations to the warranty deed and as a result, a warrantor may be able to negotiate shorter periods than would normally be acceptable to the buyer; and (ii) buyers looking for a period of time that spans two audits (which can then vary significantly depending on how close to the year end a deal exchanges).

Limitation periods for commercial warranty claims



There has been a noticeable increase in the proportion of private equity transactions that have set a de minimis threshold for warranty claims at more than 0.2% of the consideration, moving from just 2% in 2021 to 12% in 2022. Private equity transactions set at the lowest threshold of 0.05% or less declined from 40% to 32%, otherwise the data was little changed year on year.

Throwaway de minimis for warranty claims as a % of consideration



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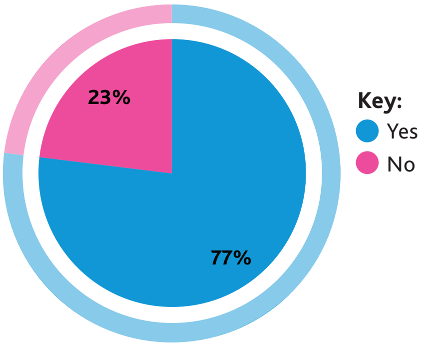
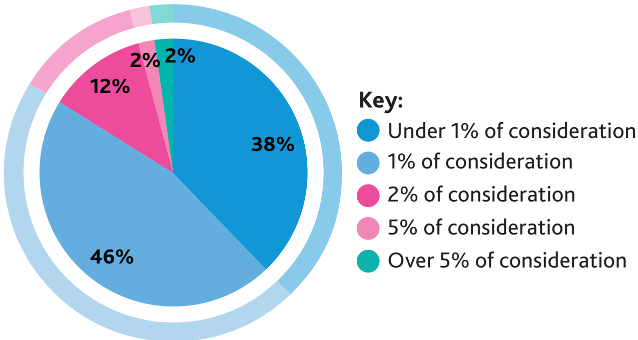
The proportion of transactions using a basket/threshold for claims declined slightly from 86% to 77% but this figure is representative of previous years' data where around three quarters of all transactions use a threshold for claims. The level the threshold is typically set at does appear to have slightly increased over the last year, with 38% of transactions set at the lowest threshold compared to 46% in 2021. Twice as many transactions were set at 2% of the consideration compared to the prior year but, as that only represents 12% of all transactions, setting at this level and above remains unusual.

Did the transaction use a basket/ threshold for claims?



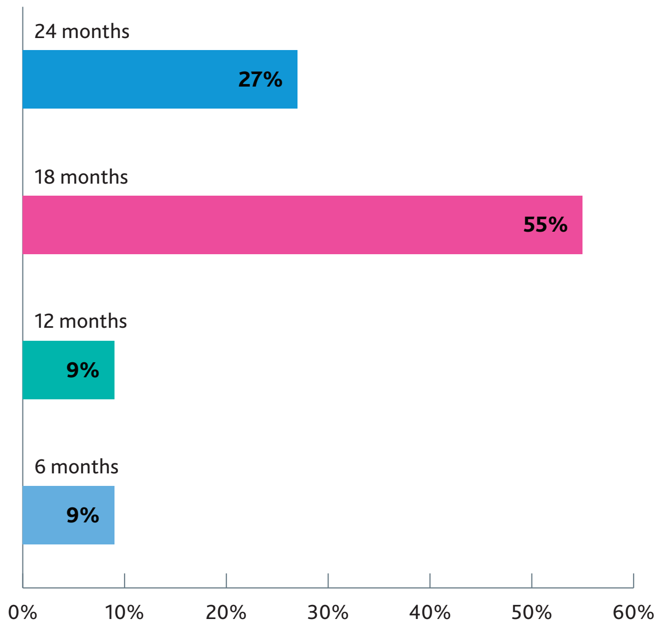
Transaction basket amount as a % of the consideration



Escrow retention accounts

The time period for escrow retention accounts was typically set at 18 months which is in line with historical data.

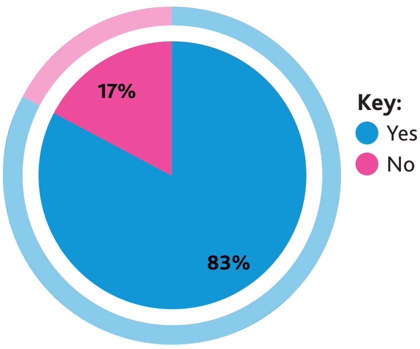
What is the time period for escrow/retention accounts?



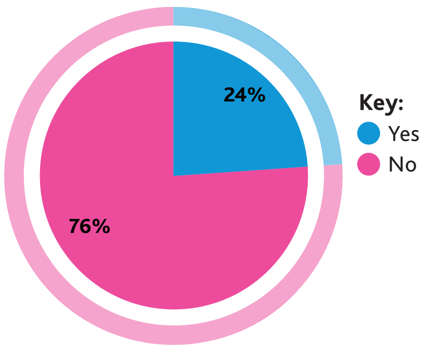
Disclosure

Disclosure trends are in line with prior years, though we saw a reduction in the number of buyers prepared to give a reverse warranty – which at 24% is the lowest level in the last three years of data.

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



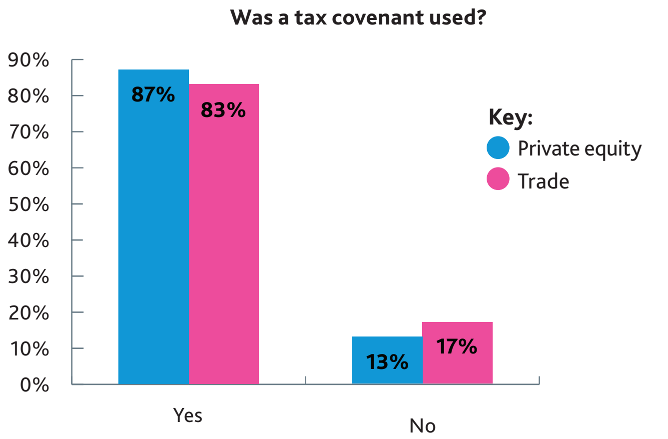
Did the buyer give a reverse warranty?

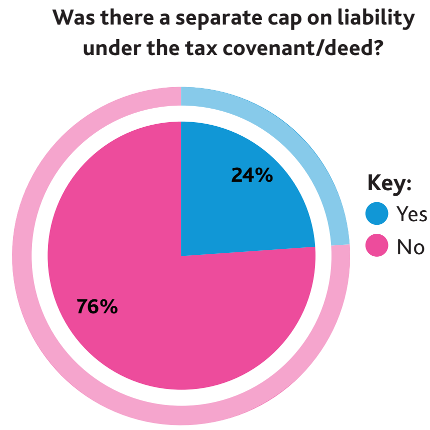


Tax

Use of tax covenants has always been high in our survey data but the proportion of transactions using a tax covenant has continued to increase year on year, up from 81% to 87% in private equity transactions and from 73% to 83% in trade transactions.

Although the use of a separate cap on liability under the tax covenant is still only common in a quarter of transactions its usage has gradually increased over the life cycle of our survey going from 14% to 20% in 2021 and to 24% in 2022. As with last year, we have seen the use of a separate cap on liability for tax matters most commonly in W&I backed transactions. What may start out as a deal with a £1 liability cap for the sellers, may pivot to a position where the sellers have actual liability up to an agreed cap for specific known issues identified during due diligence which are excluded from the W&I policy.





The limitation period for tax covenant and tax warranty claims remains firmly set in the six years or more bracket and indeed this period was preferred in 81% of transactions in 2022, up from 72% in the prior year.

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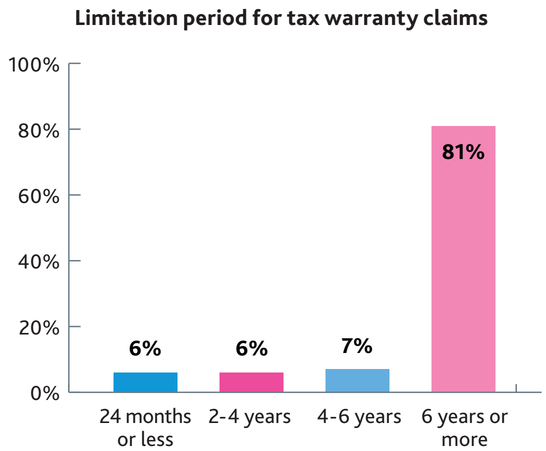


Warranty & Indemnity insurance trends

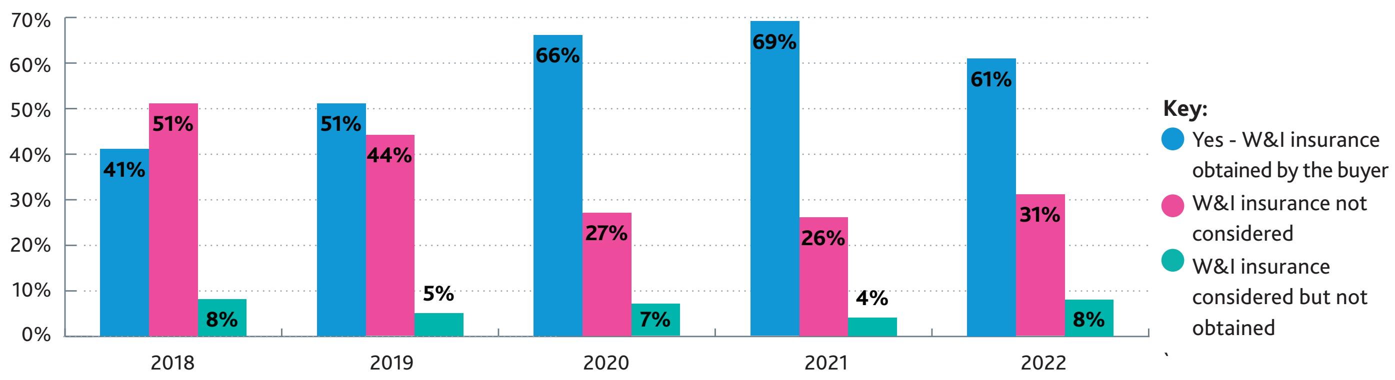
As detailed elsewhere in the report, after a record-breaking year for M&A in 2021, there was a notable slowdown in UK deal activity during the second half of 2022 as macro-economic and political factors began to hit the market.

This, combined with insurers' sizeable underwriting teams following a period of aggressive investment in preceding years, resulted in a notable expansion in insurer appetite and downwards pressure on pricing and retentions, which has carried through to the first quarter of 2023.

2022 saw three new insurers entering the European M&A insurance market with a further three arriving at the start of 2023. When considered with the factors highlighted above, this has put competition in the market at an all-time high. Despite a greater volume of W&I claims (discussed in further detail in this section), and the wider insurance market needing to drive revenue to recover from non-M&A losses experienced during the pandemic/the war in Ukraine, the increase in competition in the M&A insurance market has accelerated the downward momentum on pricing, evidenced most acutely on operational transactions.

For the first time since Howden M&A began contributing to this report, the use of W&I insurance declined across the combined deals data during the course of 2022 – albeit only slightly. We attribute this to the larger number of smaller transactions conducted in 2022 compared to the previous year, where minimum premium levels and minimum due diligence requirements made insuring deals of a smaller size less palatable to potential insureds. We expect this to change in 2023 as more insurers have entered the SME space, reducing market-wide minimum premium levels and offering alternative insurance solutions on deals where buyers cannot commercially justify full scope due diligence.

Use of warranty and indemnity insurance



The use of M&A insurance is inevitably linked to the M&A market itself, however looking at Howden M&A's data for 2022, the number of deals serviced by them rose yet again by 10.5% and the number of policies placed rose by 2.8%. This experience is echoed by insurers in the market as well as our competitors in the broking space.

How has the M&A insurance market in the UK reacted to the wider macro environment?

From an underwriting perspective, whilst insurers have expanded their appetite for risk in reaction to reduced deal flow, they have begun to factor into underwriting questions the impact that macro-economic factors have on target businesses. Particular focus will be given to whether a target has the ability to trade despite rising costs of living, and how buyers have analysed this risk. Businesses that have been (and continue to be) impacted by strikes such as those in the Healthcare or Education sectors will also be subject to slightly greater scrutiny during underwriting. On the whole, however, we have not seen a material change in underwriting focus or coverage and appetite for risk is broader than ever.

In addition to improving their offering of the core W&I product through lower pricing and broader cover, the M&A insurance market has evolved with the macro-environment. Insurers are now willing to insure alternative structures such as secondary transactions, P2Ps, distressed and insolvent deals and Howden M&A is also placing a growing number of bespoke policies outside of an M&A context. Howden M&A have managed to secure insurance cover for tax risks in live disputes, to support the value of tax credits, and for 'forward looking' risks (for example during interest or dividend cash repatriation). Coupled with high insurer appetite, cost-effective premiums, and de-coupling risk from M&A transactions, we expect the application of tax and contingent risk insurance to continue to grow in 2023.

Claims analysis

Howden M&A's claims notification rate in 2022 (up to September) stood at 9%, up from 7% in the previous year. Taking a longer-term view, notification rates were markedly higher between 2017 and 2020 and the 2022 rate is in line with the rolling average over the last eight years.

The timing of notifications has continued to lengthen. In 2022, 15% of notifications took place within six months of the policy's inception, down sharply from 25% in 2021. Meanwhile, 26% of notifications took place more than 24 months after policy inception in 2022, up sharply from 13% in 2021.

Later notifications usually arise from one of the great unknowns in M&A: third-party claims. The vast majority (80%) of notifications submitted 24 months or more after policy inception are third-party claims and most relate to tax audits. The timing of such claims is entirely dependent on the third party and so cannot be easily foreseen. This, of course, means that such third-party claims, and in particular tax issues, are extremely difficult to anticipate in due diligence.

We expect notification rates to rise once again over the coming year and beyond. This will be partly due to the natural lag between transactions and notifications of a claim. More than half of all M&A deals in 2021 (58%) took place in the second half of the year and, with a significant proportion of notifications taking place a year or more after inception, many notifications from the boom M&A year of 2021 have not yet materialised.

Financial statements and compliance with laws were the two most commonly notified warranty breaches. In respect of compliance with laws, specific issues were varied but included breach of employment law, target products breaching applicable regulations and breach of privacy laws.

Outlook for 2023

In 2023 we expect to see buyers taking full advantage of the competitive M&A insurance market. Whilst premium presents another cost parties must bear, in times of economic uncertainty the need to reduce risk and release trapped cash on the balance sheet through the use of insurance is greater than ever.

At Howden M&A, whilst the benefits presented by a more competitive marketplace and lower pricing are clear, we are placing significant focus on the quality of process and coverage offered by each insurer operating in the market as new entrants and expanded or changing teams present an unknown execution risk. Whilst pricing is of course a key contributor to recommending an insurer to work with, it is more important than ever to factor in considerations such as deal experience, commerciality of coverage, quality of policy wording and (crucially) claims behaviour into our recommendation when reviewing quotes received.

Private equity

Sweet equity allocation

With management incentivisation being a key tenet of the private equity model, management teams and their advisers are particularly keen to understand trends around sweet equity allocation. While no two deals are the same with each being subject to their own modelling both in terms of day one investment and forecast future performance and potential returns, recent years have reflected a market which has favoured management teams who have been adept at leveraging competitive tension between private equity bidders.

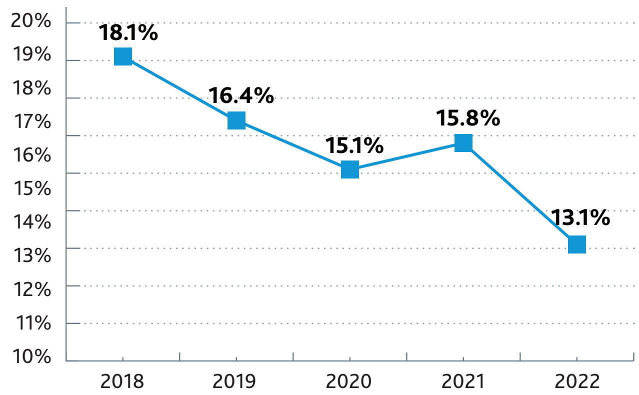
Against this backdrop, we have typically seen sweet equity allocations to management between 10% and 20%, averaging 15.7% over the last 5 years. As the private equity deal landscape became more challenging in 2022, the average pot allocated to management reduced to 13.1% which is the lowest we've seen in recent years and may reflect a hardening of sentiment by investors as the economic outlook deteriorated. As noted below, we expect coupon rates on shareholder debt to increase as investors react to increases in the cost of bank borrowings. Given this will ultimately shrink the size of any ordinary equity available on exit, management teams may seek to increase their sweet equity pot to ensure they are compensated.

For this year's report we have been keen to understand other aspects of sweet equity allocation to better inform clients and the market.

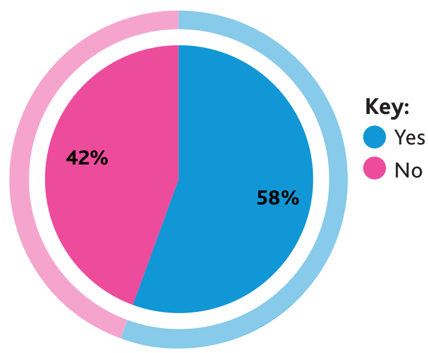
This includes understanding any trends on the percentage of sweet equity which remains unallocated on completion and who bears dilution on the issue of shares to the chair / non-executive directors – whether this allocation comes from the sweet equity pot or investor equity. Our data in 2022 showed that on average 29.8% of the sweet equity pot remained unallocated at completion, although this varied considerably between transactions. On the allocation of shares to the chair or non-executive directors' portion of the equity, in just over the half of the relevant transactions management's sweet equity pot included the chair or non-executive director's allocation – which perhaps informs us (at least in part) that it is dependent on the bargaining position of the parties.

Related to management's allocation of sweet equity, there seems to be a trend in the increase in the costs per % of sweet equity, largely driven by greater scrutiny from HMRC, making it more challenging for certain managers who are not rolling over proceeds into sweet equity to fund their allocation at completion. It is becoming increasingly common to find the investor offering management the chance to defer the payment for their equity either through loans from the company or through the use of nil paid shares.

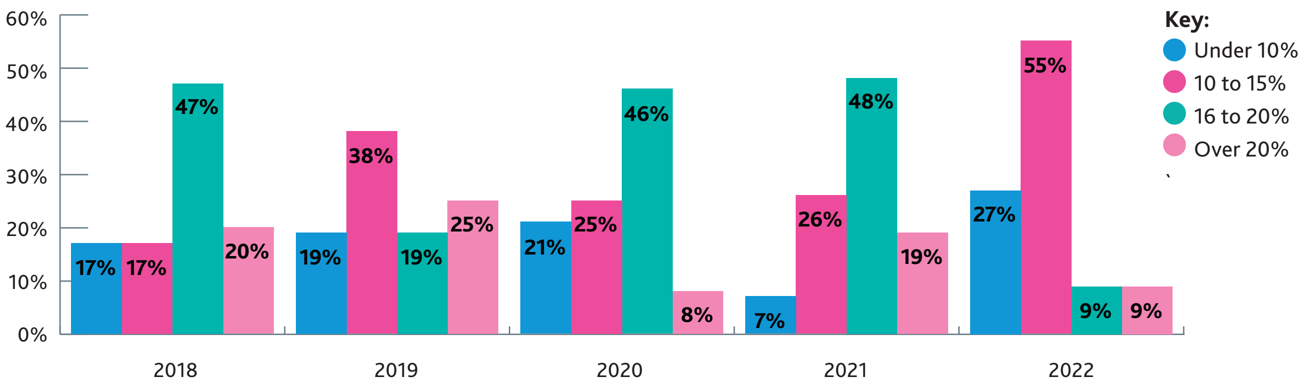
Average proportion of equity available as sweet equity



Did the sweet equity pot include the Chair/NEDs



Sweet equity offered to management teams

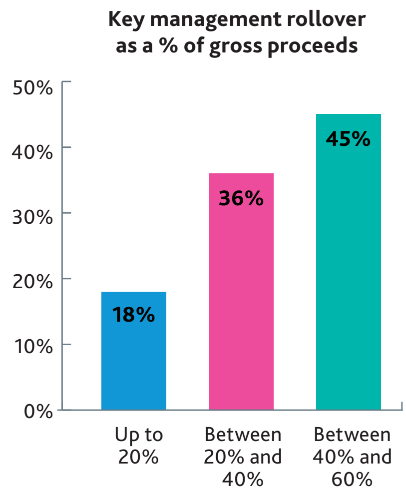


New areas of focus

As we have broadened the scope of the data set for 2022 in certain areas, we were interested to understand other private equity trends and in particular: rollover as a percentage of proceeds, the inclusion of ratchets and the provision of non-dilutive follow-on funding.

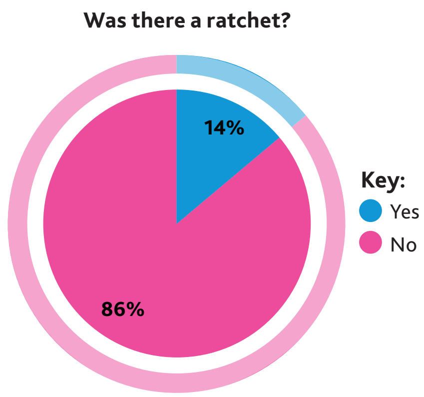
Rollover

For percentage of reinvestment, based on our experience over previous years, we would have predicted rollover at 50% of proceeds to be the norm and this has been broadly borne out by the 2022 data which shows percentages ranging between 40% to 60% of gross proceeds in 45% of relevant transactions - the highest % of the categories surveyed. In competitive auctions we sometimes see management pushing for percentages being applied to net proceeds rather than gross and in some instances winning this argument. Some investors have sought to link the % rollover to the size of the sweet equity pot being offered.



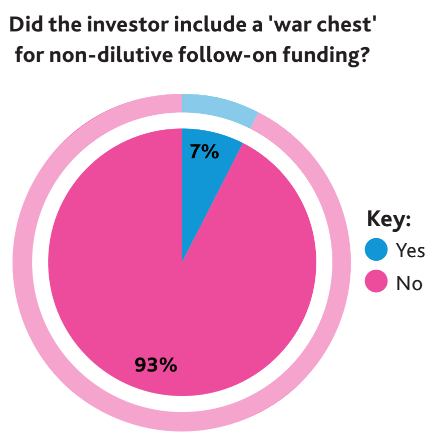
Ratchets

Perhaps reflecting the challenging deal conditions in 2022 which seemed to favour buyers and investors more than in recent years (with perhaps the exception of mid-2020 during the height of the pandemic), we saw ratchets being agreed in only 14% of relevant transactions which seems low, although we do not have historic data to act as a comparator.



Follow-on funding

Strategic or 'buy and build' M&A is an increasingly popular private equity growth strategy (and for certain investors, their modus operandi), not least as it allows for the deployment of capital into portfolio investments that can be regarded as lower risk, particularly during challenging market conditions. As part of their sales pitch to management teams investors may make follow-on funding commitments. What we have sought to understand is how often investors agree binding contractual obligations to make this funding available on a non-dilutive basis. In our experience, investors will make funding available but may be reluctant to contractually commit to this as it will be based on the terms of the deal and the conditions prevailing at the relevant time, investment committee approval, etc, and so any commitment is likely to be more aspirational as opposed to a hard obligation. So it is not surprising to see that non-dilutive follow-on funding was only committed in 7% of relevant transactions in 2022. That's not to say that investors do not want to provide this funding - in our experience, the preference will always be to utilise third party funding and/or free cash with investor funds being a last resort. Then if equity funding is required, the preferred investor position will be for investment on a pre-emptive basis to promote alignment between investor and management.

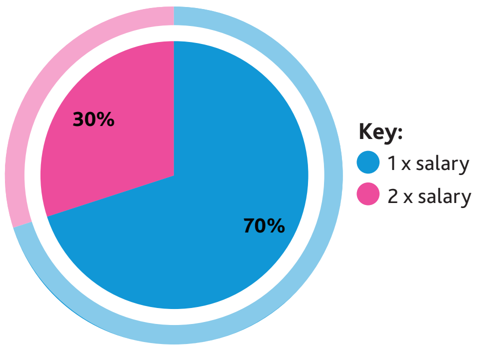


Warranty caps

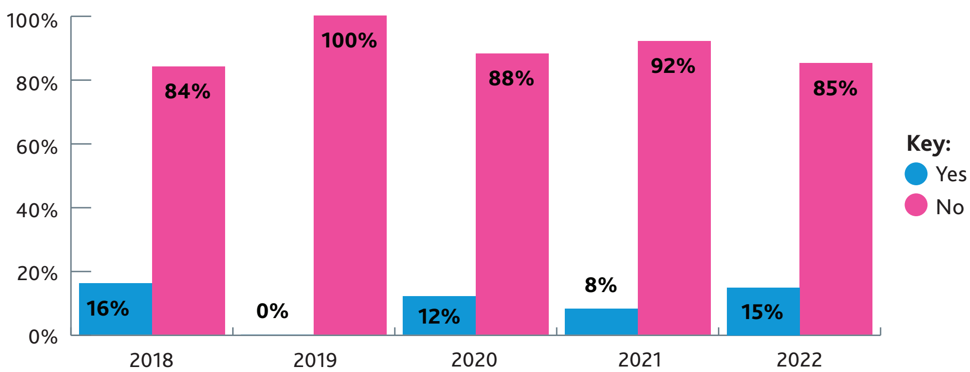
In last year's report we commented that investors were becoming more comfortable with lower warranty liability caps for investment warranties, with caps of 1 x salary per manager becoming increasingly acceptable. Despite the proportion of transactions with a 1 x salary cap falling from 79% to 70% in 2022, we do not think this suggests a change in the long term trend towards lower financial caps for management warranties, with investors continuing to generally recognise that a multiple of 1 x salary represents sufficient 'skin in the game' to ensure managers consider the warranties and undertake a meaningful disclosure exercise. There is also perhaps an increasing appreciation that the prospect of investors bringing an investment agreement warranty claim is low and limited to the most serious of breaches (for example, fraud or similar). That is not to say the importance of investment warranties and disclosure should be downplayed and it's critical for investors (and their investment committees) that management are prepared to fully stand behind the business plan, due diligence reports and personal information.

Probably for the reasons stated above, we tend not to see variation in the liability caps agreed with different categories of management warrantors and consistent with prior years this is reflected in the data for 2022. Previously, where warrantors had received significant proceeds on the sale of their shares they would be expected to give financial caps linked to the level of these proceeds. However in the previous 5 years the proportion of deals where we have seen no variation in liability caps has been (in percentage terms) around the mid-80s mark or above and we expect this trend to continue.

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



Did warranty liability cap vary for rollover investor?

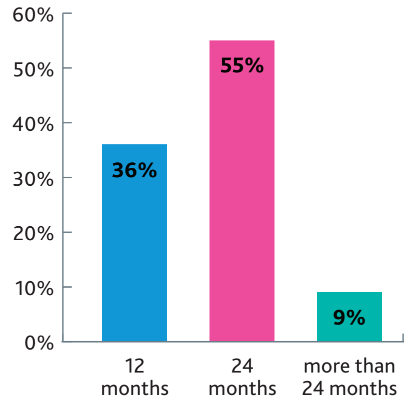


Restrictive covenant periods

We are increasingly seeing covenant periods of 24 months being acceptable to investors where previously a period of more than 24 months was the norm (which often reflected a period of 36 months) and this shift has been borne out by the data over recent years. In 2021 we noted a dramatic fall in restrictive covenants in excess of 24 months from 37% in 2020 to 8% in 2021 and the data remained at this lower level in 2022 with restricted periods of 24 months or more seen in just 9% of relevant transactions. In last year's report we wondered whether this shift towards periods of 24 months (as opposed to periods of more than 24 months) was perhaps due to a seller friendly market where investors were being pushed to propose and agree competitive investment terms to win over management teams. However, with 24 months continuing to dominate, our view is that investors are becoming more comfortable with this period of restriction with longer periods often reserved for those rollover shareholders who are receiving life-changing sums in sale proceeds and/or do not expect to continue working as a result of the transaction. This category of shareholder tends to be more inclined to agree to these longer periods.

We are continuing to see certain investors being willing to accommodate lower restriction periods for junior or second tier managers who receive shares in newco but who may not be as key to the investment case, who have a relatively low level of equity holding or who didn't receive significant proceeds from the sale transaction. We often see this where senior managers need to 'sell' the transaction to this cohort of manager. Our expectation is that this trend will continue though it will often depend on the transaction, the relevant business and/or the make-up of the next tier of management.

What was the length of restrictive covenant period in the investment agreement for managers?



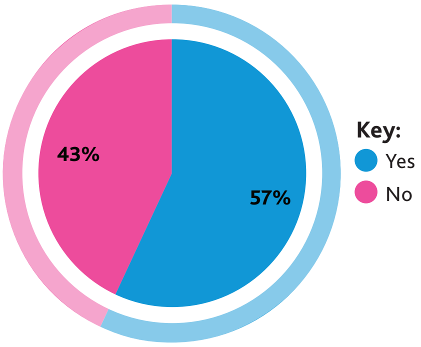
> **In 2021 we noted a dramatic fall in restrictive covenants in excess of 24 months from 37% in 2020 to 8% in 2021 and the data remained at this lower level in 2022 with restricted periods of 24 months or more seen in just 9% of relevant transactions.**

Fees

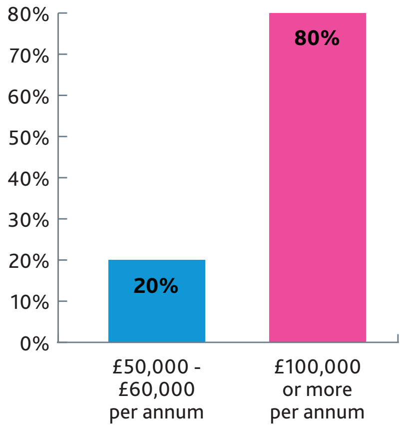
Following the theme seen in last year's report, the trend for charging arrangement fees continued with an increase from a third of transactions to 57% - a notable rise. Whether this points towards a continued general upward trajectory for arrangement fees that will be sustained or indicates that investors are seeking to maximise returns while investing in the current deal environment is difficult to say, though we suspect it may be more the latter rather than the former. With less competition for assets due to factors highlighted elsewhere in this report and with a scarcity of funding options, we can understand investors seeking to charge arrangement fees. In recent years during a buoyant sellers' market investors perhaps felt pressure to forego charging arrangement fees to make their offers as attractive as possible for sellers and management. Less so in the 2022 market it would seem.

On a similar theme we have seen a continued percentage increase in investor director fees being charged in the £100,000 per annum or more category, occurring in 80% of the deals surveyed after showing in 32% of deals in 2021. This confirms previous conclusions that investor director fees of over £100,000 are fairly standard.

Was there an arrangement fee?

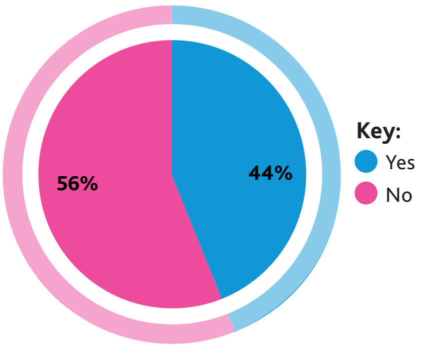


What is the investor director's annual fee?



The application of monitoring fees has also increased in recent years.

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



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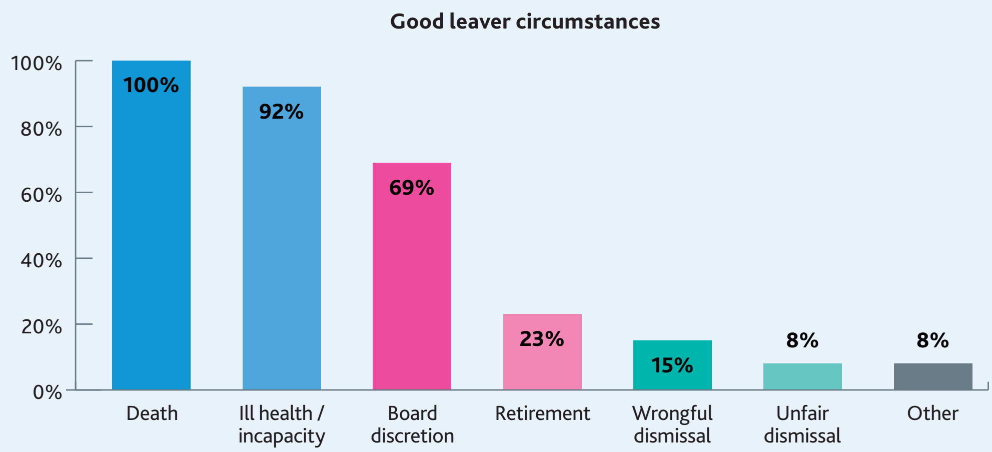
Leavers

Whilst there has been little change in those circumstances which constitute 'good leaver' status over previous years, we noted in last year's report the revival of unfair dismissal being treated as a good leaver event, which bucked this trend, occurring in 22% of relevant transactions after failing to appear in 2020. This was surprising and the reasons for this were unclear. We consider this to be an anomaly because, as of 2022, the long term trend points towards a decline in the use of unfair dismissal as a good leaver event, being seen in only 8% of relevant transactions. This was the same percentage as in 2020.

It would seem that investors and managers understand and accept the difficulties in rewarding full value for unfair dismissal which, when dealing with senior management, can be fraught with risk (including procedural risk where often management change needs to be effected swiftly). Intermediate leaver therefore strikes an acceptable balance with a value vesting mechanism which increases over time – for more information on intermediate leaver see below.



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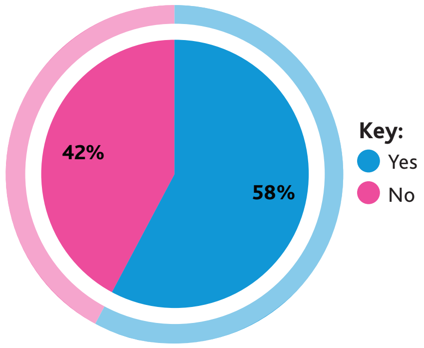
Intermediate Leaver

Intermediate leaver is used as a helpful 'catch all' for those circumstances (including unfair dismissal) which fall outside the limited circumstances constituting good leaver or the serious acts constituting bad leaver and bridges the gap between these two extremes. Where good leavers are entitled to market or fair value, and bad leavers the lower of market or fair value and issue price (or £1 depending on the circumstances), intermediate leaver works by seeking to reward managers with market value for an increasing proportion of their shares the longer they have held them before their employment ceases. Its application is enduring for these reasons and in our view is very much here to stay.

There has however been a decline in the use of intermediate leaver across the surveyed transactions, falling from 71% in 2021 to 58% in 2022. This is the third year in which we have seen a decline and the reasons for this are not entirely clear to us, although we note that its use is less common with certain types of investor who are maybe not as familiar with UK market norms (particularly those from North America) and this might be a key reason.

It is worth noting that if voluntary resignation is not to be treated as a bad leaver event (as to do so could be considered harsh in some circumstances), unless it is expressly excluded from the intermediate leaver category it would fall within it and, as such, managers would effectively be rewarded under the intermediate leaver vesting schedule for voluntarily walking away from the business, which seems unduly generous perhaps.

Is intermediate leaver concept included?



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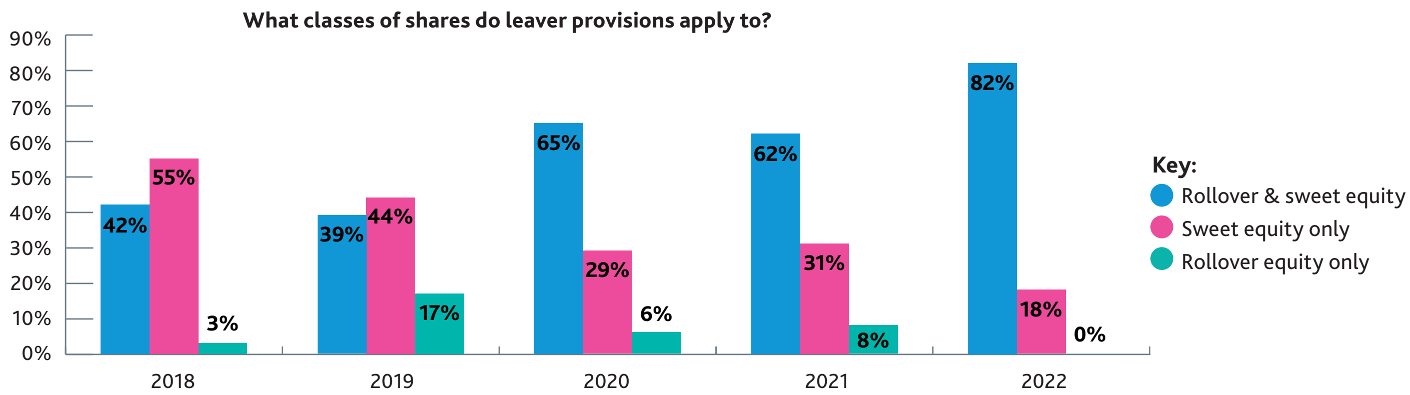
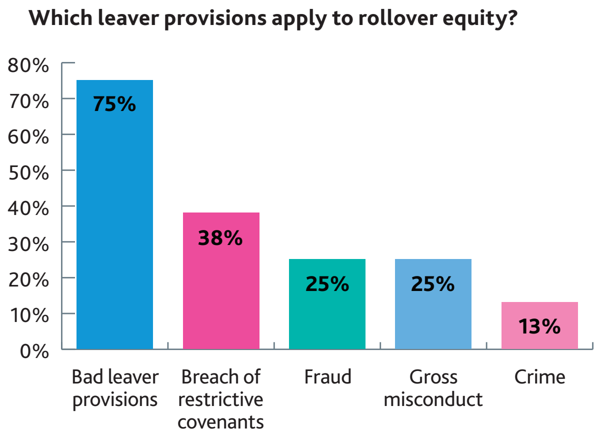
Rollover applying to leaver provisions

The data for 2022 reflected a sizeable jump to reinforce a trend we have seen over recent years for rollover equity to be subject to leaver provisions, albeit in limited circumstances (see below). Last year we noted that the percentage of deals where leaver provisions applied to rollover remained consistently high, averaging at 63.5% in the previous two years after a historic trend of private equity investors treating rolled value as off limits and so falling outside the leaver provisions. The 2022 data saw leaver provisions applying to rollover in 82% of relevant transactions and it is now clear to us that investors and their investment committees will generally not tolerate rollover shareholders continuing to hold all (or any) of their rollover equity where serious acts such as fraud or gross misconduct have been committed or restrictive covenants have been breached. As stated in our previous report, areas of negotiations around this issue focus more on the price at which rollover comes up for sale in such limited circumstances (market value, lower of market value and issue price or £1 in aggregate) and whether a proportion or all of rollover is offered. In our experience (though outside of the data set) we are seeing investors treating voluntary resignation as a leaver event for rollover shares although the price at which rollover is offered for sale (and the proportion) tends to be less punitive than in the other bad leaver circumstances referred to above.

Worth noting that where a manager has committed a bad leaver act, there is often an impact on the loan notes or preference shares held by them and which will often result in the coupon being 'switched off' or reduced or, less commonly, the notes being redeemed or transferred for £1.





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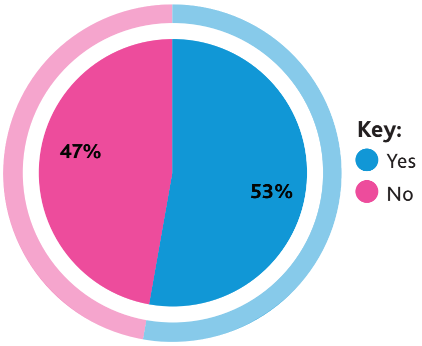
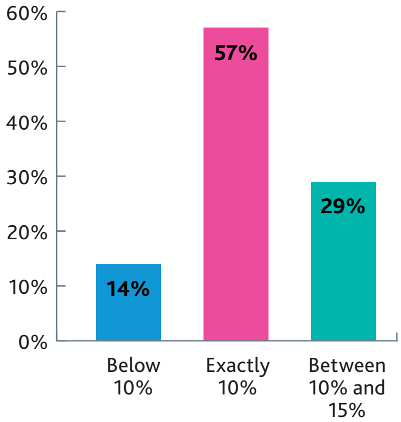
Preference shares & loan notes

Where a transaction utilised preference shares, the coupon was typically set at 10%. Just over half of relevant private equity transactions saw loan notes issued with an interest rate of 10% employed most frequently. Given the recent material increases in Bank Base Rates, we would expect investors to increasingly look to try and set coupons at a level in excess of their senior debt interest, which is likely to see the 2023 data skew more to the 10-15% category.

Were investor loan notes issued?



What was the interest rate on investor loan notes?



> **Where a transaction utilised preference shares, the coupon was typically set at 10%. Just over half of relevant private equity transactions saw loan notes issued with an interest rate of 10% employed most frequently.**

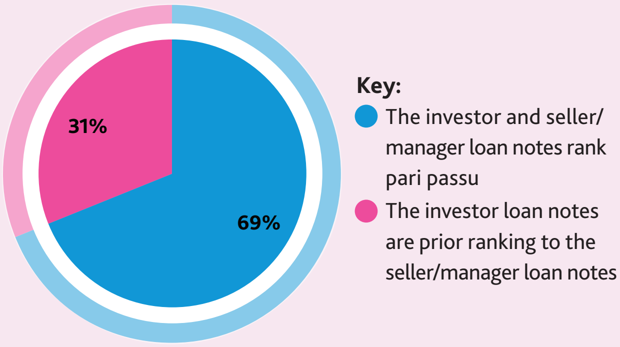
Ranking of loan notes

We noted last year particularly in competitive scenarios movement towards parity between management and investors on loan note ranking which was reflective of a sellers' market. Given the uncertain deal environment in 2022 we saw a change in sentiment from investors most likely to protect their downside risk with a marked reduction in equal ranking from 81% in 2021 to 69% in 2022. Again this could be a case of investors reasserting their position in a buyer's market where sale processes have often been less straightforward than in previous times giving an advantage to investors, where previously investors may have been forced to agree to equal ranking to maintain the competitiveness of their bids.

While non-investor loan notes have gained ground over recent years in terms of equal ranking, we expect investors to continue to insist they control how all loan notes are dealt with, particularly where an investment experiences difficulties and remedial action may be required, for example, to refinance or recapitalise the investee group, deliver an exit or re-cut management incentive plans. Investors regard these controls as essential to allow them to deal in management or seller loan notes quickly provided it is on an equivalent basis so that whatever action is taken, the same proportionate change or impact will apply to the investors' loan notes.

Interestingly, we have seen an increase in there being one class of loan notes for investors and management so that the investor does not have to concern itself on having the ability to vary the loan notes in the manner and circumstances described above as the investor will usually be the majority loan note holder giving it the ability to approve any such variations.

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



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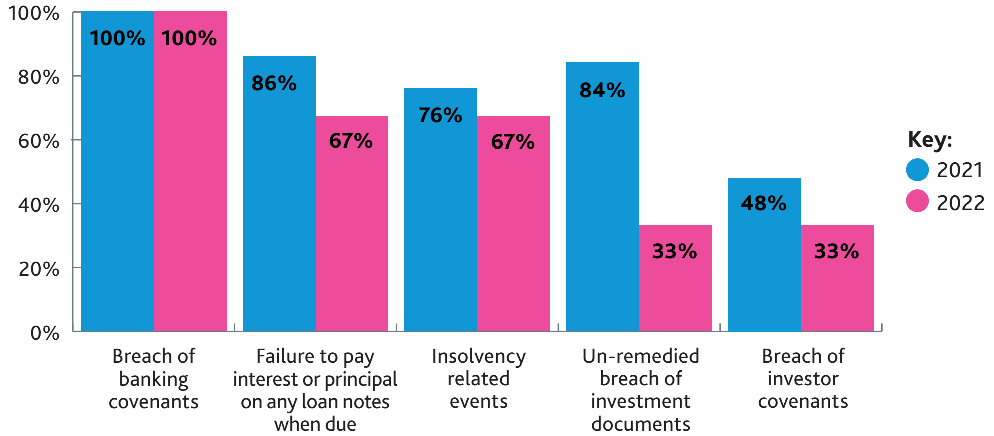
Swamping rights

We continue to see investor swamping rights as a fundamental investor protection against downside risk and underperformance and do not expect this to change in the foreseeable future. That said, we sometimes see anomalies in the data that cannot be explained away by market conditions or other factors and may be due to the specifics of the deals surveyed. As can be seen in the graphs, swamping rights on a breach of banking covenants tends to be an evergreen protection occurring in all (or almost all) cases year on year; however in 2022 we saw a reduction in the occurrence of all other rights, being: (i) failure to pay principal or interest on loan notes, (ii) insolvency related events, (iii) unremedied breach of investment documents and (iv) breach of investor covenants. The decrease in (iii) and (iv) was particularly marked and while we may at times see investors foregoing an investor covenant, relying on the right to step in on an anticipated future breach of banking covenants (and not just on an actual breach), a drop of over 50% on the inclusion of a right to step in for unremedied breach of the investment documents is unusual and we would suggest a quirk of the data.

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



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European perspectives

Ireland

While Irish deal-making held up in the first half of the year, activity fell in the second half of 2022 as buyers became more cautious in the face of a weakening global economic outlook, equity and credit markets tightened and many potential sellers struggled to accept reduced valuations for their business. Overall, similarly to the position in the UK and throughout the EU, this meant that the value and number of deals completed in 2022 fell dramatically after a record high the previous year. As such, 2021 was always going to be a tough act to follow, as the near perfect conditions that existed that had allowed M&A activity to flourish changed in 2022.

The sectors where we are continuing to see the most deals are in technology, energy, life sciences, construction and logistics.

The interest of international private equity funds in Irish assets remains strong and those funds have been participating in a number of competitive sale processes in the last 12 months. In addition, the domestic Irish funds continue to be very active ensuring there remains a wide range of options for sellers. In the last 24 months Synova, MML, Elysian Capital, Melior, Cardinal, BGF and Waterland have transacted in the Irish market. We anticipate other international funds will follow suit.

New European fundraisings in 2022 for funds such as Waterland, Synova and Bowmark will mean that there is even more capital to deploy with these funds committing to investing in Ireland and growing their portfolio businesses through buy and build strategies, as Waterland are doing with Silver Stream and Wri Tech and Synova have done through DM Financial's recent acquisition of Netherlands based Solutional.

Where deals failed or stalled in 2022, the primary reason tended to have been buyers and sellers failing to agree on valuation which was exacerbated by debt becoming more expensive and the overarching global macro economic factors. Investors are looking to various strategies to bridge valuation gaps – earnouts, minority investments and increased amounts of reinvestment from selling shareholders. It remains to be seen whether the Irish market will see continuation fund exits becoming a feature.

The trends present in the UK market are largely consistent with transactions in the Irish market. For higher value transactions, given the turnover-based thresholds which are applicable under the Irish merger control regime, it isn't surprising they have tended to have been more likely to involve a split between exchange and completion. As has often been the case in the UK, where there is a split, buyers have typically been contractually permitted to walk away only for sufficiently material breaches of warranty or interim covenants during the period between exchange and completion. Sellers have also often felt able to agree to this where the question of breach remains within their control. The Irish market has also seen a decline in the use of general MAC clauses. In some instances, distressed sellers have agreed to deferred consideration mechanisms.

One key difference we see in the Irish market compared to the UK is the approach to rollover/institutional equity. While attitudes in the UK have shifted in recent years such that this equity is no longer protected, and can be subject to leaver terms in defined circumstances e.g. breach of restrictive covenants or gross misconduct, the approach in Ireland generally continues to be that rollover equity should be treated as co-investment and not capable of buy back earlier than or for less than the shareholder would receive at a future exit date.

A trend in the Irish market that seems to be prevalent is that investors are more willing to accept a broader category of what comprises a good leaver, including in cases, where there has been an unfair dismissal.

We also anticipate a greater role for regulators in approving transactions, which will be largely due to the Screening of Third Country Investments Bill. This Bill is currently before the Irish Parliament and is expected to come into force this year. This piece of legislation forms part of an EU-wide drive for greater scrutiny of inward investment. There is a concern which is shared throughout the EU that important technology and infrastructure should not be owned by hostile powers. It remains to be seen how exactly this regime will work in practice, and what effect this will have on timing and execution of deals.

Overall, the outlook for 2023 is positive. Despite a slower start to the year, there are a number of businesses in prep stage for sale later in the year. Interest from both Irish funds and UK and overseas investors remains extremely strong due to the quality of the businesses on offer and the attractiveness of the Irish economy as a place to invest.

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Germany

The general theme is that deal activity has picked up again in Q1 of 2023. Deals that had stalled in 2022 have been picked up again by investors and deal activity in general is increasing, though still some way off from the levels seen in the boom years prior to 2022.

Reasons for the increased activity are probably the improved economic outlook as well as re-adjustments of sellers' valuation expectations.

Despite this uptick in Q1 2023, some deals were postponed due to increased cost of debt financing in the past months. These deals might also get back on track again when debt markets normalise. Small cap deals less dependent on debt financing are not impacted in the same way.

As both domestic and international PE investors have a lot of dry powder and incentives to invest, we expect to see a further improvement in market activity, also fueled by the acceptance of adjusted valuations by sellers.

On the regulatory side, many more deals are subject to FDI procedures in Germany, driven on the one hand by the tightening of regulatory requirements and on the other hand by the treatment of UK investors as non-EU buyers post Brexit.

Two hot sectors are technology and life sciences, whereas the appetite to invest in the retail & consumer sector has cooled.

As in the UK, ESG is high on the agenda and an increasing factor for deal considerations.

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Luxembourg

Consistent with trends worldwide, the fears due to the war in Ukraine and the inflationary environment pushed a significant number of deals to the second half of 2022, with many being delayed to the last quarter of the year. Regulatory scrutiny in foreign jurisdictions also caused significant delays, especially if a deal had USA or UK exposure. Buyers became cautious about pricing deals in the face of deal uncertainty and sellers did not feel that the valuations were meeting their expectations. We saw considerably fewer exits closing through 2022. Surveys conducted and reported widely by the PE industry in Luxembourg indicated a decline of up to 35% in exits through to June 2022 compared to exits completed in the same period in 2021, whereas private to public deals decreased to minimal levels. Instead, we saw a trend of holding investments in the investors' portfolio, waiting for an improvement in market conditions. The same sectors that were attractive and busy in 2021 continued in 2022: technology, energy, life sciences and real estate.

However, although there were definitively less deals closing through 2022, we noted a marginal increase in the overall value of transactions closed in 2022. Activity was driven more by both sellers and buyers having to increasingly adapt portfolios to the financial markets' conditions, with many portfolios in play due to the higher cost of debt impacting the availability of liquidity in the debt markets, as opposed to the usual M&A deal origination dynamics.

Luxembourg serves primarily as a platform for private equity investment, being a domicile and gateway for foreign capital investing through Luxembourg funds and/or special purpose vehicles into diversified assets located abroad. The private equity interest in investment based in Luxembourg remains mostly focused in real estate, although there were new opportunities emerging in 2022 such as in the financial sector or in fintech. Broadly speaking the private equity funds in Luxembourg are of foreign origin, while there are many international private equity firms locating operational teams in Luxembourg (to name a few Blackstone, Genii, 3i, InvestIndustrial, Apex, Ardian, EQT, Cinven). The result of this integration is that worldwide trends will be followed closely by Luxembourg.

Like elsewhere, the number of transactions declined in 2022 as a result of sellers seeking to avoid the transfer of assets at discounted prices in comparative terms, while buyers abandoned potential acquisitions to avoid price volatility due to activity risk in general and financing costs which inhibited valuations and pricing ranges.

In our experience, deals concluded through auctions were less prevalent, with exclusivity periods longer than 6 weeks increasingly agreed. The majority of transactions we saw concluded through Luxembourg in 2022 were secondary transactions. The split between exchange and completion was the rule, with a steady use of locked box but wider use of contractual conditions allowing parties to apply deferred consideration mechanisms. In lessons learned from the previous years, pre-deal diligence is increasing. Post-exchange contractual terms permitted parties to abandon deals for some sort of warranty, covenant issue or breach in more instances than MAC clauses. Warranty & Indemnity insurance remained a staple in 2022.

We still found that buyers made an effort to stabilize and proceed with the managers inherited with the acquired portfolios. This means an increase in the establishment of management incentive plans and stock option plans through 2022 including non-dilutive funding. We feel that the trend is here to stay.

Deals which required regulatory approval or scrutiny were significantly delayed, in particular those involving regulatory bodies in the USA or the UK. Although not initially expected, we saw the spin-off and split of businesses exposed to, or with activities in, Russia being done quickly and smoothly, avoiding any issues from the international sanctions applied. This year we are still expecting that the EU directives on tax aspects influencing PE investment entities (BEPS, ATAD 3, etc.) will bring more focus to the private equity held corporate structures in Luxembourg. The legal requirements in some cases will require the local modus operandi to be completely reshuffled.

A new trend which we are watching this year is whether the increasing investor conscience concerning CSR and ESG principles and the financial industry's preparation for the effective implementation of the Sustainable Finance Disclosure Regulation (SFDR) will translate into changes in private equity investments in terms of deal targeting and portfolio management.

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Netherlands

One key trend in the Dutch private equity market is the increased interest in sustainable and impactful investing. This trend seems to be driven by both investor demand and increasing regulatory requirements. In the last year we have seen private equity firms being increasingly focused on investing in companies that have a positive social or environmental impact. In addition, companies that are committed to sustainability in their operations and supply chains seem to be attractive. In line with international trends, it seems that the focus on sustainable investing is most signficant in the energy sector, with a number of private equity firms investing in renewable energy projects such as solar energy and wind farms, but we have also seen an interest in companies that provide sustainable products and services, such as sustainable packaging or green transportation solutions.

We further see in the Dutch private equity market the increasing use of technology and data analytics. Private equity investors are using data analysis for identification of potential investment opportunities but also for monitoring performance of their portfolio companies. As the market - mostly because of macro-economic factors such as the war in Ukraine, inflation and increasing interest - becomes more challenging, private equity investors are realizing that simply acquiring companies and waiting for them to accrue in value is no longer sufficient. Instead, they are focusing on actively improving the operations (by streamlining processes) or expanding (into new markets) with portfolio companies using technology and data as a tool.

Compared to the private equity market in the UK, the types of investors in the Netherlands are different. In the UK, there are a number of established private equity firms that dominate the market. In the Netherlands the market is more fragmented with a mix of small and medium-sized investors. We expect however that the Dutch private equity market will experience more consolidation, with larger firms acquiring the smaller ones to expand their reach and to diversify their investment portfolios. As a result of this consolidation, Dutch private equity firms will move towards more mature processes and be able to achieve benefits of scale and to better serve the needs of investors.

The investment focus in the Netherlands is slightly different compared to, for example, the UK. Private equity firms in the UK tend to focus on larger deals, with a focus on the mid-market and large-cap companies. The Dutch market is more focused on smaller deals and often it concerns early-stage and growth-stage companies.

Finally, the Dutch private equity market is a dynamic landscape, with a focus on investing in tech and sustainability. We expect the trend of increased competition for deals and focus on operational improvements to continue in 2023. Private equity investors will need to be agile and innovative in order to stay ahead. Also, we expect to see the trend towards cross-border investment further developing.

One key trend in the Dutch private equity market is the increased interest in sustainable and impactful investing. This trend seems to be driven by both investor demand and but also, increasing regulatory requirements. In the last year we have seen that private equity firms are increasingly focused on investing in companies that have a positive social or environmental impact.

Spain

Last year ended with high liquidity (resulting from deals that were delayed by the pandemic) and transactions focused on buy-and-build strategies and secondary buyouts. Despite uncertainties such as the war in Ukraine, inflation and rising interest rates, the trends from late 2022 have continued into 2023: high liquidity and high levels of activity and strong dynamism in relation to buy-and-build strategies and secondary buyout transactions, though many in the sector are wondering whether the trend can be maintained. However, in the current economic environment, it would not be a surprise that recently raised funds, or those with flexibility in their investment timelines, may decide to slow down their investment pace in the coming months until some of the unknowns of the macro-economic and global geopolitical situation become clearer.

Indeed, according to private equity managers, private equity funds will be decreasing the flow of investments in 2023 because of the current situation of economic uncertainty, current constraints on access to debt and price discrepancies between buyers and sellers.

Prices will tend to stabilise or even decrease. However, as the market has shown in the past, the level of activity will remain high for strong performing businesses. In this regard, we believe that private equity investors will continue to show a strong appetite for the Spanish middle market. There are still many fragmented sectors in Spain where consolidation processes offer great opportunities for value creation. On the other hand, many companies need up to a decade or more to reach their full potential through growth, consolidation, professionalisation and internationalisation, which are important sources of opportunity for private equity funds through secondary buyouts. In addition, considering the impact of the last two years of Covid on business plans, the opportunities for secondary buyouts are further increased as some business plans have been delayed by several years, affecting the status of portfolios.

Overall, renewable energy, healthcare, education, technology and, in general, those sectors with a greatest ability to pass through price increases to the final customer will continue to be more active in 2023. Notably, established companies in sectors such as fintech and e-commerce are also seeing increased investment from private equity investors as they look to expand and modernize their operations.

Finally, ESG factors will continue to be a priority for investors in their decision-making. Investors are increasingly looking for companies that demonstrate a commitment to sustainability, diversity, and ethical business practices, and private equity investors are increasingly incorporating ESG considerations into their investment strategies.

About us

Our award-winning international private equity team works closely with investors, management teams, corporate and individual sellers and providers of debt and equity finance, offering a full range of legal services and strategic advice. We have experience of acting on private equity transactions of all sizes, from early stage investment and portfolio building through to eventual exit, whether by trade sale, secondary buyout, IPO or refinancing.

We take a sector approach, truly understanding the environment in which your business operates, from the competitive landscape to the risks and challenges particular to each industry.

We have offices across all three UK jurisdictions and spanning Europe, Middle East, Africa and Asia-Pacific, offering a global perspective. To find out more about our team or to sign-up for legal updates, please visit **Pinsent Masons**

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