SPECIAL REPORT

PE M&A Report 2020

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Executive Summary

Welcome to the 2020 edition of our annual review examining deal terms and trends in the M&A and private equity markets. For the second year running we are delighted to work alongside Howden M&A and Arrowpoint Advisory to pool our deal data, which we believe provides the most comprehensive analysis of UK mid-market transactions available for review by buyers and sellers alike. We hope it proves a useful benchmarking tool for your transactions.

So what of this year's findings? Clearly economic conditions in 2019 were testing and not helped by the ongoing political uncertainty of Brexit and President Trump's ratcheting up of international trade tensions. While the UK election result in December 2019 appeared to have proffered some investor certainty going into 2020, the advent of the Covid-19 virus and what looks like a potentially difficult post-Brexit trade negotiation with the EU means buyers and sellers will continue to face significant uncertainty and deal volumes are likely to be suppressed.

We are at present in uncharted economic waters - since the outbreak of Covid-19 global financial markets have been extremely volatile and central banks and governments across the world have had to intervene to provide some liquidity and stability. At the same time reports suggest the global private equity industry started the year with dry powder of in excess of $1.5 trillion. In the short term, private equity funders will focus their attentions on managing their existing portfolio companies particularly as they navigate their way out of lockdown, but later this year we anticipate private equity will look to take advantage of pricing adjustments borne out of the current economic crisis by targeting both P2P transactions and private company acquisitions. Where activity is currently continuing, this is typically in what are perceived to be more robust/less impacted sectors such as IT and infrastructure where companies are more resilient to the impact of the Covid-19 crisis.

Despite the economic uncertainties presented by Brexit in 2019, there were strong levels of M&A activity, particularly by private equity houses or private equity backed companies. Primary buyouts in 2019 were at their highest level, as a proportion of deals surveyed, since we began our deal trends reporting five years ago. This is particularly refreshing as it demonstrates that deal origination activities remain strong and a growing range of businesses are getting access to private equity firepower and expertise.

The rise in use of W&I insurance continued in 2019 and featured in over half of all deals surveyed and in a staggering 93% of all new platform private equity deals covered by this report. Even where insurance has not been used, the fact that it is an available option has continued to drive incredibly seller friendly limitations on liability. As 2020 progresses it will be very interesting to see whether this insurance driven trend continues or whether there is something of a rebalancing prompted by a revised appetite for risk or indeed an adjustment to insurance coverage options after the insurance industry has absorbed the costs of the Covid-19 crisis.

We hope you find our report of interest and please do get in touch if you would like us to provide more detail on specific points raised.

Ed Stead
Head of Private Equity
Pinsent Masons

Caroline Rowlands
Head of Private Equity
Howden M&A

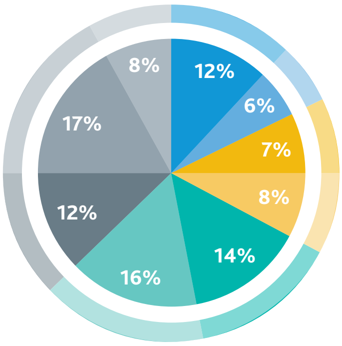
Simon Cope-Thompson
Managing Director
Head of Management Advisory
Arrowpoint Advisory

Survey Methodology

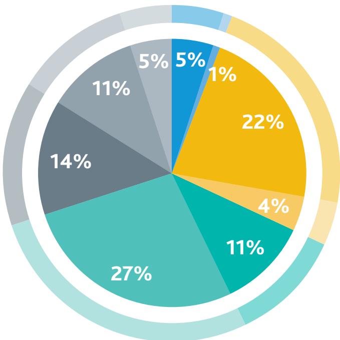
This year's survey reviews data collated from the 190 UK-led transactions that Pinsent Masons, Howden M&A and Arrowpoint Advisory advised on during 2019. The combined value of these transactions was £12.5 billion. We advised on three deals valued in excess of £500 million and 26 deals between £100 million and £500 million. The average transaction value across all deals (where the value was disclosed) was £77 million.

The transactions we advised on offer a representative mix of the UK economy, with TMT (17%), Real Estate (16%), Life Sciences and Healthcare (14%), Diversified Industrial (12%) and Retail and Consumer (12%) sectors the most heavily represented. Real Estate-related transactions accounted for 27% of the value, followed by Financial Services at 22%. As in previous years the average transaction value was highest in the Financial Services sector.

Transactions by sector



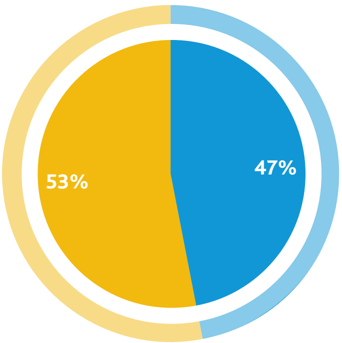
Transaction value by sector



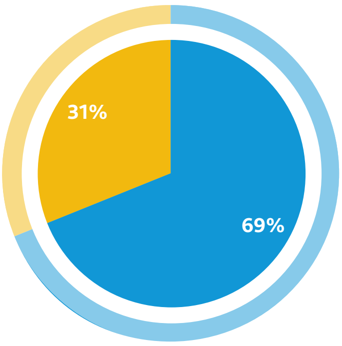
Key:
- Diversified Industrial
- Energy
- Financial Services
- Infrastructure
- Life Sciences & Healthcare
- Real Estate
- Retail & Consumer
- TMT
- Other

Just under half of the transactions in our survey included an element of private equity - which is a higher proportion than in previous years. Our 2019 survey saw a growing number of 'bolt-on' acquisitions by private equity backed companies and this deal type is treated as a private equity transaction for the purposes of this survey. With the uncertain macroeconomic and geopolitical climate during 2019, and a continued lack of volume in terms of attractive buy-out opportunities, private equity has solved capital deployment pressures by supporting those bolt-on transactions. This strategy also provides risk mitigation as these deals are typically in sectors and markets which are more familiar to investors and where they understand the likely challenges and routes to value creation. As in previous years, private equity transactions accounted for over two thirds of the total value of the transactions in our survey – once again confirming private equity as a significant driver for deal activity.

Transaction type



Transaction type by value



Key:
- Private equity
- Trade

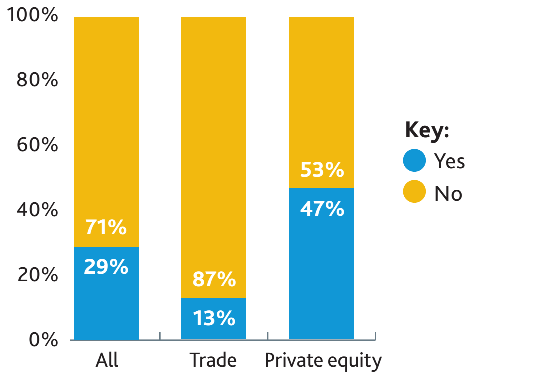
Deal Process Trends

Interestingly, the percentage of deals that were the subject of an auction process in 2019 was similar to 2018, up marginally from 25% to 29%, and there was little change in the split between trade and private equity transactions. Only 13% of trade deals were subject to an auction process compared to 47% of private equity transactions. This is consistent with last year's statistics and indicates a continued preference for trade buyers to source bilateral opportunities in an attempt to avoid highly competitive auction processes. We found auction sales were typically used in higher value transactions accounting for 63% of total deal value but only 25% by volume, which indicates that a high proportion of smaller deals were bilateral. We are already seeing an increase in bilateral discussions rather than auctions and would expect this to continue through 2020.

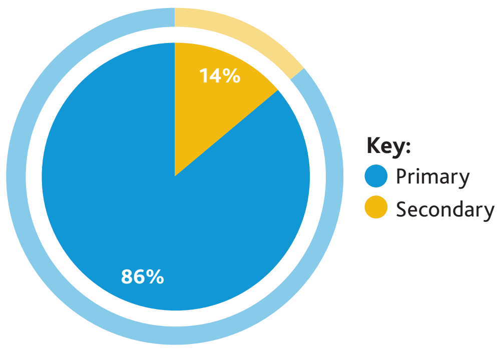
Our experiences in 2019 indicate that a strong asset in the right sector will attract the attention of hungry private equity and trade bidders. Private equity bidders in particular showed a strong appetite to compete, and pay full prices, for the right assets, demonstrating that they are willing to take a strategic and longer term view on asset selection. We anticipate that, once we are through the current deal-making hiatus, these trends will continue during 2020, though clearly we may also see a number of supressed valuations which could attract distressed and special situations funds.

The volume of primary buyouts increased in 2019 accounting for 86% of all private equity transactions, the highest proportion in the five years that we have published in this survey. It will be interesting to see whether this trend continues 2020 given the uncertain market conditions we find ourselves in.

Was the sale via an auction process?



Was the deal a primary or secondary buyout?

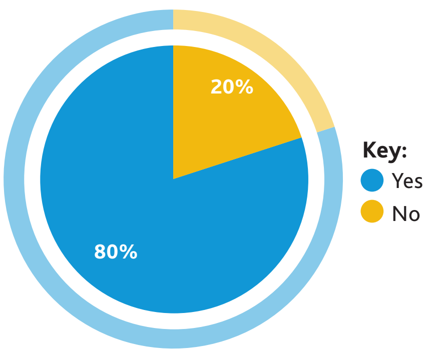


Consistent with 2018, in transactions involving an auction process buyers were granted a period of exclusivity in four out of five deals in our study.

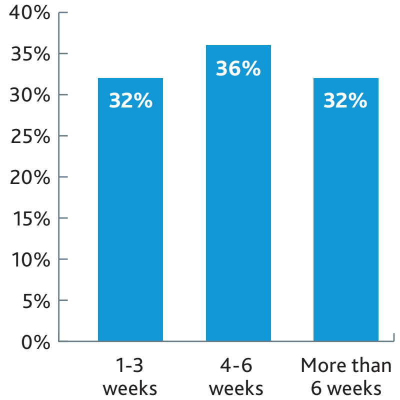
Where an exclusivity period was granted the average length of this was 5.8 weeks, one week less than in 2018. In the transactions surveyed 36% saw typical exclusivity periods granted for between four and six weeks with a comparable proportion of transactions (32%) favouring either one to two weeks or over six weeks. On average 25% of transactions completed within a week of expiry of the initial exclusivity period granted, and 35% completed within two to three weeks of expiry of the initial period. Exclusivity periods in auction processes were typically shorter given that most of the due diligence has already been completed. In auction processes 40% of transactions completed in 1-3 weeks, and 40% within 4-6 weeks.

Simon Cope-Thompson, Managing Director at Arrowpoint Advisory comments, "The fact that average exclusivity periods were shorter in 2019 than in 2018 reflected the continuing strength of the M&A market and the continuing trend towards the use of a suite of Vendor Due Diligence which allows deals to complete more rapidly".

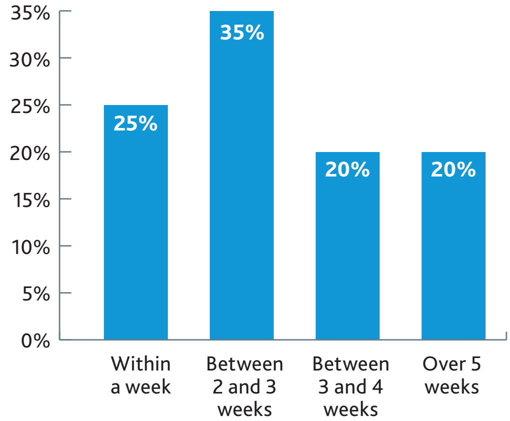
Was a period of exclusivity granted?



Exclusivity period granted



Weeks between granting exclusivity and completion

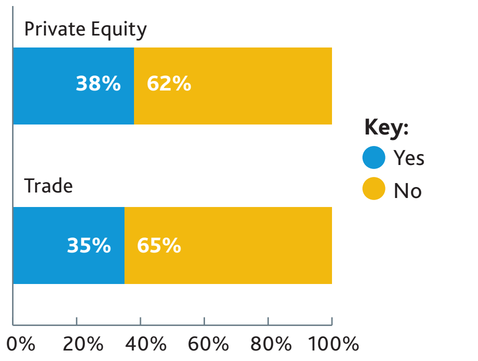


Split exchange and completion

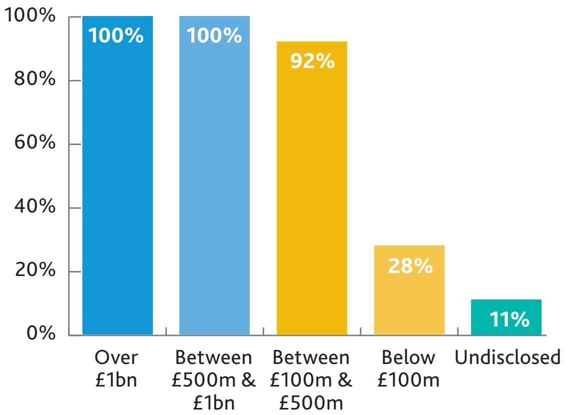
Consistent with the previous year's findings, over one third of all transactions included a split between exchange and completion, with a slightly higher proportion for private equity transactions. For a third year running the proportion of trade transactions subject to a split has increased, rising from 29% in 2018 to 35% in 2019.

In value terms, around 77% of the total transaction value of the deals surveyed was subject to a split, an increase from 68% in the prior year. All transactions over £500 million in value were subject to a split while a split applied to just 28% of transactions under £100 million. However, we have seen a marked increase in splits in deals valued in the £100 million to £500 million range - 92% of transactions compared to just 52% in 2019.

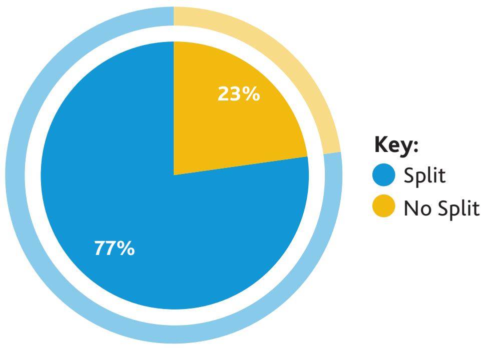
Was there a split between exchange & completion?



Proportion of transactions subject to a split



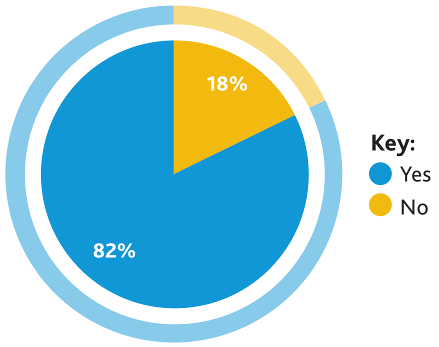
Transactions involving a split between exchange and completion (by share of total transaction value)



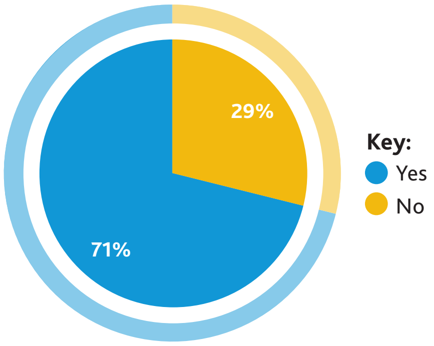
Warranties given by sellers at exchange were repeated at completion in 82% of the split exchange and completion transactions surveyed (rising from 55% for equivalent transactions in 2018). This may point towards increased buyer caution, with fewer buyers willing to accept non-repetition of warranties during periods of economic and political uncertainty – a sign perhaps of buyers taking an increasingly hard line with sellers to manage and mitigate investment risk.

Where warranties were repeated at completion, 71% of split exchange and completion transactions surveyed allowed for updated disclosure against the warranties which tracks the 2018 trend. In the majority of these transactions the buyer had the right to walk away if the disclosure resulted in a material deterioration in the value of the target. In the 29% of transactions where no further disclosure was permitted the buyer could not terminate but was effectively only taking risk from completion due to its ability to sue for breach of warranties repeated at completion.

Were the warranties repeated at completion?

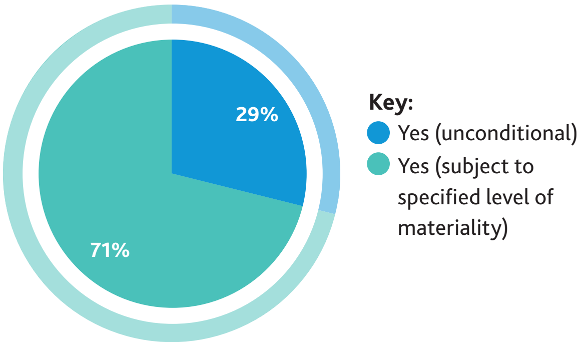


Was a second round of disclosure allowed?

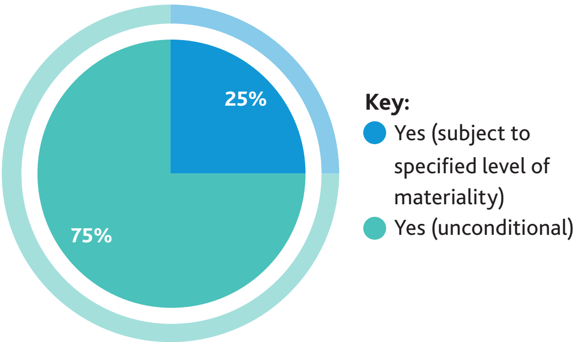


In all relevant transactions the buyer was permitted to walk away in the interim period where there was a material breach of the sale agreement. Whilst our survey results noted below suggest private equity buyers are securing more unfettered rights to terminate for breach in an interim period before closing. Tom Leman, Partner at Pinsent Masons, notes that in practice "this probably reflects the fact that private equity bidders request fewer overall contractual break rights and instead focus only on breach of fundamental clauses, so materiality qualification becomes less important".

Could a buyer walk away for breach of contract in the interim period (trade)

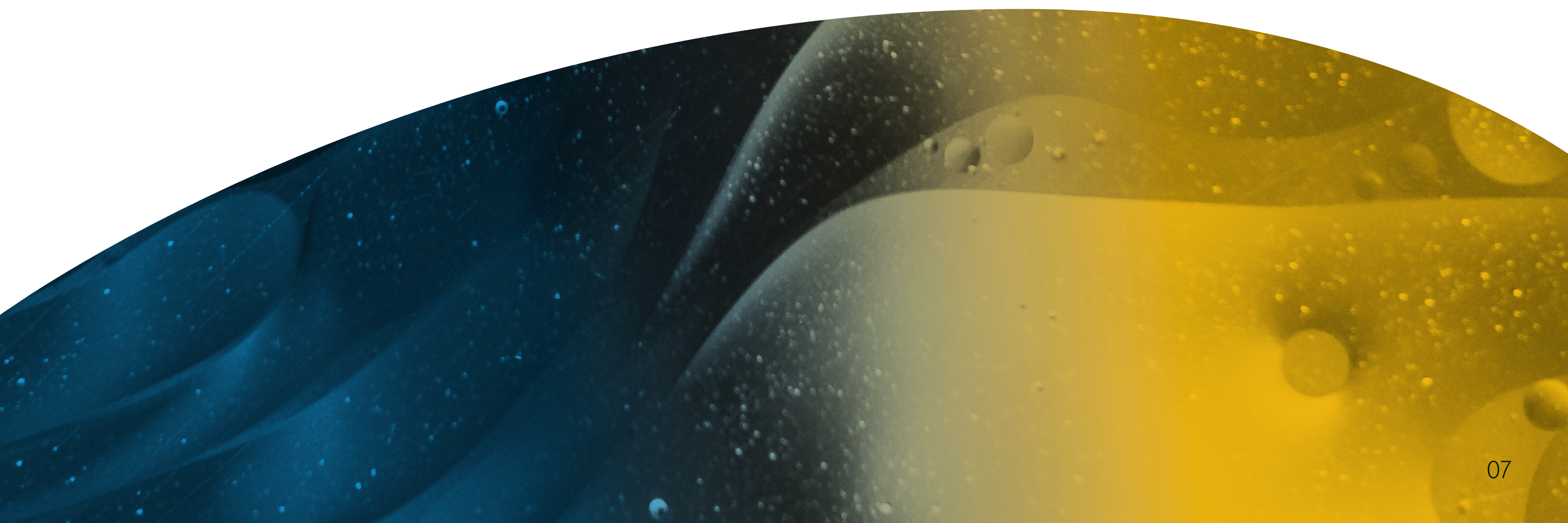


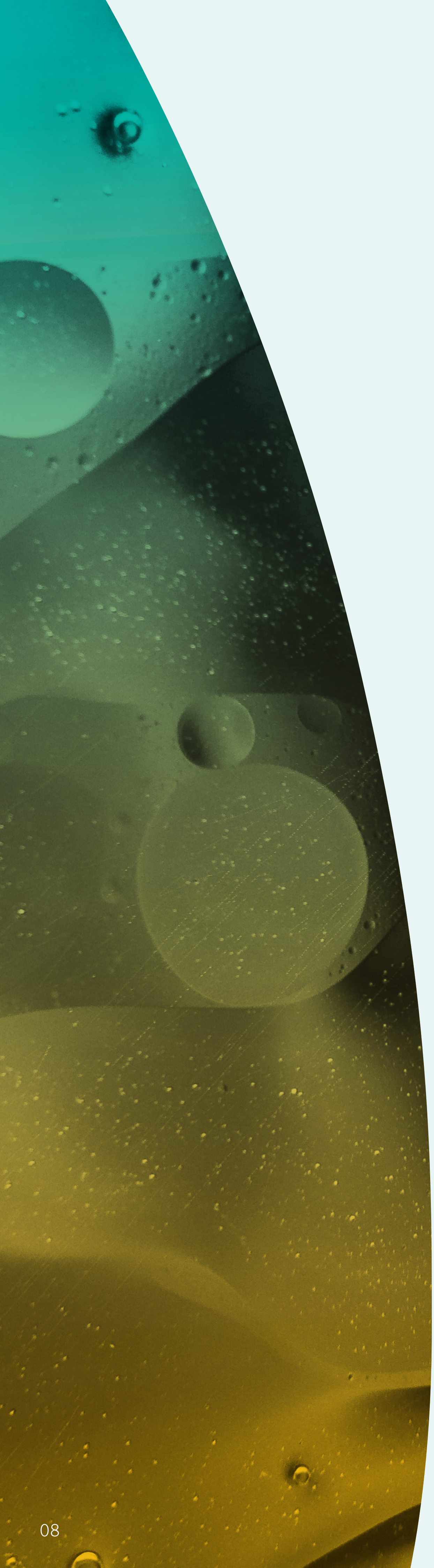
Could a buyer walk away for breach of contract in the interim period (private equity)



This probably reflects the fact that **private equity bidders request fewer overall contractual break rights** and that they are focussed on such fundamental matters that materiality qualification becomes irrelevant.

Tom Leman, Partner - Pinsent Masons



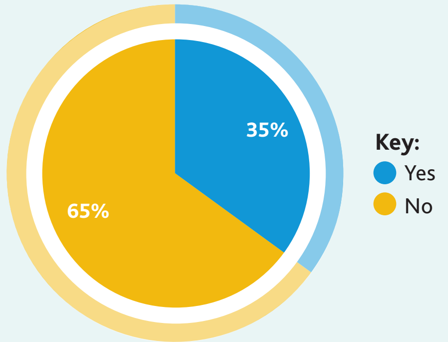


MAC Clause

Use of MAC clauses declined for a third year running and only featured in 35% of surveyed transactions involving a split exchange and completion.

Ed Stead comments, “This is not particularly surprising. MAC clauses present significant transaction uncertainty and where there is any degree of competitive tension in a sale negotiation, the sellers have typically managed to resist them. As debt lenders re-assess their approach to equivalent clauses in their lending agreements in light of Covid-19, it will be interesting to see whether they also become prominent in sale transactions during the course of 2020”.

Was there a MAC clause?



Where MAC clauses are employed, they tend to be fairly generic in nature commonly referring to ‘any event which affects or is likely to affect materially and adversely the financial position or business prospects’ of the target company. A few transactions specifically include reference to potential regulatory investigations or regulatory changes as triggering a material breach. We have already seen sellers and buyers attempting to include or exclude (as applicable) from MAC clauses any impact arising from the Covid-19 outbreak or material changes in the prevailing tax regime.

> **MAC clauses present significant transaction uncertainty** and where there is any degree of competitive tension in a sale negotiation, the sellers have typically managed to resist them.

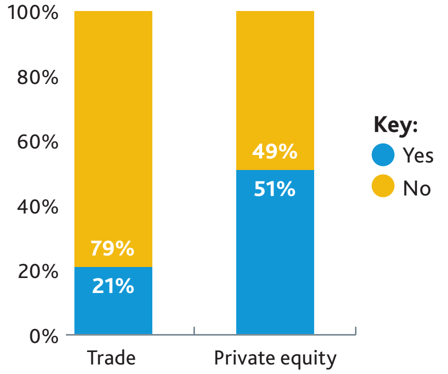
Ed Stead, Partner, Head of Private Equity - Pinsent Masons

Locked box, completion accounts and deferred consideration

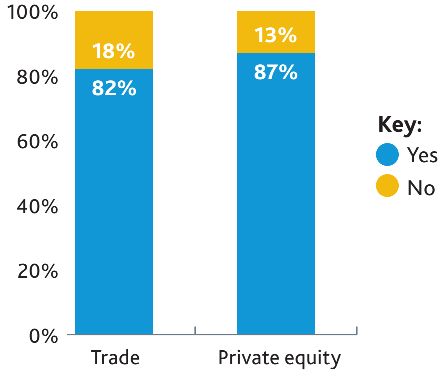
Locked box v completion accounts

Consistent with previous years, around 35% of all transactions employed a locked box mechanism with the proportion higher (51%) in buy-side private equity transactions compared to deals involving a trade buyer (21%). Last year we noted strategic buyers becoming more familiar with the use of locked box mechanisms rather than completion accounts while retaining a preference for the post closing true-up and this continues to be the case in our most recent data. As expected, private equity buyers more regularly accept a locked box mechanism provided there is high quality financial due diligence. This is probably due to the greater certainty for sellers and buyers, avoids scope for dispute and provides clarity on a private equity buyer's deal funding commitment.

Proportion of transactions including a locked-box mechanism



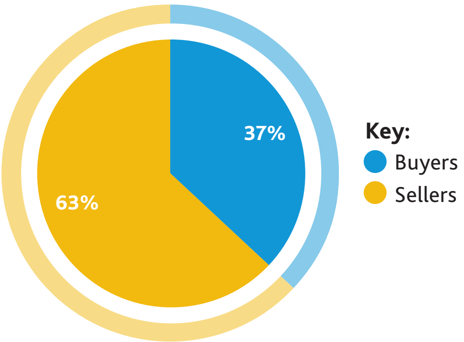
Did the SPA contain a net assets/working capital adjustment clause?



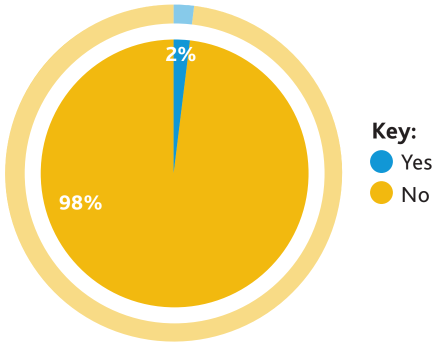
Whether the buyer or sellers prepare the first draft of the completion accounts is a common area of debate and our survey results demonstrate that there is no dominant answer on this, albeit sellers produced the first draft completion accounts on 63% of relevant transactions (a slight increase on 2019). This statistic perhaps points to the continued negotiating strength of sellers, but perhaps also recognises the fact that 'who goes first' in producing completion accounts is less important to the parties where there are detailed policies and procedures in place governing the way in which they are produced.

Where completion accounts were used very few (just 2%) of transactions set a cap and collar to exclude immaterial price adjustments within agreed parameters.

Who will prepare the first draft of the completion accounts?



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

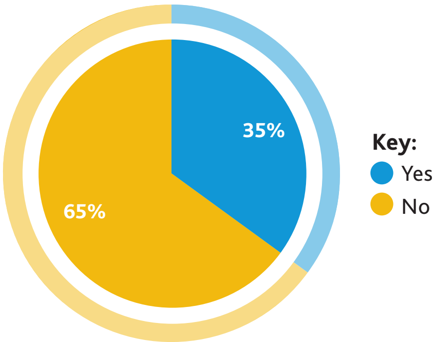


Deferred consideration

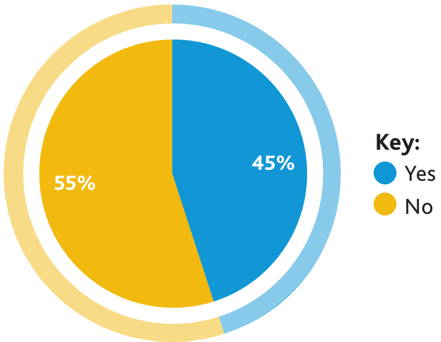
Across all transactions surveyed 41% included an element of deferred consideration - which was the third year in a row that we have seen a rise. Private equity transactions saw a lower use of deferred consideration than trade (35% of private equity transactions as against 45% of trade transactions) which is consistent with 2018.

The number of private equity transactions involving an element of deferred consideration has remained at just over one third in the last two years. Ed Stead comments, “Whilst we do need to remember that our survey counts bolt-on acquisitions as private equity transactions, this does indicate that private equity bidders are prepared to supplement the potential offer of equity in their buyer group with consideration structures which drive appropriate behaviours and bridge gaps in price expectations”.

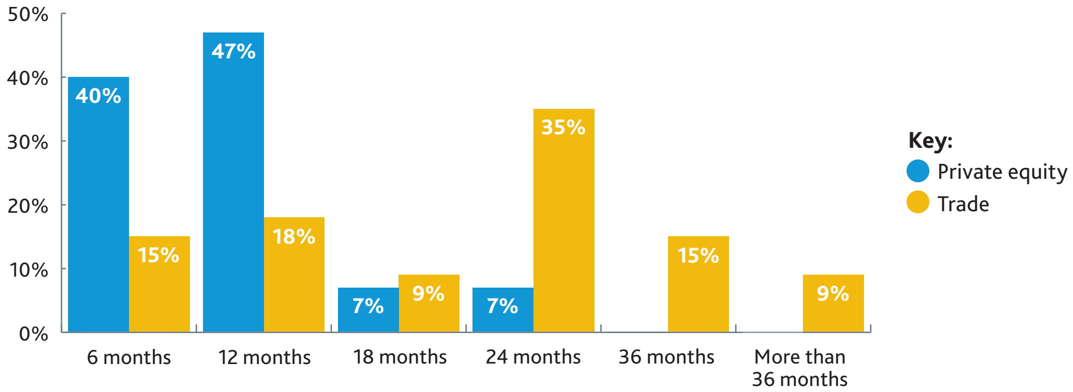
Did transaction include an element of deferred payment? (private equity)



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



Time period for deferred consideration

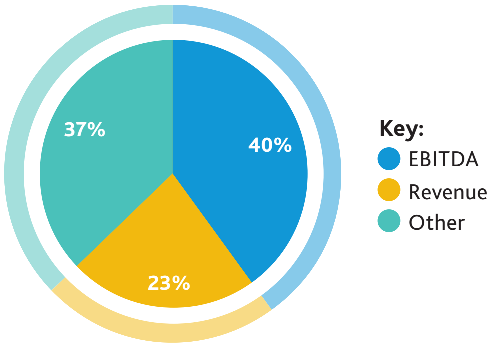


In the majority of transactions the deferred consideration period was 18 months or less. Private equity transactions typically favoured a shorter deferred consideration period with 40% at six months and 47% at twelve months. The deferred consideration period for trade transactions was more varied with 24 months the most favoured period (representing 35% of the transactions reviewed) and a longer period preferred in 24% of transactions.

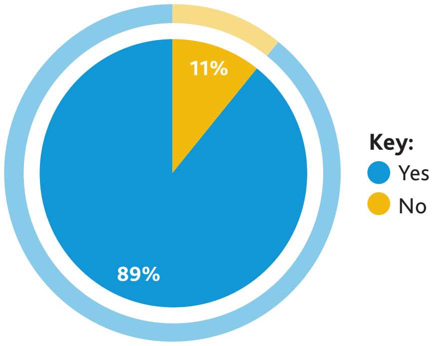
Tom Leman comments, "These findings confirm our experience that trade buyers often implement longer deferred consideration periods because, in the absence of equity incentive schemes, they want to promote specific management behaviours and they are not necessarily constrained by the prospect of having to close out any such incentive arrangement before an ultimate exit transaction in the same way as private equity bidders are".

Achievement of EBITDA targets remains the most common measure for calculating the value of deferred consideration and this was the key metric in 40% of relevant transactions, with revenue used as the primary measure in 23%. It remains standard practice to include certain earn-out protections for the duration of the deferred consideration period typically including management sellers' continued involvement in target businesses and an agreement from the buyer not to make changes to the target group, but rather to run the target business in the ordinary course. However, certain businesses or sectors may require other specific or more appropriate metrics to evaluate performance and value creation. In the 2019 surveyed deals, specific measures ranged from tax outcomes and the resolution of outstanding claims, to clearance of old stock and the achievement of agreed post-merger synergies.

Basis for calculation of deferred consideration



Were any protections in place for the deferred consideration period?



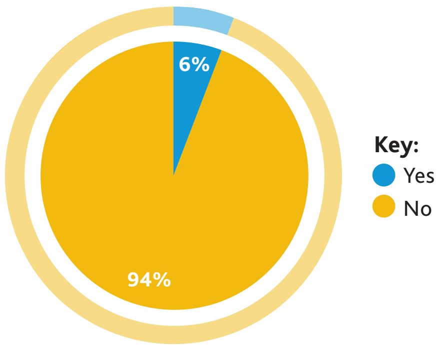
These findings confirm our experience that trade buyers often implement longer deferred consideration periods because **they want to promote specific management behaviours and they are not necessarily constrained by the prospect of having to close out any such incentive arrangement** before an ultimate exit transaction in the same way as private equity bidders are.

Tom Leman, Partner - Pinsent Masons

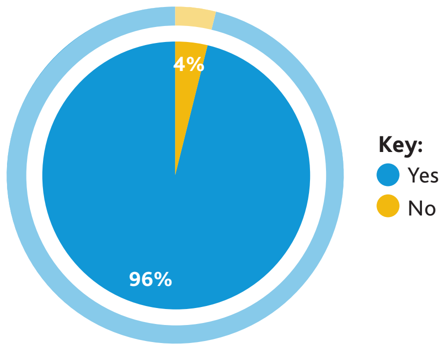
Warranties

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

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



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

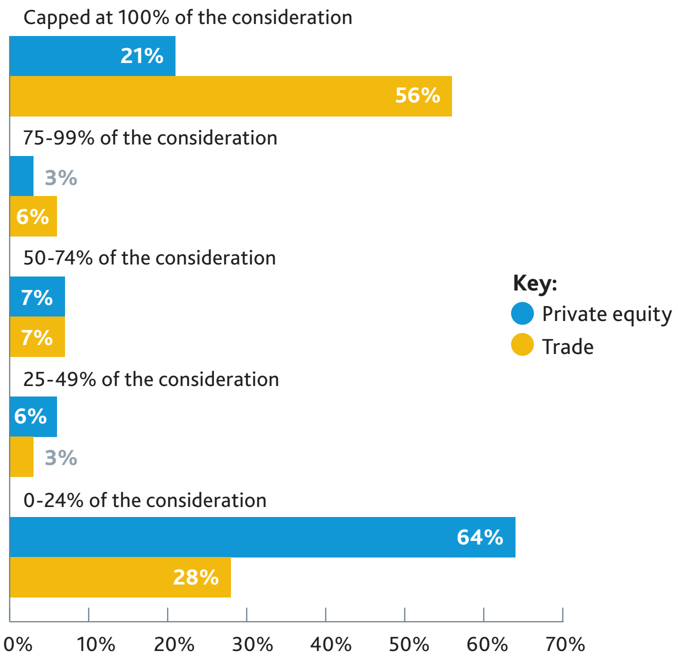


In private equity transactions the warranty cap was typically set at a relatively low proportionate amount of the overall consideration, with 64% of those transactions including a warranty cap set at between 0-24% of the consideration, a proportion which is significantly up on our 2018 survey (47%). The proportion of those private equity transactions capped at 100% was only slightly lower at 21% (previously 25%). In trade transactions it was more common to see the warranty cap set at the maximum consideration paid, with 56% of our relevant surveyed transactions having a liability cap set at 100% of proceeds.

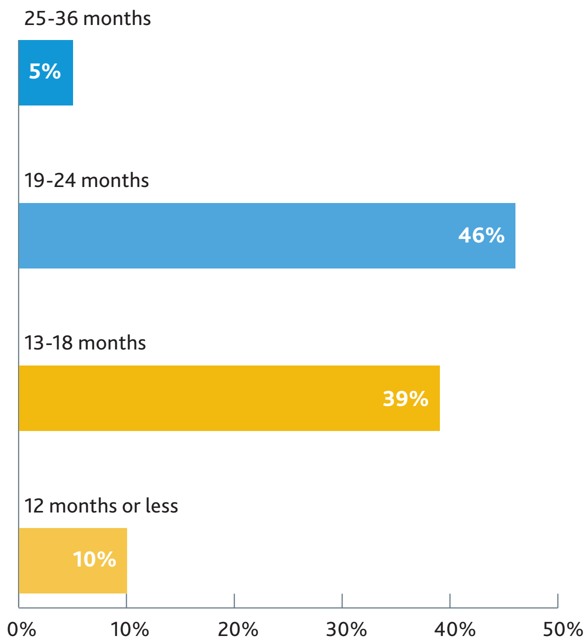
We had wondered in previous reports if market uncertainty might drive private equity investors to push for higher warranty caps to mitigate investment risk. However, this has not been borne out in the latest data which instead points towards an even greater acceptance by private equity of warranty and indemnity insurance and the role it can play in transactions (see below).

Analysis of warranty limitations data across our transactions is in line with previous years and confirms that limitation periods for commercial warranty claims are typically set at between 12 and 24 months. This time period typically allows for the completion of two audit cycles under the new ownership structure which is normally sufficient time to identify any potential claims. This is a relatively settled market position.

What was the value of the warranty cap?



Limitation periods for commercial warranty claims

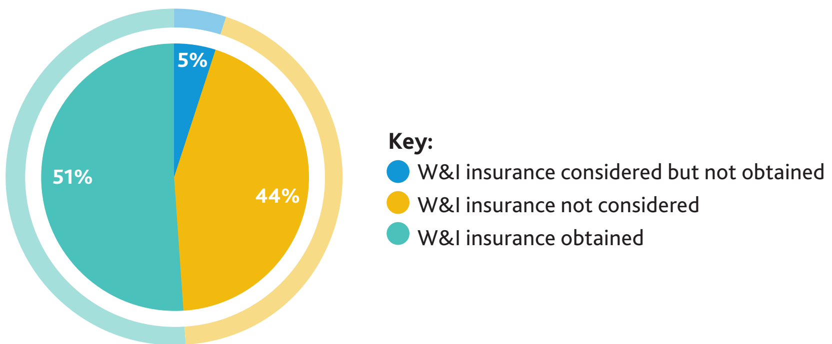


The number of transactions now utilising warranty and indemnity insurance has increased year on year to the point where a W&I product was used in just over half of all transactions surveyed in 2019 compared to 41% in 2018. The proportion of private equity buyers using W&I was even higher at 55% and where the private equity buyer transacted via a newco (more typically in a buyout rather than a bolt-on), W&I insurance was obtained in 93% of transactions. This confirms that insurance is now better understood by the market and has become a standard tool for reducing risk for both sellers and buyers in UK mid-market transactions.

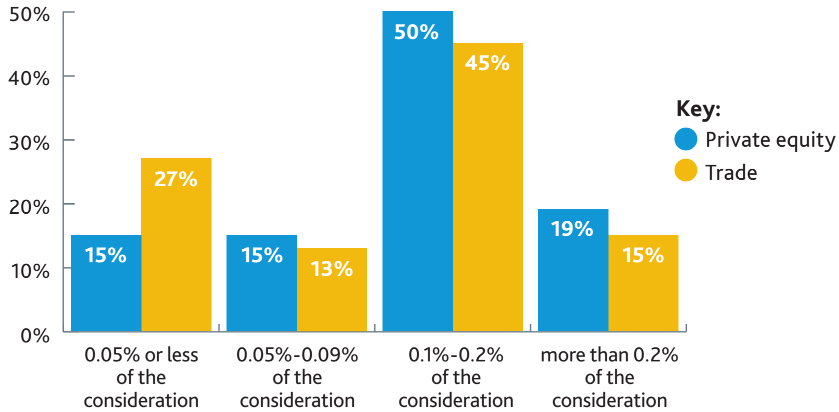
Last year we commented on a subtle move towards a higher de minimis for warranty claims as a percentage of the consideration, with a de minimis threshold of 0.05% of consideration or less applied in under 20% of all transactions, and a marked increase in the use of higher de minimis thresholds. In 2019 we saw 50% of private equity transactions in our coverage use a de minimis threshold of 0.1% to 0.2% of the consideration, up from 38% in 2018. Further, 0.2% of the consideration was set as the threshold in 19% of private equity transactions - a significant change from the 5% seen previously.

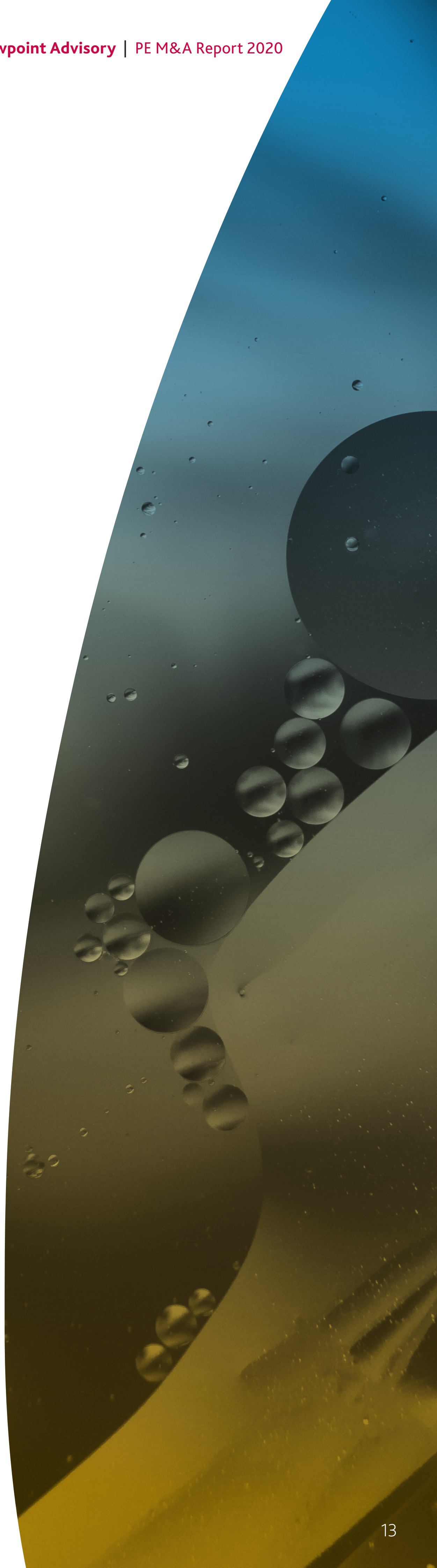
These survey results do support the middle market “rule of thumb” approach which often sees the throw away de minimis set at 0.1% of the transaction value (with the aggregate claims threshold then set at 1% of transaction value). An increase in the size of throw away de minimis is also perhaps consistent with the increased use of W&I insurance where the underlying policy might either match that level of threshold or provide the buyer with a means of insurance recovery at a lower de minimis threshold.

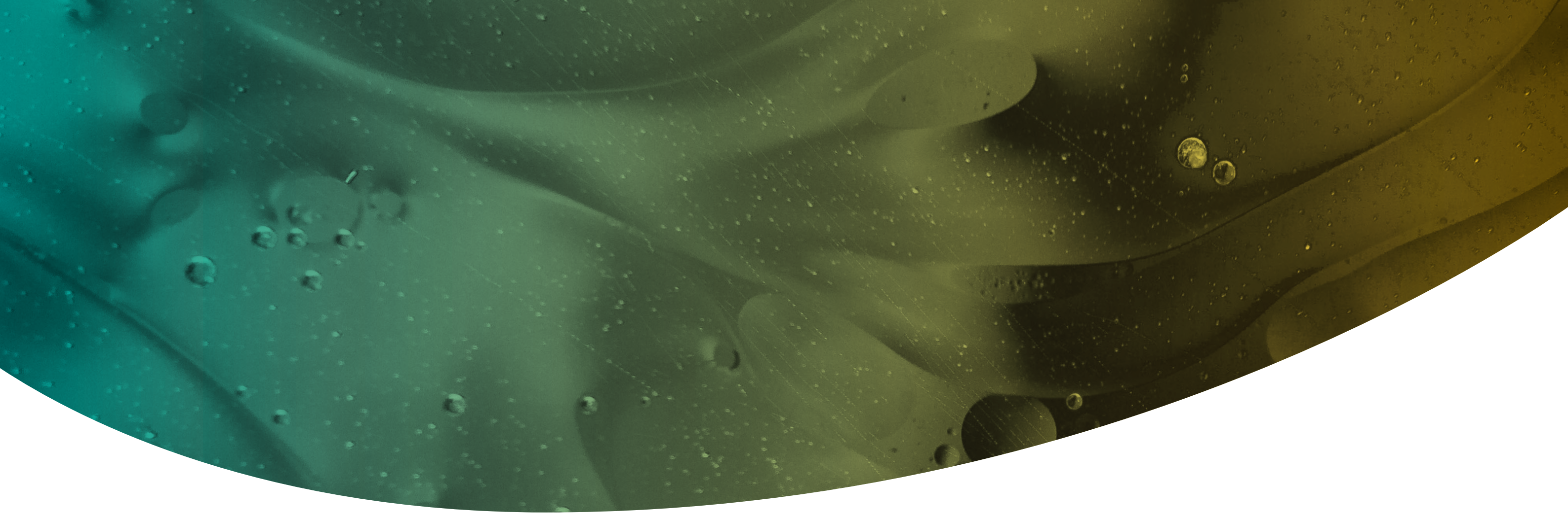
Use of warranty and indemnity insurance



Throwaway de minimis for warranty claims as a % of consideration

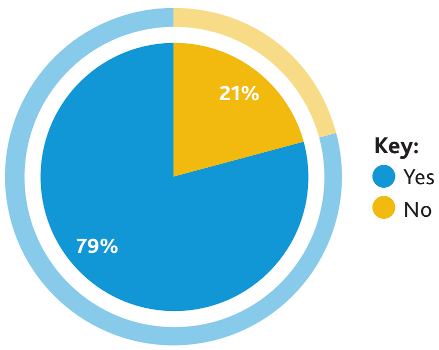




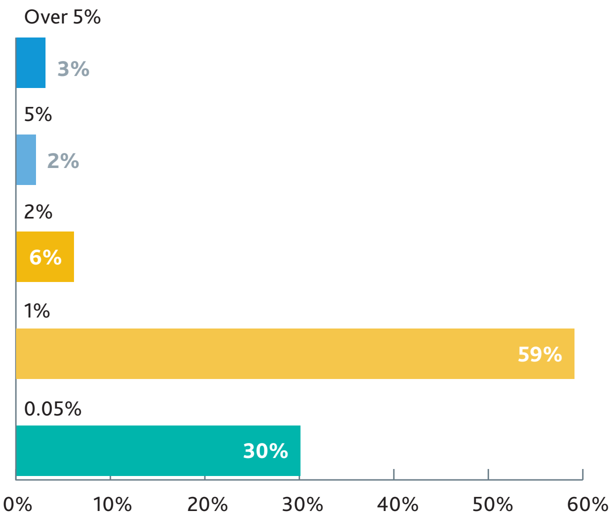


The vast majority of transactions (79%) continue to use a claims basket/threshold albeit the proportion was down slightly on 2018 (85%). As in previous years, the mainstream approach was to set the threshold at 1% (or less) of the consideration value, with 59% set at 1% and 30% set at 0.05%. Few thresholds were set at 5% or higher.

Did the transaction use a basket/threshold for claims?



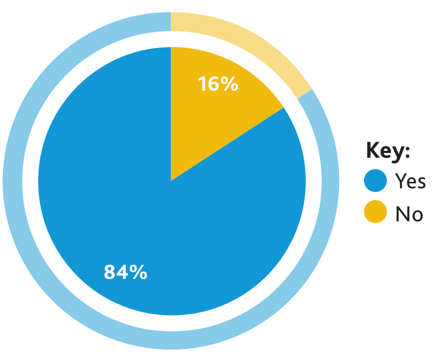
Basket/threshold as a percentage of price



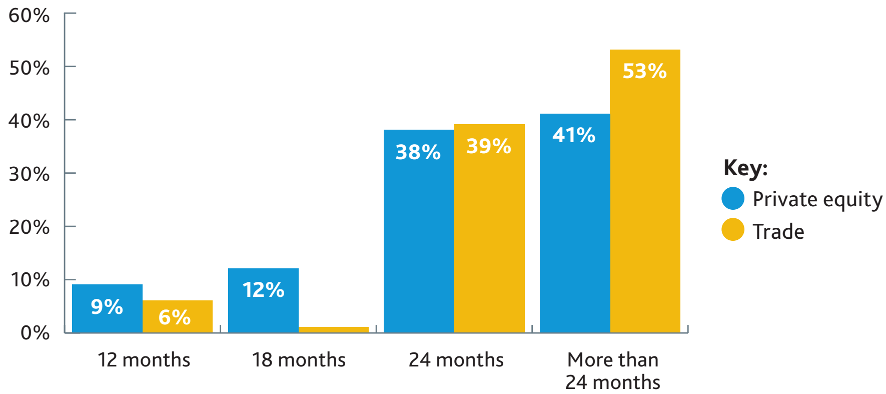
Non compete

It remains typical for transactions to require the seller to give a non-compete covenant with 84% of transactions including such a covenant in 2019 (which is similar to 2018). Over three quarters of all transactions required a non-compete clause of 24 months or more with 41% private equity and 53% of trade buyers insisting on over 24 months (most typically set at 3 years from the closing date). Whilst our survey data does not capture situations where different sellers are subjected to different lengths of restriction, this is an approach we have seen deployed to good effect where it is fair and appropriate to place longer restrictions on a seller realising material proceeds when compared to a small minority shareholder who still needs to be able to earn a living in their field of work.

Was the seller required to give a non-compete undertaking?



Length of restrictive covenant/non-compete

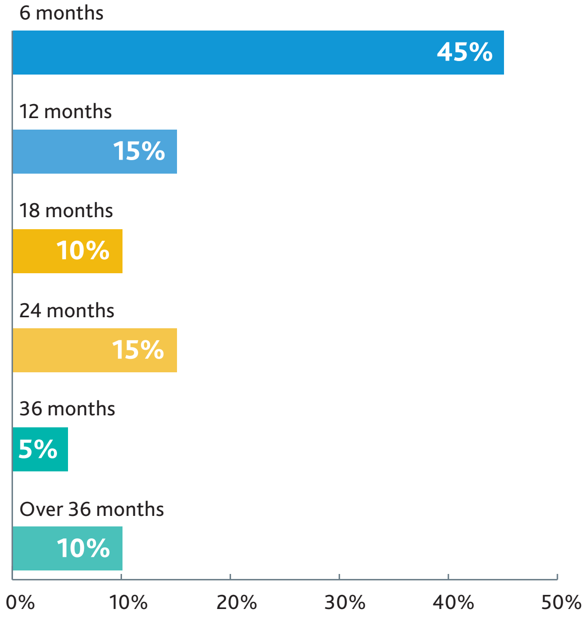


Escrow / retention account

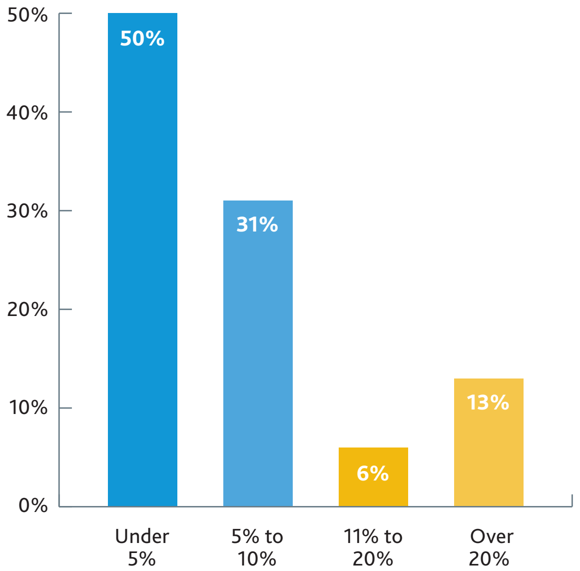
In transactions where an escrow account was used as security our survey saw 45% of transactions being subject to a holding period of six months. However we do not consider this result to reflect market norms as they included the specific escrow requirements of a particular buyer making multiple acquisitions on similar terms. If this specific data is excluded the escrow period becomes more evenly spread between 12, 18 and 24 months (which is more consistent with our findings from prior years).

The amount retained in the escrow account was typically under 5% of the consideration, a figure seen in 50% of transactions up from 40% in 2018. Around 13% of deals required a retention representing 20% or more of consideration – the same figure as last year.

What is the time period for the escrow/retention account?

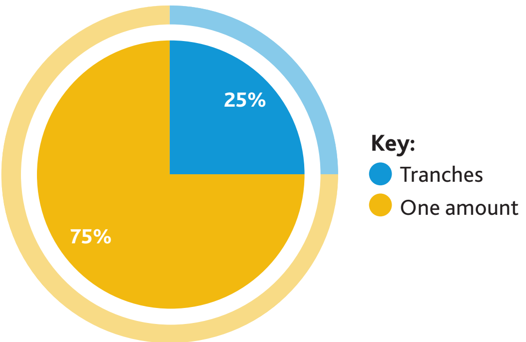


What is the amount retained in the escrow/retention account (as a % of consideration)?

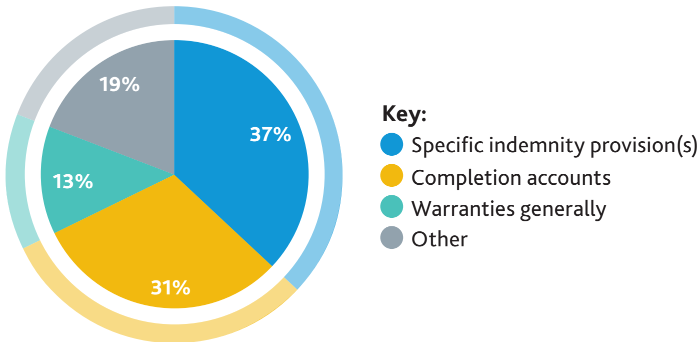


In three quarters of the surveyed transactions it was agreed that the funds held in escrow would be released in one amount rather than in tranches. In over a third of transactions where funds were held in an escrow account, it was typically with regard to a specific indemnity provision. As a general point, we would sound a note of caution in assuming that these findings on escrow matters point to particular long term trends. In experiences are that private equity houses are accustomed to proceeding without escrow retention in the absence of identified material issues, whereas trade and international buyers remain more attached to the concept.

Is the retention released in one amount or in tranches?



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

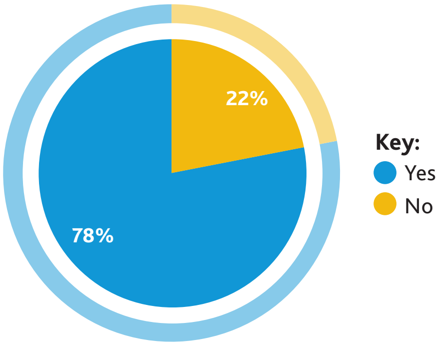


Disclosure

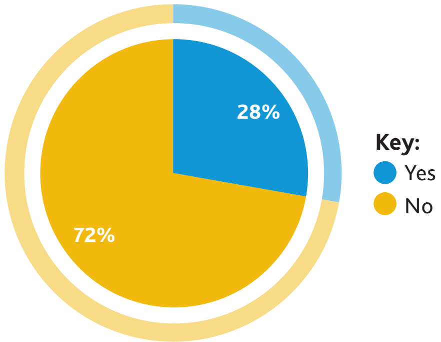
The buyer agreed to general disclosure of the data room in 78% of transactions which is a little higher than the figure seen in 2018. Separately, the buyer only gave a reverse warranty that it does not have any knowledge of a possible warranty claim at the time it entered the SPA in 28% of transactions, which is lower than the 36% figure seen in 2018.

In our experience, private equity investors are often comfortable to provide such reverse warranties provided that the scope of the knowledge is limited to the actual knowledge of specific deal team members. Nevertheless, the survey results suggest that buyers are successful in resisting this in a significant majority of transactions.

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



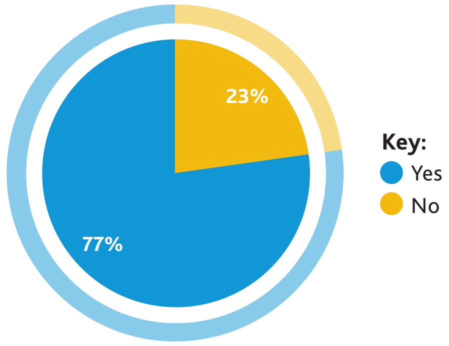
Did the buyer give a reverse warranty?



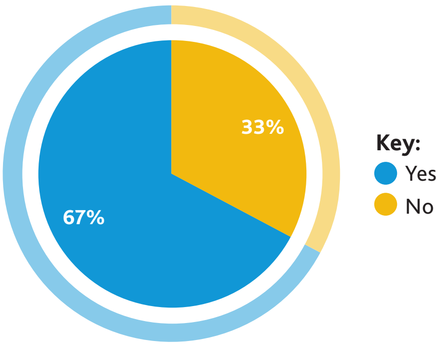
Tax

Tax covenants continue to be a common feature in both private equity and trade transactions with a higher proportion in private equity deals (77%) compared to trade deals (67%). For a second year we saw a small number of deals use insurance to support a tax covenant which contained a £1 cap on the covenantors' liability. This continues to challenge the market perception that insurance, particularly in private equity deals, is expected to be the main recourse for tax risk and indicates that a significant proportion of deals are being transacted with just one financial limit applying to both the warranties and tax deed.

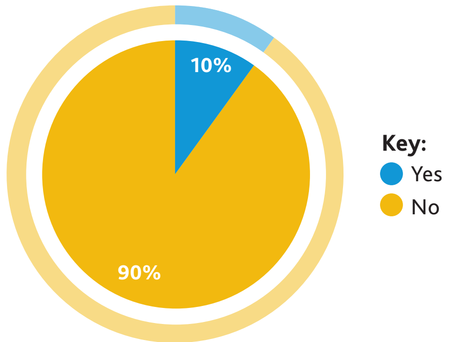
Was a tax covenant used? (private equity)



Was a tax covenant used? (trade)

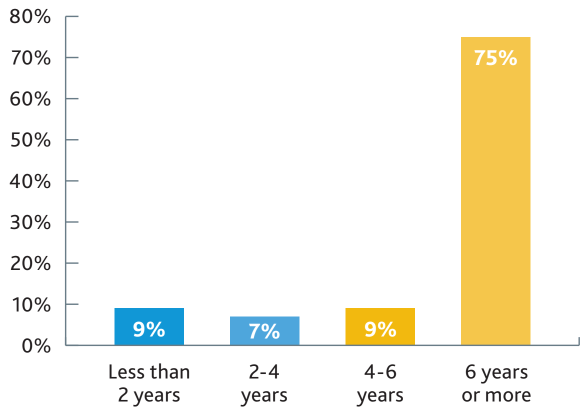


Was there a separate cap on liability under the tax covenant/deed?



The limitation period for tax warranty claims continues to be set at six or more years in the majority of transactions. This period is in line with HMRC's extended time limit for review of tax liabilities. Buyers clearly feel uncomfortable with a four year limit despite it being HMRC's standard look back review period and the only period in which Sellers can adjust their CGT computations. Sellers have attempted to encourage buyers to accept four years as a market norm but we think that this will prove difficult to achieve for most transactions particularly given the general trend for an increase in HMRC scrutiny of business transactions.

Limitation period for tax warranty claims



A German, French and Spanish perspective

Germany

The situation in Germany does not materially differ from the detailed findings for UK transactions. One exception to this is the decreased level of deal activity from UK of strategic buyers or private equity houses into Germany. We have seen this now in the second consecutive year, as a consequence of the ongoing Brexit process. Given the expected uncertainty in this area for over the coming months it is probably an effect which will impact, besides all other effects, the market to the same extent in 2020.

We can confirm for Germany that there is an increasing number of transactions having a gap between exchange and closing. This is very likely due to increased deal volumes as well as an increased number of large buyers and private equity backed buyers which require merger control notifications, especially for private equity bolt-on acquisitions.

There also seems to be a trend for more exclusive deals than non-exclusive ones. Further, the use of deferred consideration has been on the rise. We assume that this is a result of the high valuations in the market in 2019, which allowed participants to become more comfortable with a smaller percentage of the value being fixed upfront, with sellers happy to accept this given the higher transaction values, with the potential for further upside through deferred consideration. The use of W&I insurance is rare, but is on the rise, albeit currently being used mainly in higher mid-market transactions and above.

Obviously, the latest developments with Covid-19 will have a tremendous short term impact. It is hard to imagine how new deals will progress when teams are not able to meet and get to know each other in person for several weeks or months. However, given the huge amount of dry powder available to PE investors and the increasing need for strategic buyers that survive the crisis to grow, we would expect that the markets will pick up soon after the Covid-19 crisis is over, whenever that may be.

France

For full year 2019 and the first quarter of 2020 deal activity has been strong in the French market with activity mainly driven by sellers as money has been readily available over the period. In this sellers' market auction processes have been on the rise with pre-emptive transactions appearing to drop off as multiples and prices rise.

Considering that the French market has been mostly driven by sellers' expectations increasing competitive tension for the buyers, sellers have sought to reduce every element of uncertainty. Accordingly, locked box price structures, absence of MAC clauses, escrows rather than retention, overall cap on warranties and indemnities (when accepted) appear to be market standard terms.

However, it may be worth noting that buyers sometimes combine locked box and completion accounts structures depending on the reliability of reference accounts and more generally on the quality of the disclosures.

The proposition for W&I insurance coverage by sellers is steadily increasingly though market data indicates that costs attached to insurance coverage still imply that the deal value needs to exceed €30 million to be financially relevant.

As across most of Continental Europe, the French market has been encountering severe uncertainty since the Covid-19 outbreak. Confinement, lock down of non essential industries and businesses, general lack of confidence in the strength of companies and the economy across all sectors for the coming months will prompt a slow down in M&A transactions generally. Despite this reasonable anticipation, a few sparks have emerged as some sellers are considering taking the money now. In these circumstances, discussions are around tailored and limited MAC clause capturing only the impact of Covid-19 outbreak above thresholds and limited price adjustments. It may be that the market in France, if not knocked down will enter into a more buyer friendly turn.

Spain

The Spanish overview does not differ very much from the trends shown in the UK market, whether in relation to trade or private equity transactions. Save for some distinctive particularities of the UK market (ie. instruments such as the tax deed), the Spanish market follows a similar direction. Nevertheless, there exists a notable divergence: the use of W&I. While the rise of these instruments has continued in the UK, these solutions still have not taken off in the Spanish market. Whether because of certain inflexibility from insurance providers or because of some other factors like cost, the fact is that these schemes are barely used and, if so, mostly are only offered by private equity houses from the sell side. The lack of reliable precedents about how they work in practice does not help either.

With reference to the prospects of the Spanish market, this will be hugely impacted by the Covid-19 pandemic. The confinement of a big part of the population as well as the lock down of non essential industries and businesses will prompt a severe hiatus in the number of transactions, regardless of the sectors involved. However, it is not unreasonable to think that, once this break has elapsed, the activity levels will recover or even will increase. Just as a healthy company in an attractive sector will whet the appetite of investors (private equity or strategic), we anticipate that there will be a significant amount of consolidation activity in those industries which have shown to be less resilient over this crisis or which have suffered a deeper impact (ie. hospitality and leisure businesses).

Warranty & Indemnity Insurance Trends

In line with the trend from previous years, we saw the use of W&I insurance on UK M&A transactions continue to rise in 2019. Our data suggests that W&I insurance is increasingly becoming a "must have" for private equity houses - over 55% of all private equity deals used an insurance solution, with this figure rising to 93% when a newco was incorporated as the purchaser. While private equity buyers remain the biggest users of W&I insurance, we continue to see increased awareness amongst corporates and family offices. Most trade buyers and their advisors are now well aware of the process involved with, and the benefits of, using W&I insurance to facilitate smoother negotiations. 2019 also saw the product being used for the first time in the context of secondaries transactions. We expect further innovations to come in 2020, with the W&I product adapting and evolving to apply to a new range of scenarios, including distressed/ insolvent and public-to-private transactions.

Pricing and retentions

For the first time in the history of this report, we saw a marginal increase in W&I premiums for both real estate and operational deals.

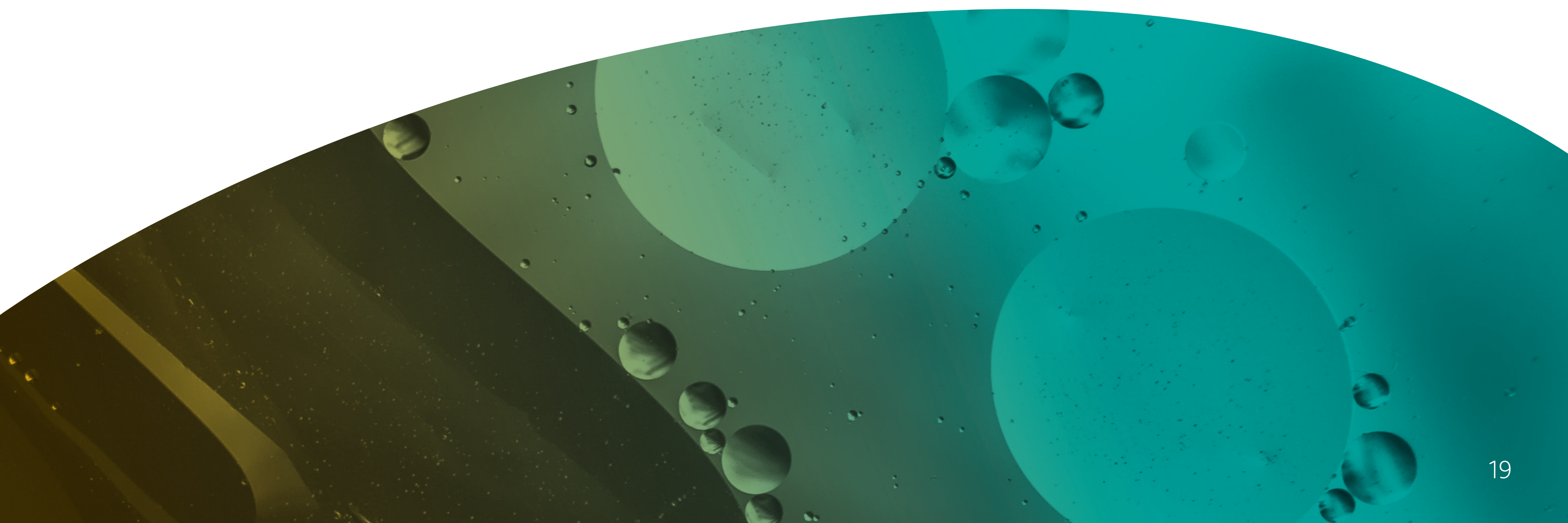
The higher average premium for operational deals can be explained by: (i) W&I insurance being used on an increasing number of large and complex global businesses; and (ii) a rise in the number of insured healthcare and financial services transactions. Both of these categories are perceived as higher risk by insurers and therefore, attract higher premiums. Setting large cap, global transactions aside, average premiums for UK mid-market M&A once again decreased (from 1.16% in 2018 to 1.03% in 2019), reaffirming that mid-market deals really do represent the 'sweet spot' for W&I insurers. It remains to be seen whether the Covid-19 outbreak will alter this dynamic and shift pricing and retention options back up in the mid to long term.

On the real estate side, the marginal increase in premium rates can be explained by real estate buyers showing greater appetite to purchase policy enhancements (in particular, affirmative cover for low tax risks matters such as the potential application of WHT on distributions and debt push-down risks).

Average Premium Rates (% of the Policy Limit)			
Real Estate		Operational	
2018	2019	2018	2019
0.89%	0.92%	1.16%	1.26% (but 1.03% for UK mid-market M&A)

Typical Retentions (% of Enterprise Value)*			
Real Estate		Operational	
2018	2019	2018	2019
NIL	NIL	0.25% - 0.5% fixed (with certain insurers beginning to offer tipping retentions on private equity backed transactions)	0.25% - 0.5% fixed (with most insurers now offering tipping to NIL retentions on private equity transactions)

*Also referred to as excess deductible



Policy enhancements

Transaction documents are now regularly drafted with the use of insurance in mind, as both sellers and buyers seek to take advantage of the various policy enhancements on offer. As the prevalence of W&I insurance has grown, it has become common to see sellers/management cap their liability at a nominal €/£/$1.00 and/or give the warranties on a blanket knowledge qualified basis. Insurers remain comfortable with either or, indeed, both of these dynamics, with insurers offering to increase the cap on liability and deem the blanket knowledge qualifier to be disregarded for the purposes of the policy.

As noted above, buyers are increasingly purchasing affirmative tax coverage, reflecting the fact that a greater number of insurers are now willing to offer this enhancement as they build out their in-house tax expertise. In line with last year's report, we have continued to see an increase in the number of insurers who are willing to offer "US-style" enhancements. These enhancements include non-disclosure of the virtual data room (typically only if agreed in the SPA but with a few insurers starting to offer this in contrast to the SPA position), non-disclosure of the due diligence reports and provision of warranties on an indemnity basis. We are continuing to see insurers charge an additional premium for these enhancements in the region of 5% - 15% of the base premium.

Specific risk insurance policies

2019 saw an uptick in the use of specific risk insurance products, including policies and products for known tax risks, identified pollution, ongoing litigation or defects in share and/or real estate title. A combination of factors contributed to this: increased awareness of these products and their benefits, a reduction in premiums and increased risk appetite amongst insurers. We expect this trend to continue into 2020 and beyond.

> In 2019, Howden M&A experienced a **five times increase in the number of notifications above £5 million vs. 2017.**
>
> **Anna Robinson, Head of Claims - Howden M&A**

Stapling and initial approach to the market

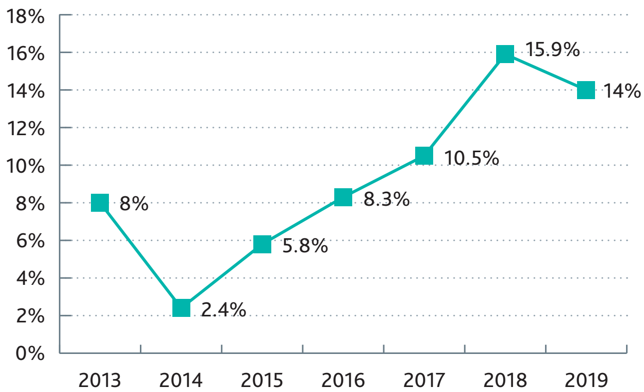
Throughout 2019, sellers continued to see the benefit of stapling insurance to their deals, allowing them to cap liability at a low level and ensure a smooth process. In line with the discussion in last year's report, "hard staple" approaches remained more common on deals in excess of £250 million (including several £1 billion plus deals). However, we continued to see a sustained increase, particularly on smaller and mid-market deals, in the number of sellers adopting a "soft staple" approach.

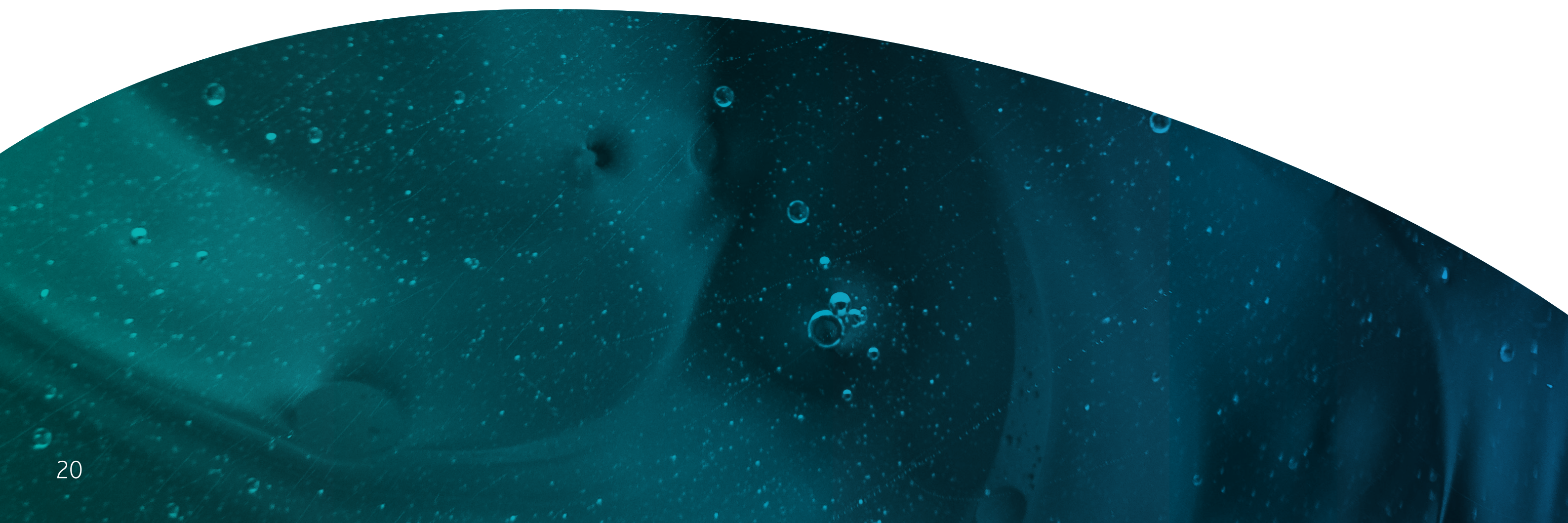
W&I insurance claims

While the percentage of transactions producing a claims notification decreased slightly from last year (14% in 2019 compared to 15.9% in 2018), the severity of claims (ie. the monetary value) has significantly increased. Head of Claims at Howden M&A, Anna Robinson, comments, "In 2019, Howden M&A experienced a five times increase in the number of notifications above £5 million vs. 2017".

Notwithstanding the increase in the magnitude of claims, insurers continue to respond positively. In line with last year's report, Howden M&A has continued to secure successful pay-outs for our clients, with our data showing that payments have been made on over 90% of the claims processes that have concluded. Claims continue to arise predominately from breaches of financial and tax warranties, as well as breaches of material contracts and compliance with law warranties.

Percentage of transactions producing a notification





Private Equity

Sweet equity

The amount of sweet equity available to management remains one of the most commercial focal points, where each additional percentage of equity available to management can be financially very attractive on a successful future exit.

The amount awarded is largely governed by the commercial negotiations between parties rather than accepted norms, with the strength and depth of the management team, the overall deal structure / incentive package (loan note coupon, ratchet etc.) and the competitive tension within the process all key factors.

As in previous years sweet equity typically comprises between 10% and 20% of the overall equity available, and this was the case in 50% of relevant transactions in 2019, down from 55% in 2018. The proportion of transactions seeing equity pots of more than 20% increased from 21% to 28%.

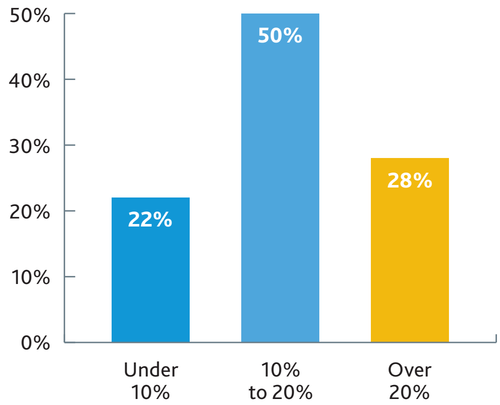
Simon Cope-Thompson comments, "Whilst there is a variance in the level of sweet equity from deal to deal, what we are continuing to see are higher amounts awarded in secondary buy-outs. Having been exposed to the private equity world, management teams are often more commercially minded the second time round. In the majority of cases they take independent management advice and working along side their advisors are able to drive an improved set of equity terms."

Jamie Hutton, Director at Arrowpoint Advisory comments, "What is also of particular significance to the management team is the cost of the sweet equity. Simply put, the lower the cost of share capital in the Newco, the less management teams will have to pay for their sweet equity." Private Equity has been increasingly supportive of adopting a lower overall value for the Newco share capital as it enables the majority of their funding to sit in higher ranking interest accruing loan notes (or preference shares) providing downside protection. However, in the last 12 months HMRC has become more focused on thinly capitalised businesses and the potential tax implications for management teams receiving equity incentives at an undervalue. As such we have seen a trend towards an increase in the cost of equity, particularly where ratchets are involved, which can have a material impact for management teams.

Jamie adds, "For managers who do not have a huge amount of liquidity or have not created significant value to date (common in primary buy-outs), providing the funding to be able to pay for a high cost of sweet equity on day one can be challenging. The problem can be solved, such as through a company loan, but it needs to be identified early so all parties can agree on a preferred solution.

For managers who can roll (ie. in successful companies in secondary buy-outs) or invest a significant quantum of money, the increased cost of sweet equity means a higher percentage of their investment goes into an equity instrument where leaver provisions are often less favourable compared with their money sitting alongside the private equity house in the strip equity and loan notes."

Proportion of equity available as sweet equity



> Whilst there is a variance in the level of sweet equity from deal to deal, what we are continuing to see is higher amounts awarded in secondary buy-outs. **Having been exposed to the private equity world, management teams are often more commercially minded the second time round.** In the majority of cases they take independent management advice and working along side their advisors are able to drive an improved set of equity terms.

Simon Cope-Thompson, Managing Director - Arrowpoint Advisory

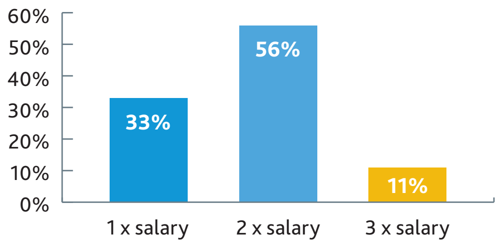
Warranty caps

2019 saw an increase in the cap for investment warranties with two times a manager's salary seen in 56% of transactions compared to 40% in 2018 and a decline in transactions with a warranty cap of one times salary from 50% to 33%. This increase is consistent with our previous findings where the proportion of transactions capped at two times has risen annually since 2017 averaging around 45% over the last four years. This would underline the importance placed by private equity investors on the preparation and review of due diligence reports, business plans and other relevant matters and supports the sense that private equity's attitude to management terms may have hardened in recent times.

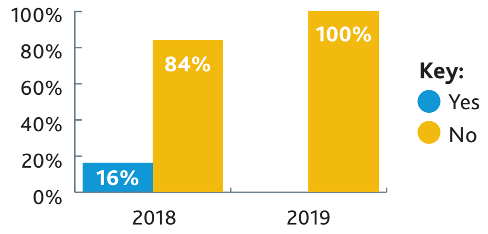
That being the case, it remains unusual for the liability cap on investment warranties for managers taking sweet equity to be set at three times salary or higher.

In previous years we have seen a small number of transactions in which the private equity house accepts a different warranty liability between managers receiving rollover and those receiving sweet equity, but as we have previously commented it remains far from the norm and indeed no transactions in 2019 included a different warranty liability cap as between different categories of managers.

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



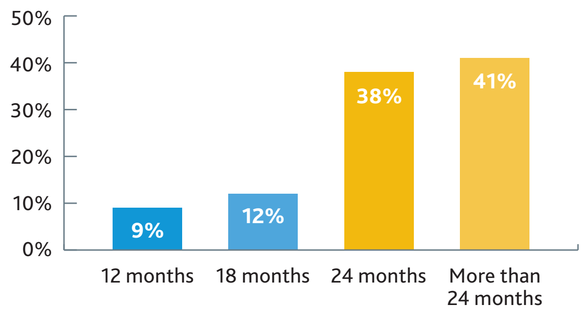
Did warranty liability cap vary for rollover investor?



Restrictive covenants

Unsurprisingly, restrictive covenants remain an important tool for investors to mitigate investment risk by restricting key management from competing against investee companies or soliciting employees, customers or suppliers. Our data suggests that investors took a harder line in 2019 with investors continuing to prefer covenant periods of 24 months or more. However in this year's data, periods of more than 24 months increased from just 3% to 41%, with 24 months seen in 38% of transactions. In a climate of continuing market uncertainty, investors seem less sympathetic to arguments from management that longer covenant periods restrict their ability to earn a living when they cease to be employed by investee companies.

Length of non compete (private equity)

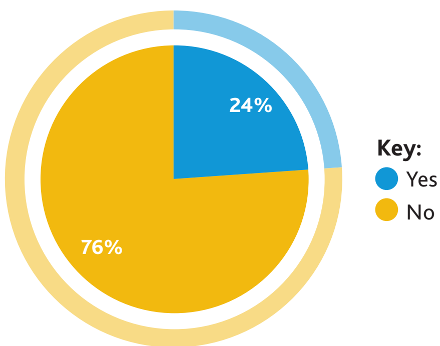


Fees

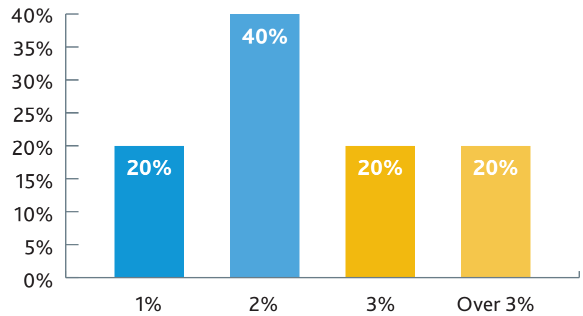
This year we continued to see fluctuation in the use of arrangement fees charged by investors with the number down to 24%, the lowest we have seen in the last four years of data (and down from 56% in 2018).

Where they feature, arrangement fees were set at two percent in 40% of transactions, up from 33% in 2018. The substantial reduction in the charging of arrangement fees may in part be explained by Management's ability to press for a better economic deal in a competitive market but perhaps also by the fact that arrangements with LPs no longer provide for such arrangement fees to be charged by the investment manager.

Was there an arrangement fee?

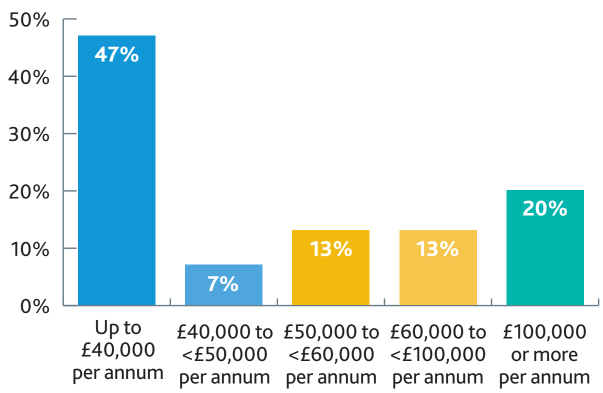


What was the value of the arrangement fee as a % of funds invested by the institutional investor?

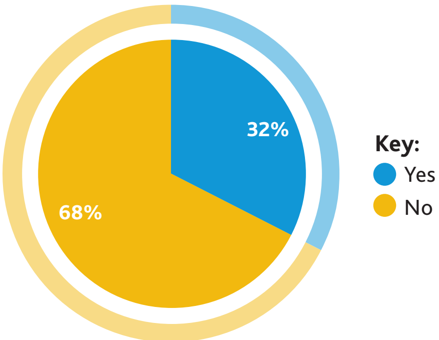


In transactions where investor director's annual fees were charged, just under half received up to £40,000, an increase from 29% in 2018. We view the long term trend to be towards a lower aggregate package of fees being charged by investors, particularly for competitive auction processes where investors strive to make their investment terms as attractive as possible to capable management teams. That said the data evidenced an increase in the higher ranges of fees with 20% of transactions seeing a charge of £100,000 or more (up from 15% in 2018) and 13% between £60,000 and £100,000. There was also an increase in the use of monitoring fees on top of the director's fee from 19% to 32% though in our experience the use of monitoring fees is seen in a minority of transactions perhaps for the reasons stated above.

What is investor director's annual fee?



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

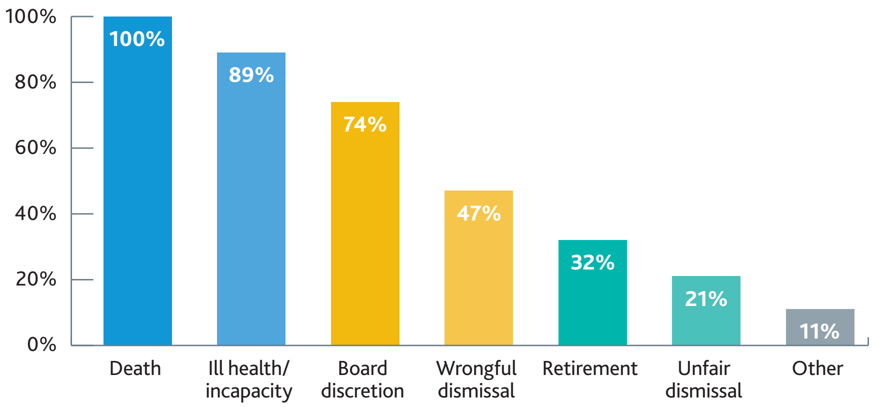


Leaver circumstances

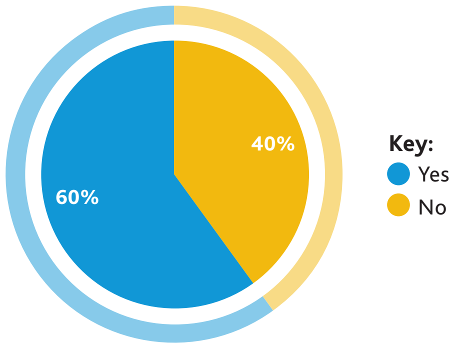
The standard position for good leaver has largely remained unchanged over previous years and this trend continues. Death, ill health/incapacity and categorisation at board discretion remain the most common good leaver circumstances. We have previously noted that wrongful dismissal tends to fluctuate in usage as a specific good leaver circumstance from year to year and this is once again true, being used in 47% of relevant transactions against 31% in 2018. Where an investor accepts the inclusion of wrongful dismissal as a good leaver circumstance, this is typically because they feel comfortable that the investee company is well placed to ensure wrongful dismissal circumstances do not arise. The application of unfair dismissal as a good leaver circumstance increased from 15% to 21%.

Notwithstanding these yearly fluctuations, anecdotally we tend to see a continued resistance to unfair dismissal by investors due to the difficulty in managing the dismissal process for senior executives which often requires the investee company to act swiftly where management change is required. As an increasingly acceptable alternative, investors are more comfortable in agreeing vesting provisions through the use of the intermediate leaver concept which rose for a third consecutive year, from 28% in 2017 to 57% in 2018 and 60% in 2019. We expect the use of intermediate leaver to continue at these kinds of levels in the future.

Good leaver circumstances

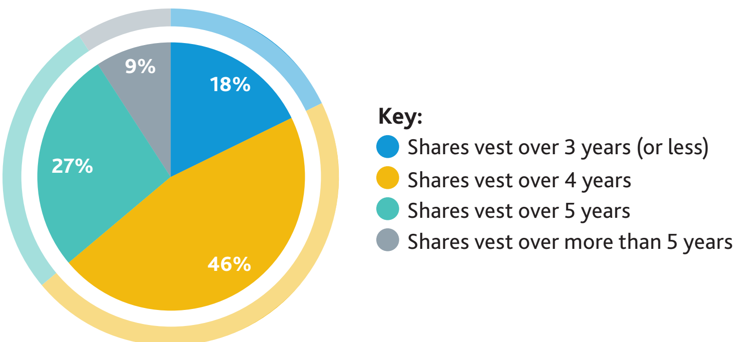


Is intermediate leaver concept included?



Vesting arrangements remained similar to those reported in previous years with a straight line vesting period of four years now typical in almost 50% of deals (2018: 40%). There was an increase in the proportion of transactions applying a vesting period of more than five years (up from 5% to 9%) but it is too early to say if this is an ongoing trend or a one-off increase. On 63% of relevant transactions the vesting schedules we saw allowed 100% of shares to vest, which is consistent with previous years. We do, however, see a resistance to management's equity vesting 100% as investors seek to ensure some of management's shares are offered for sale at a value lower than market or fair value. This allows departing management's shares to be recycled cheaply and to minimise or avoid entirely any dilution arising from the issue of shares to replacements.

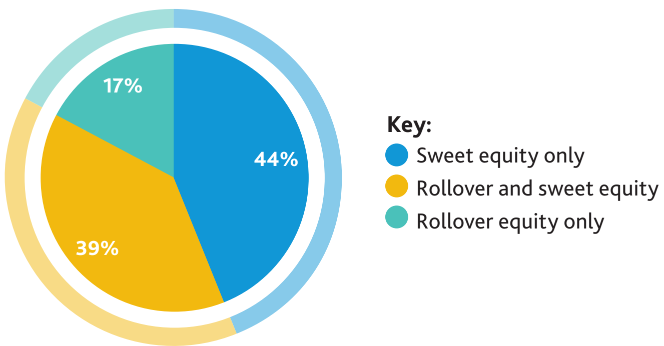
What are the vesting arrangements?



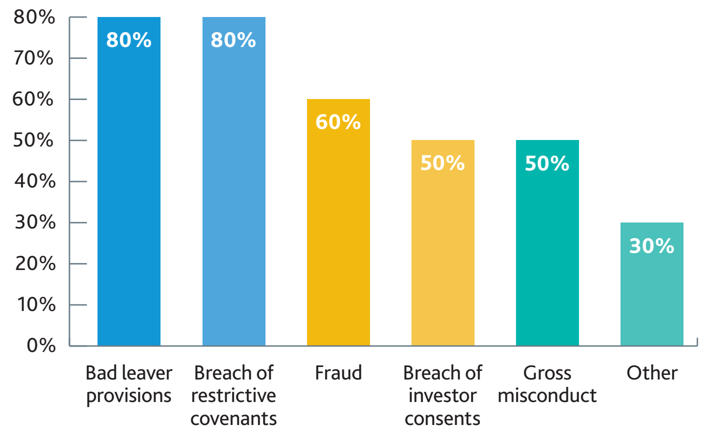
The application of leaver provisions to sweet equity or to rollover and sweet equity in 2019 was consistent with previous years' results. There was an increase in transactions where leaver provisions applied to rollover equity only from just 3% to 17%. However, we regard this result as an outlier and not consistent with the general trend. The proportion of transactions where leaver provisions applied to both sweet equity and rollover reduced slightly to 39% from 42% although often the price paid for sweet equity and rollover will differ depending on the circumstances of departure.

Where leaver provisions are applied to rollover equity they tend to be limited to bad leaver circumstances and breach of restrictive covenant. It is not clear whether this result is an outlier or whether this is due to investors placing greater importance on compliance with key investor consents rights, where any breach may have serious consequences for management.

Do leaver provisions apply to sweet equity/rollover?



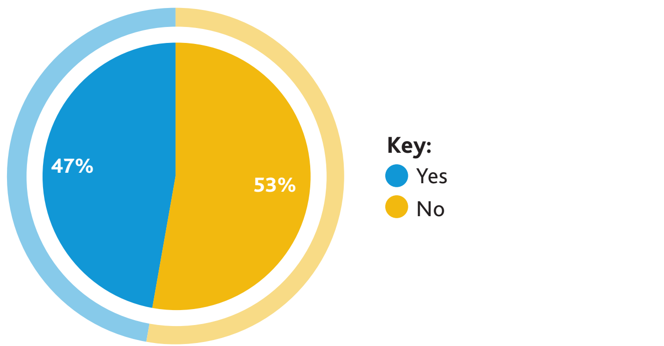
Which leaver provisions apply to rollover equity?



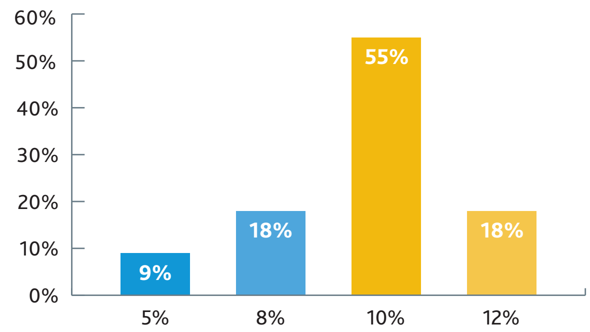
The use of preference shares declined from 58% of relevant transactions to 47% in 2019 but this figure still evidences an upward trend based on historic data and supports our previous forecast that the use of preference shares is likely to increase over the long term due in part to changes in tax legislation.

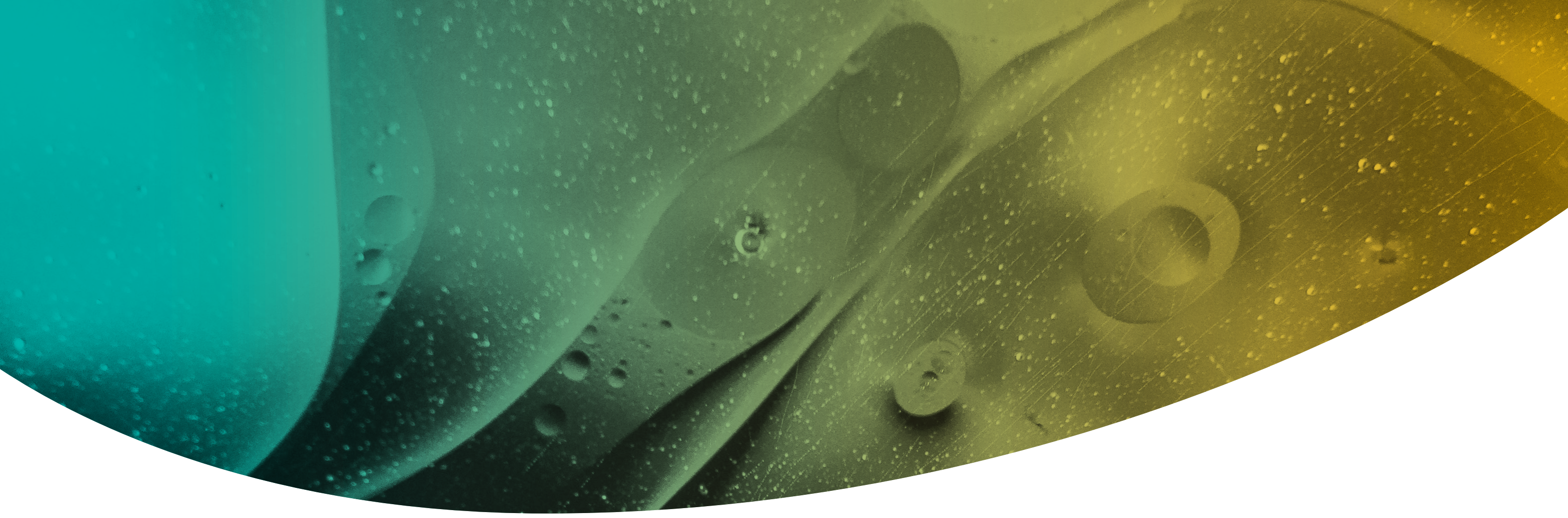
The coupon on preference shares typically averaged 10% which is consistent with our 2018 findings. This is also consistent with the coupon on investor loan notes where 55% of applicable transactions included loan notes with an interest rate of 10% (usually per annum).

Were preference shares issued?



What was the interest rate on investor loan notes?

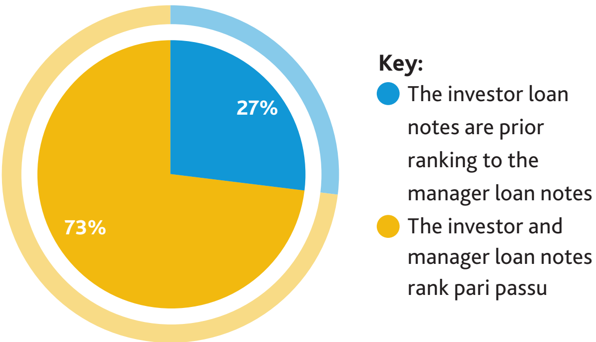




Each year our survey has found that loan notes or preference shares held by private equity investors tend to be ranked equally with those held by managers and the latest data is broadly consistent with 73% of transactions compared with 86% in 2018 which was the highest yet seen in our study. The fall to 73% appears to evidence a return to historic norms and is equivalent to the level seen in 2017. The pegging back of management's ranking as against investors' loan notes and preference shares may be reflective of wider market uncertainty and indicate that investors are using more of the tools available to them to mitigate downside investment risk.

We would generally expect that, where investors and management rank equally, investors will have an ability to vary the terms of management's loan notes so long as the same proportionate amendment is made to the investor's loan notes. We would also expect a lead investor to be able to control the sale of all loan notes on an exit, with the proceeds payable for such instruments to be distributed in line with the agreed capital return waterfall. These rights are useful in situations where an investor may look to exit its investment at an undervalue or where funding of the investee group may need to be restructured (i.e. for reasons of underperformance) or to incentivise new management to salvage value where equity may be 'under water'.

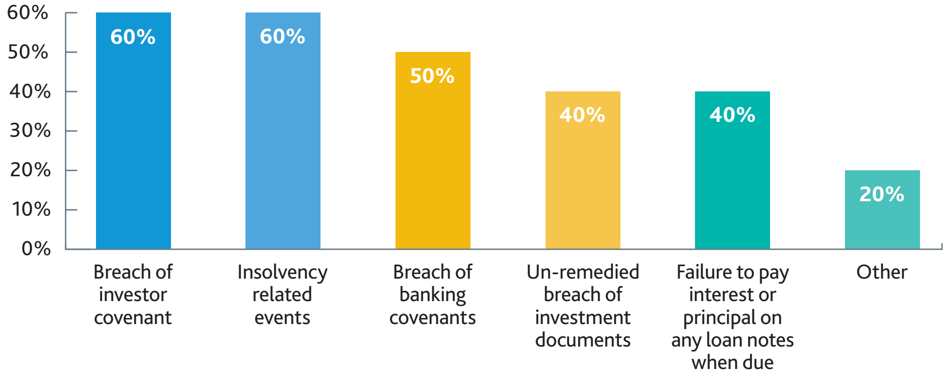
How do the investor and manager loan notes sit for ranking purposes?



Swamping rights

Swamping rights are an important and generally accepted tool for private equity investors to protect the value of their investment in the event of a material default or downturn in the performance of investee companies. In our 2018 survey, breach of banking covenants was the most common swamping event, applied in 79% of transactions. However this figure fell to 50% in 2019 (but we suspect this is because other triggers will have been chosen rather than because there has been a loosening of control in this area). Breach of investor financial (or 'equity') covenants was cited in 60% of applicable transactions last year up from 43% in 2018 and the use of insolvency related swamping events also increased to 60% from 42%. As they often mirror financial covenants agreed in banking documents, investor financial documents are often sensitised against banking covenants and so are seen as an important 'early warning' sign for investors around possible under-performance. Investors sometimes include other KPIs for their investor covenants to enable them to monitor business performance that may not be directly linked to breaching covenants so can offer a wider range of protection for investors beyond financial metrics.

Circumstances in which investors can invoke swamping rights



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