ADDLESHAW GODDARD

TRENDS IN MID MARKET PRIVATE EQUITY TRANSACTIONS

2019

Introduction

We are delighted to present our Trends in Mid Market Private Equity Transactions Report 2019.

2018 was another really strong year for our award-winning private equity team. During the year, the team advised on over 80 private equity transactions with an aggregate value of approximately £4.5billion - an increase on 2017 of almost 50%. We have worked on transactions for a host of leading private equity investors, as well as founder shareholders, debt funders and management teams.

Thank you to all of our clients for entrusting us to deliver their transactions throughout 2018 and we look forward to another strong year in 2019.

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About Addleshaw Goddard

Ranked Tier 1

for mid-market private equity Legal 500

Ranked Tier 1

for M&A (£50m-£250m) Legal 500

Their subject matter expertise combined with their practicality makes them exceptionally valuable advisers.

SECTORS AND SERVICE LINES

Retail & Consumer
Real Estate
Energy & Utilities
Financial Services
Industrials
Transport
Digital
Health

Corporate & Commercial
Litigation
Finance & Projects
Real Estate

80%

of the Top 10 UK mid-market PE investors are regular AG clients*

24%

We advised the Sponsor on 24% of the deals done by the Top 10 PE Investors between 2015 - 2018

* Mergermarket data of deals of £25m to £500m from 2015 to 2018

Industry Awards WINNER

Real Deals 2016, 2017, 2019

Unquote 2015, 2017

14 dedicated transaction partners:
one of the UKs largest specialist PE teams

Repeat Winners of the leading mid market **Private Equity Awards** & The **only firm** since 2015 to be **shortlisted** each year for **both awards**

ranked #3

We were ranked #3 by number of PE deals in 2018 by Mergermarket.

£366m

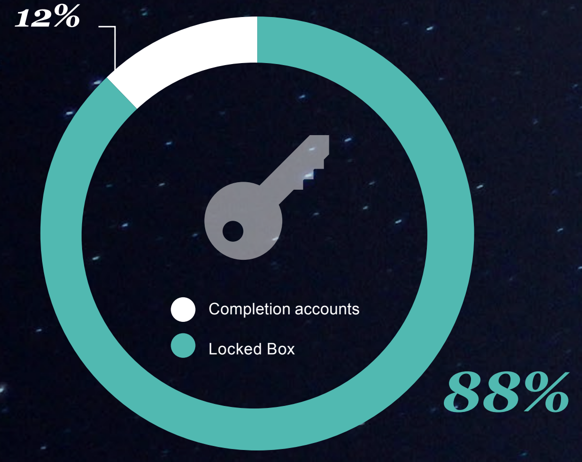
£366m: the average value of our top 30 deals between 2015 - 18

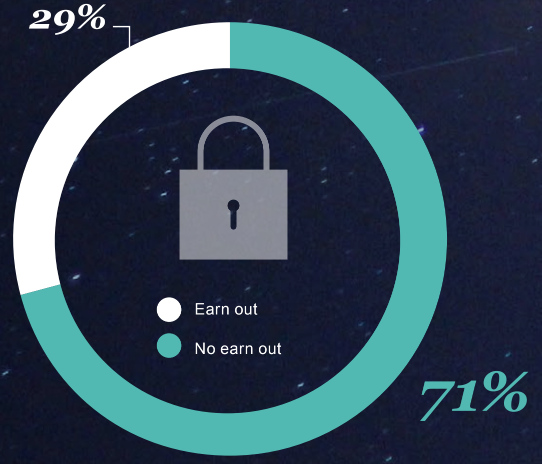
Our Key Findings

In depth commentary of key deal terms can be found in the following sections, but our expert team of corporate, banking and tax lawyers have identified some of the most notable features of our deals in 2018 here.

W&I pushback

- W&I insurance remains a feature of PE deals, but bidders are starting to look at pushing the risk back onto sellers where there are exclusions in the policy coverage - particularly where exclusions relate to the core business (such as regulatory compliance).
- This development reflects buyers' increasing awareness of the limitations in W&I coverage, but risks muddying the waters as to who actually bears the risk of a particular loss (unless what constitutes "Excluded Risks" is 100% clear). Looking ahead, this may well lead to disputes between buyers, sellers and insurers in future.





Increased use of locked box and earn outs

- Locked box mechanisms are still the most popular pricing mechanisms and have increased in popularity when compared to the previous period (88% versus 76%).
- 2018 also saw an increase in the number of deals containing earn outs (29% compared to 19% in 2017). When earn outs are used, it is important to leave flexibility for changes to the target business which the buyer may wish to make and ensure the SPA caters for these changes, to reduce the risk of costly disputes.

SPA liability caps

- More than half of all deals involving a private equity investor involved a liability cap for breach of warranties in the SPA of less than 25% of the total purchase price; and 18% of such deals involved a cap of less than 5% of the purchase price. Our research of warranty claims in practice suggests such lower caps could leave investors short where there is a material issue.
- Unsurprisingly, the size of the deal has a material bearing on the proportion of the sale proceeds that are exposed as cover for warranty claims. Two-thirds of deals with a value of less than £10m had a liability cap equal to 100% of the total purchase price. In contrast, 62% of deals with a value in excess of £100m had a liability cap of less than 10% of the purchase price. This highlights how applying a simple percentage approach can be misleading.

Our research of warranty claims in practice suggests caps of 25% of the purchase price or lower could leave investors short where there is a material issue.

Borrower-friendly debt environment

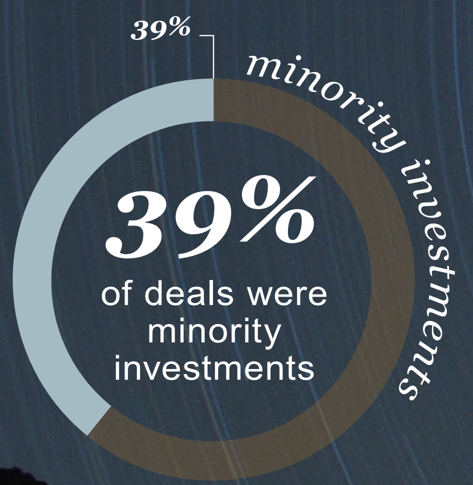
- Conditions in the debt markets remained borrower-friendly throughout 2018, with competition amongst debt funds eager to deploy capital helping to drive increased leverage and higher deal multiples, lower pricing and looser covenants. Average leverage levels were between 5-5.5x. Deal multiples have mirrored the increases in leverage, with global multiples hitting levels not seen since the 2007 peak.
- With the rise of direct lending by debt funds in recent years, many sponsors were concerned how they would behave in times of stress and distress. In our experience to date, direct lenders have proven themselves pragmatic and sensible in work out scenarios and fears that defaults would be used to acquire equity have not materialised.

Average leverage levels were between 5-5.5x. Deal multiples have mirrored the increases in leverage, with global multiples hitting levels not seen since the 2007 peak.

Tax topics

- Recent changes to qualifying requirements coupled with an increasing scrutiny of corporates and individuals' tax affairs has seen tax continue to play a prominent role in the structuring of transactions for both investors and management teams.
- Changes introduced in October 2018 will inevitably result in a reduction in the number of deals in 2019 that involve ER structuring – or at least a reduction in the number of managers who qualify for ER on each deal. Managers who expected to qualify for ER as a result of structuring that was in place before October may need to revisit their position.
- As the W&I insurance market has become more competitive we have started to see more nuanced tax specific W&I insurance products, addressing a coverage gap that previously existed.

Changes introduced in October 2018 will inevitably result in a reduction in the number of deals in 2019 that involve ER structuring.



Minorities on the rise

- Minority investments are not confined to the lower end of the market, with AG instructed on almost as many minority deals with an EV over £100m as majority deals.
- Mature businesses that continue to target significant growth, or which could benefit from additional sources of capital to fund bolt-on acquisitions, but whose shareholders are keen to retain control have presented ideal opportunities for investors to cast their net wider and deliver deals in a crowded marketplace.

Investors are continuing to hold the line as regards equity terms with no discernible softening from the previous period despite the increasing prominence of proactive management advice in sale processes.

LIABILITY CAP AS % OF ANNUAL SALARY

Investors holding firm on equity terms

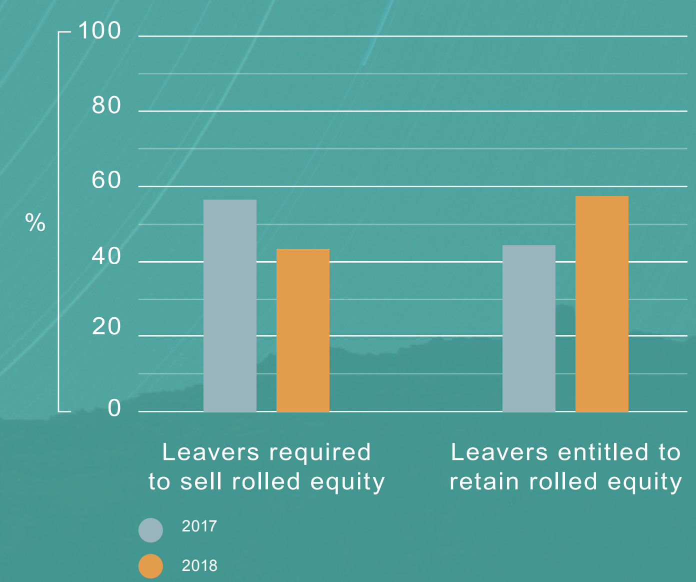
- Whilst we continue to see a relatively seller friendly position adopted on acquisition terms, particularly in the area of warranty caps, investors are continuing to hold the line as regards equity terms with no discernible softening from the previous period despite the increasing prominence of proactive management advice in sale processes.
- This is illustrated by managements' cap on liability for investment agreement claims being 2x salary on 52% of deals (up from 41% in 2017) and a reduction in the percentage of deals featuring management-friendly terms such as manager permitted transfers.

Whilst we continue to see a relatively seller friendly position adopted on acquisition terms, particularly in the area of warranty caps, investors are continuing to hold the line as regards equity terms

Rolled Equity

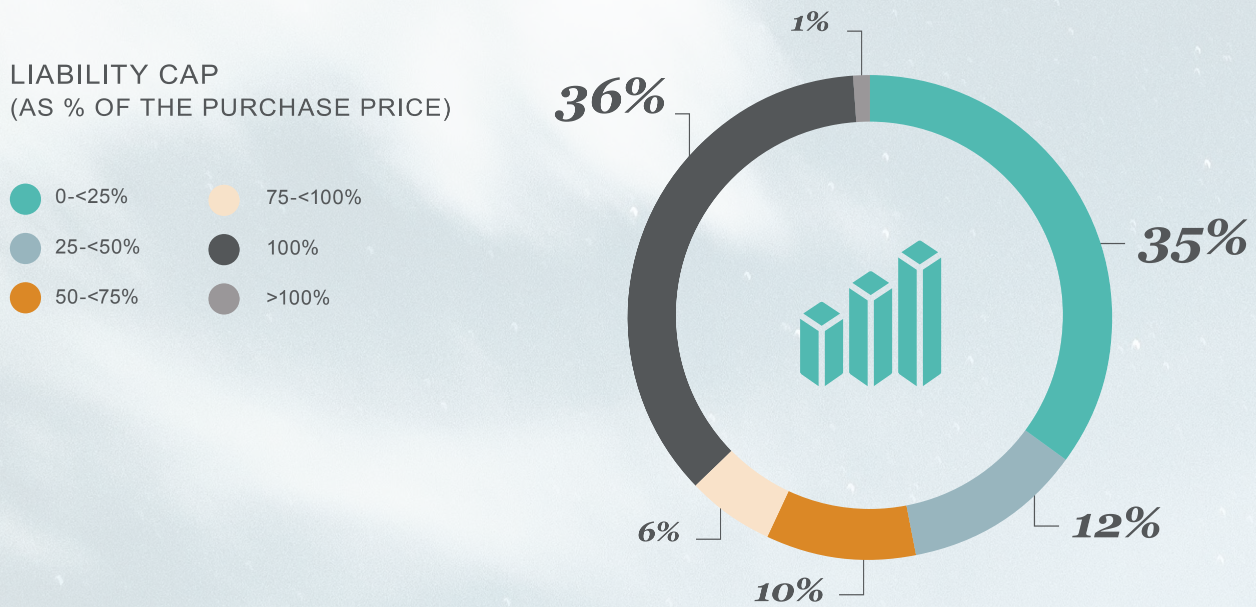
- Treatment of rolled equity is something that we have seen different investors adopt different positions on, such that it has often been difficult to discern market practice in this area. Our statistics show that in 2018 we saw more deals where leavers were able to retain their rolled equity than in the previous 12 month period. However, there has been no change in the proportion of deals where a manager's loan note coupon is reduced or eliminated in a leaver situation, and the approach that mid-market investors take in this area does vary and remains a point of difference.

TREATMENT OF ROLLED EQUITY



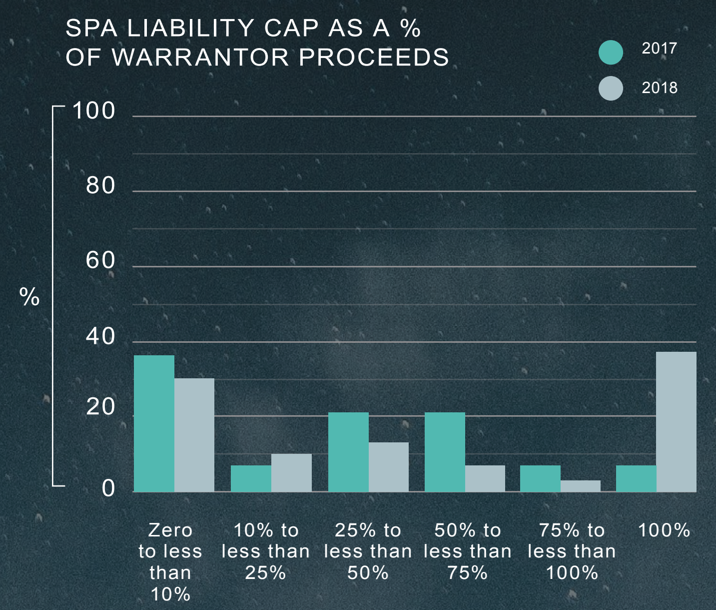
A hardening in acquisition terms?

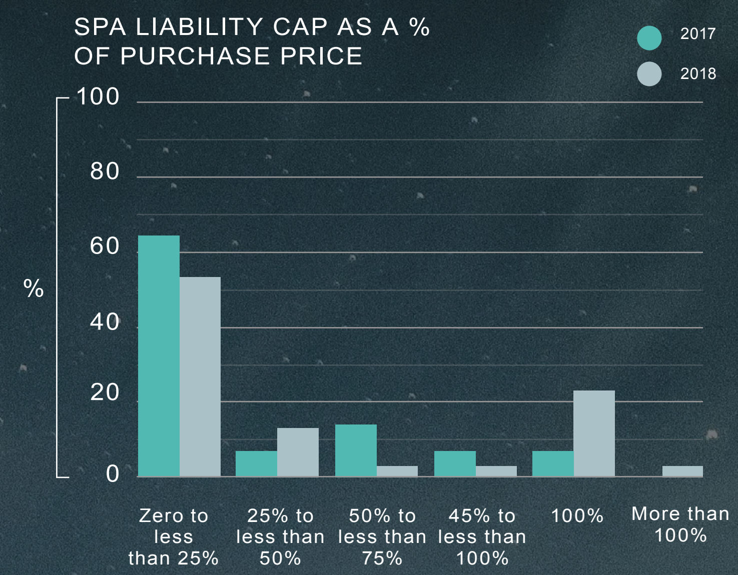
- Whilst 2018 remained, on the whole, a seller's market, there were signs that the balance was shifting a little with buyers starting to take more robust positions on deal terms – e.g. asking for higher liability caps, more extensive indemnity cover and a notable increase in deals featuring earn-outs, with buyers looking to make some of the purchase price linked to post-completion performance of the acquired business.
- However, for the most attractive assets there remains healthy competition, particularly those assets that are suited to private equity investment. PE funds are sitting on near-record high levels of capital that needs to be deployed, meaning that we are still seeing investors willing to propose and deliver on seller-friendly terms – including being prepared to exchange without W&I insurance in place on the basis of a NBI report suggesting cover should be available and then putting cover in place in a short period following the deal, as well as funding the acquisition with their own bridging facility before looking to refinance post completion.
- The level of competition for prized assets also reflected itself in the liability caps seen, particularly on deals involving private equity investors (whether as buyers or sellers). More than half of all deals involving a private equity investor involved a liability cap of less than 25% of the total purchase price. In fact, 18% of private equity deals involved a liability cap of less than 5% of the total purchase price – with the availability of warranty and indemnity insurance being leveraged by investors to offer sellers generous terms on liability caps.

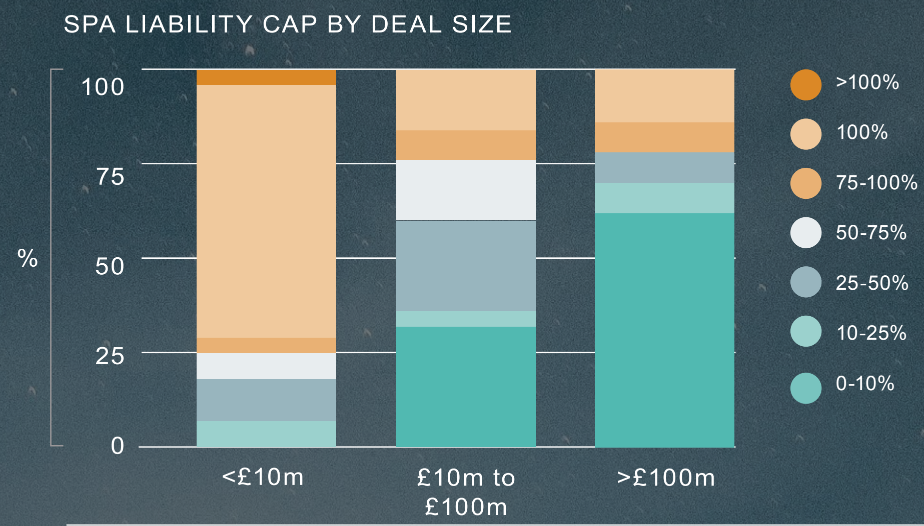


SPA warranty caps

Overall deal size has a material bearing on where on the spectrum the liability cap as a percentage of the purchase price will be. Transactions with a value of less than £10m are much more likely to have a cap of 100% of the purchase price (68% of such deals), whereas for deals of over £100m a cap of less than 10% is the most likely outcome (62%).





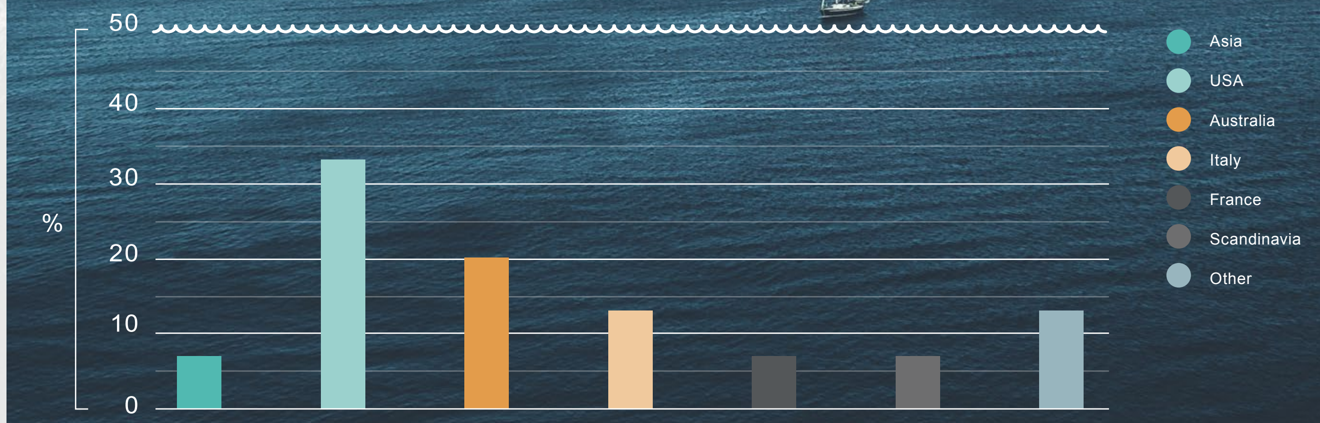


Our analysis of warranty claims that have arisen showed that where the liability cap was less than 25% of the purchase price, the loss claimed exceeded the cap in 3 out of 5 disputed claims.

Cross-border M&A

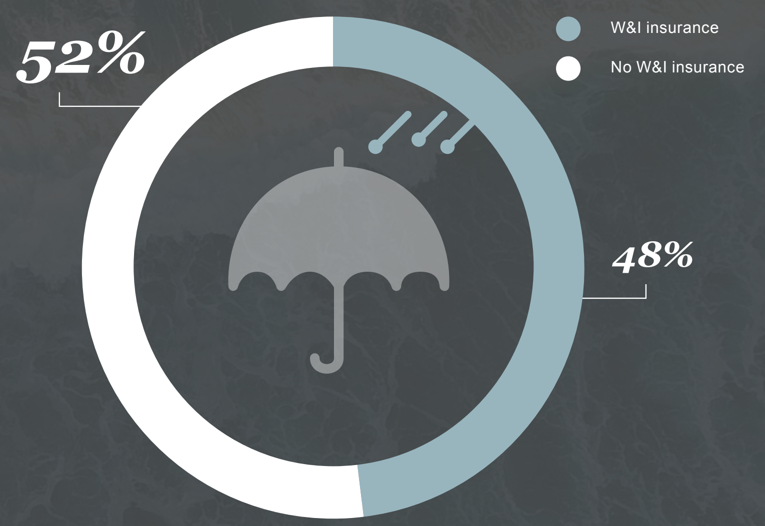
As we anticipated, analysis of our 2018 deals saw a decrease in the percentage of cross border deals. Recent years have seen a significant number of transactions involving buyers from outside of the UK. The adoption of protectionist policies by a number of countries, including the Chinese government imposing restrictions on outbound investment in certain sectors, plus the escalating trade war between China and the U.S. and, of course, Brexit uncertainty has led to conditions that are far from ideal for cross-border transactions.

JURISDICTION OF OVERSEAS INVESTORS INTO THE UK



W&I Insurance

PE DEALS INVOLVING W&I INSURANCE



13%

Around 13% of policies see a claim notification, typically in the first

6 months

following completion

Developments in W&I insurance

- We continue to see W&I insurance being used on a range of deals for a number of reasons, although there is some evidence that investors are pushing back on, or at least limiting, its use to ensure that sellers/management teams have some meaningful level of risk under the warranties being given on a sale process. 2018 also saw a few instances of buyers pushing for the sellers to "go back on the hook" for any breach of warranty in respect of which cover was excluded under the W&I insurance policy. Whilst this has a certain attraction for buyers as it allows them to attempt to plug the gaps in the policy, it can cause confusion and therefore lead to disputes between buyers, sellers and underwriters as to who bears the risk of a particular loss. If such an approach is adopted, care needs to be taken to make clear what the "excluded risks" are that the sellers are providing meaningful warranty cover for.
- There is still demand in the underwriting market to place policies and an increasing level of flexibility is being offered around pricing, with some underwriters even willing to provide cover with no retention at all.
- One interesting trend that we have seen in the market is the use of US style policies. A standard UK market policy will, in addition to the specific exclusions, exclude anything which is 'known' – meaning that there is a risk upon a claim being made that there will be disagreement as to whether the matter being claimed for was known or not. However, under a US style policy only specific matters are excluded, and commonly due diligence reports and the contents of the data room are not generally disclosed. Whilst there is an additional cost to a US style policy, it can offer a practical solution where certainty, as opposed to just additional financial cover, is important to the insured – but deal teams will still need to sign no claims declarations, so anything that they are aware of having read through the reports will still prevent a claim.
- Around 13% of policies see a claim notification, typically in the first 6 months following completion and notifications are most commonly made in respect of alleged breaches of the financial statements, material contracts or compliance with laws warranties.

The public M&A perspective

Public M&A activity in 2018 remained broadly consistent, with 45 completed bids, compared to 43 in the previous year. The average deal size was larger, with 16 bids having a value in excess of £1bn (compared to 12 the previous year). TMT and Financial Services were the most popular sectors, accounting for approximately half of these bids.

30% of all bids had a private equity element, and this bolstered the number of offers which were entirely in cash (76%) and 93% of all bids contained an element of cash, as all-share deals became less popular than they have been in recent years. This is indicative of a decline in UK-based offerors who in recent years have generally preferred to carry out all-share M&A in the search for synergies rather than pay knockout cash premia. As a consequence in 2018, over three-quarters of all bidders were domiciled overseas, and approximately 40% were based in the USA, taking advantage of a strong dollar. We see the trend for US-led private equity interest in public M&A continuing, but there are some signs of UK sponsor activity increasing in 2019. While the larger deals attract the headlines, we anticipate continued deal flow in the mid-market – where comparatively lower liquidity among potential target companies means share prices are less susceptible to Brexit-related exchange rate movements.

Offerors use schemes of arrangement as the structure of choice for implementing takeover offers, being used in 76% of all deals in 2018. Two offers in 2018 switched from a scheme to an offer in light of competition or opposition to the initial bid. 'Switching' has been relatively uncommon to date but such a high proportion of offers now being carried out by scheme, together with a rise in shareholder activism, suggests that more offerors may well switch in the future to counter opposition to a bid. The Panel will allow a switch, provided the revised deal is no less deliverable, but it will be keen to ensure the offeree company does not remain under siege for longer than is necessary.

During 2018, the Addleshaw Goddard team advised on a host of high value and complex takeovers transactions, including:

9 *Takeovers*

9 completed takeover transactions. This means we acted on 20% of all UK takeover transactions completed during 2018

More than **30%**

more than 30% of all public takeovers of AIM companies completed during 2018

Largest AIM takeover

the largest takeover of an AIM-quoted company made during 2018 (the £641 million hostile bid for Faroe Petroleum by DNO)

4 *of the* **7** *Largest AIM takeovers*

4 of the 7 largest AIM takeovers completed during 2018 (the takeovers of Sinclair Pharma, Harvey Nash, Artilium and Produce Investments)

Switch to offer

one of only four takeover bids ever to have successfully switched from a scheme to a contractual offer during the offer period (the £99 million hostile bid for AIM-quoted Harvey Nash by funds managed by DBAY Advisors)

Unrivalled experience

Our team includes 4 ex-Takeover Panel secondees – more than any other law firm

30%

of bids with a private equity element

76%

of offers entirely in cash

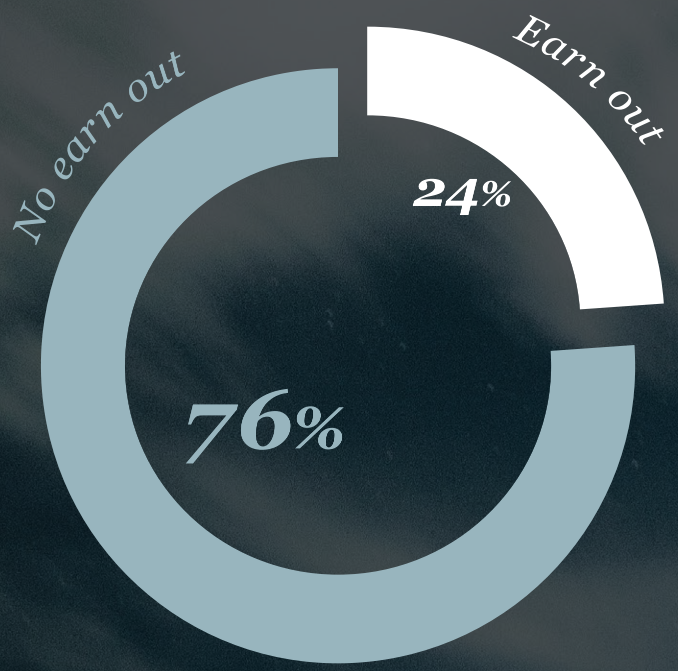
3/4

of bidders domiciled overseas

30% of all bids had a private equity element, and this bolstered the number of offers which were entirely in cash (76%) and 93% of all bids contained an element of cash, as all-share deals became less popular than they have been in recent years.

What could possibly go wrong?

We have seen an increase in the number of deals containing earn outs (2018: 29%; 2017: 19%). Earn outs are typically more common on bolt-on transactions, to bridge any valuation gap between the buyer and sellers, but can be used in transactions where the business is very people-focussed / critical (such as insurance brokering businesses). Whilst buyers and sellers might enter into M&A deals with clear goals in mind and carefully crafted strategic plans for how they will develop the acquired business (in the case of the buyer) or reinvest the sale proceeds into other ventures (in the case of the seller), how often are those plans fully realised in practice and what are the areas where things can easily go wrong? Aside from the risk of warranty claims, which tend to arise primarily due to alleged breaches of the accounting or finance warranties, what other aspects of M&A can give rise to issues post completion and potentially lead to protracted disputes and litigation?



Earn outs

- From our experience, earn outs can be a fertile ground for disputes unless careful thought is given to how the relevant earn out metrics will be calculated and how the business will be operated during the earn out period. There is an inevitable tension between the buyer's desire (or potentially, depending on whether the business is in a regulated sector, regulatory requirements) to integrate the acquired business and thereby change certain practices that existed pre-completion, and the common belief amongst sellers that the best way to meet the earn out targets is not to interfere in the running of the business for the duration of the earn out period.
- Whilst some tension between the buyer's and the seller's interests is inevitable, the risk of this resulting in disputes can be mitigated by giving careful thought when negotiating the earn out to what integration is expected to involve in practice. For example, where a smaller business is acquired by a large group it may well be that the process for taking on board new clients or pitching for new business is more protracted and burdensome than the seller is used to. Will this jeopardise delivery of growth projections, and can it be managed in any way in the earn out mechanics?

Regulatory risks

- Another theme that carried over into 2018 from previous years was the need for regulatory approvals, an area that we still see overlooked by buyers, sellers and their advisers. The change of control process that must be completed where a target business has an FCA authorisation can result in frustrating delays to a transaction timetable if the issue is not identified and planned for at an early stage; this is another issue that sellers and all of their advisers should be alive to from the very earliest stages of planning for a sale.
- There were also plenty of cautionary tales regarding merger control and competition law more generally in 2018, including buyers being fined for breaching initial enforcement orders imposed by the CMA whilst they investigate the potential impact on competition of completed transactions and even the notable case of a buyer being ordered to dispose of the acquired business.

Technology is at the core of the buyer's integration of the target to its existing businesses. Buyers need to know what its existing businesses can do for target and what if any technology and dedicated technology services and products will form part of the sale, to plan for the integration.

IT Transition Risks

- Technology issues in M&A transactions have received a lot of press following the failure last year of TSB's project to migrate its customers from one IT platform to another, after Lloyds sold TSB to Sabadell. This incident has highlighted how damaging technology issues can be to a company's reputation and the importance of allocating sufficient time and resources in M&A transactions to technology, and whilst it is perhaps the most extreme example given the nature of the business and information involved, technology issues can affect businesses of all shapes and sizes across all sectors.
- Technology is at the core of the buyer's integration of the target to its existing businesses. Buyers need to know what its existing businesses can do for target and what if any technology and dedicated technology services and products will form part of the sale, to plan for the integration. Focussed due diligence in this area is key to identifying gaps in service provision and contract issues. If there is bespoke technology, with knowledge held by key personnel, their retention or access to them prior to and post-sale could be extremely important.
- These issues are not the sole concern of the buyer though. In the majority of M&A transactions involving the sale of a business out of a corporate group, the seller will provide services to the buyer/target for a transitional period. The seller will often need to use third party IT products to provide these services and the buyer/target may also need continued access to the seller's IT systems. In providing these services and access, the seller could be in breach of its third party contracts with IT providers and, because software is often protected by copyright and a breach of copyright is a criminal offence, could be breaking the law if it knows or had reason to believe that copyright would be infringed. Allowing time to get appropriate consents in place and the negotiation of a TSA is more important than ever.
- For both parties sufficient time and resource needs to be given at the outset to identify the relevant IT systems required to provide the services and how the parties will transition from those services to the buyer's replacement IT systems. Most issues arise at this stage due to poor planning and insufficient time to allow for dress rehearsals or phased migrations and rigorous testing. Migration of data is a key factor, particularly in the retail and consumer and financial services sectors, and specific planning and processes will need to be in place to guard against loss or corruption of data during migration. The buyer's key risk is ensuring that the exit from transitional services to the alternative provision that it puts in place for the target, is dealt with efficiently and without interruption to its own and the target's ongoing business.
- When a company or part of a business is sold out of a larger group, the seller may have contracts with IT suppliers that require amendment post sale, for example if a contract contains volume licensing commitments, these may not be achievable post sale. The seller should review its contracts with IT suppliers, particularly software licences, to identify any such issues and seek to address those with its third party suppliers. It may be possible to divide scope and volume agreements between existing and new agreements, if the buyer/target requires the same IT service/product post completion/transition.

In this section we delve deeper into our deal data to look at market practice in relation to key debt and equity terms and tax structuring considerations on private equity transactions and how the position has changed since 2017.

3 | VIEW FROM THE DEBT MARKETS

FINANCING

In 2018 the debt markets were confident and liquid continuing the trends of the last few years. Private equity was able to avail itself of that liquidity and a highly competitive market in order to gain continued favourable terms from both banks and direct lenders. Key aspects of structures and documentary terms in the mid-market are set out here.

First Out / Super Senior Structures

Banks showed a willingness to enter into 1st out 2nd out structures with direct lending funds. We suspect that this trend will continue as banks become increasingly confident in the legal protections for this product. As a result sponsors can access these structures to help drive a blended cost saving on debt packages and to keep relationship banks involved.

Similar to first out structures, super senior revolving facilities remain a prevalent facet of the market. We have seen some key protections (particularly around significant disposal thresholds and a right to repayment on a change of control) come under some pressure this year from sponsors and debt funds alike, but on the whole these terms are well settled and known to the market.

A number of private equity transactions with debt structures including super senior facilities have been through work outs in 2018 and in our experience the legal protections given to those super senior lenders have been proven to work. That should give bank lenders the confidence that their first out/super senior position is protected and the debt funds confidence that they control the enforcement processes.

Debt funds and behaviour at times of stress

Through 2018 we saw direct lenders continue to sustain market share and presence. Direct lenders now hold a market share of around 50% in the UK mid-market, which has resulted in a wider awareness and acceptance of the product with many mid-market private equity houses now using it in addition to or as a replacement for their traditional relationship banks. The direct lending product is now mature and as a consequence has seen its share of stressed and distressed private equity assets.

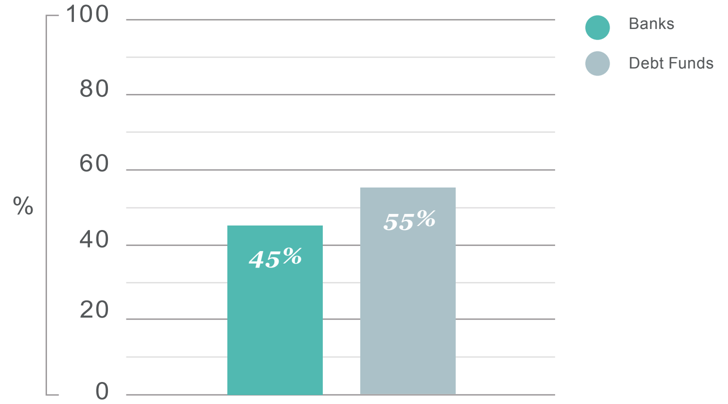
When direct lenders first started providing facilities for buy-outs many market participants (including sponsors) worried how the direct lenders would behave in times of stress and distress. In our experience direct lenders have proven themselves pragmatic and sensible in work out scenarios. We have seen them be supportive of turnaround plans and patient with sponsor investee companies. Fears that defaults would be used to acquire equity have been shown to be unfounded as a general trend. It is for that reason and the continued flexibility of the debt product that we expect to see market share continue to grow for direct lenders.

Through 2018 we saw direct lenders continue to sustain market share and presence. Direct lenders now hold a market share of around 50% in the UK mid-market.

Banks

Through 2018 some bank lenders continued to be significant market players, with HSBC in particular continuing to support strongly private equity, and Santander taking market share from others who have shown less appetite. We have seen banks show larger hold appetites which has been driven by mid-market syndication desks, partnerships with pension funds and asset managers (Santander and Aviva, Lloyds and Aimco and the longer standing RBS arrangements with M&G, Hermes and AIG). Banks will continue to play an important role in private equity transactions, but a portion of them will need to convince credit committees to accept some of the current market terms or patiently wait for some market adjustments.

MARKET SHARE: DEALS GREATER THAN £100M



Documentation

As competition for mandates continued throughout 2018, documentary terms continued to be favourable if not relatively settled.

2018 saw sponsors gain more operational flexibility for investee companies through basket adjustments being linked to EBITDA growth and on permitted acquisitions. The controls around those adjustments are becoming less strict with adjustments now operating at least annually and no longer being linked to the annual audit. Carry forward and carry back on baskets are now a well established feature of the mid-market.

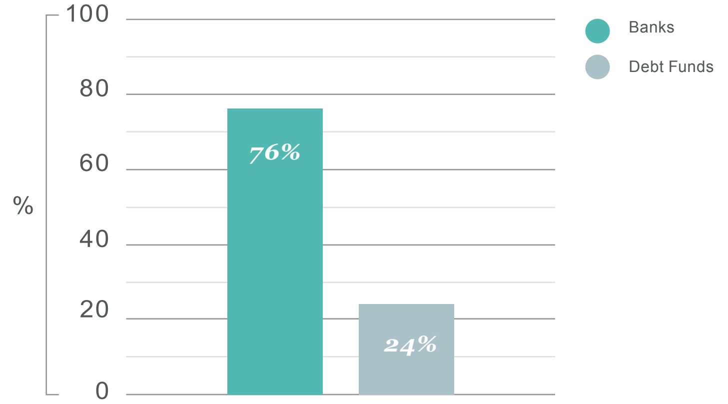
Continuing the trend of operational flexibility we are also seeing permitted acquisition controls loosen with financial caps being removed and DD requirements for lenders being weakened.

Adjustments to EBITDA have become increasingly favourable to sponsors. In particular we see sponsors successfully argue for synergies that arise not just on acquisitions, but disposals, group reorganisations and cost saving initiatives. The threshold for external due diligence on synergies has moved upwards from a historic base of between 5%-10% and the absolute caps on how large an adjustment one can obtain by synergies (whilst often deal specific) is no longer at 10% and we have seen as high as 25%.

Deemed cure became (mid) market standard in 2018 (with its exercise counting as one of the exercises of the equity cure) and EBITDA cures started to be seen (although usually for businesses with an EBITDA greater than £10m and even then with restrictions).

Mid-market debt packages can still expect to see financial covenants (usually leverage only for direct lenders and cash cover and leverage for banks). Cov-lite remains the preserve of the large cap market.

MARKET SHARE: DEALS LESS THAN £100M



The outlook

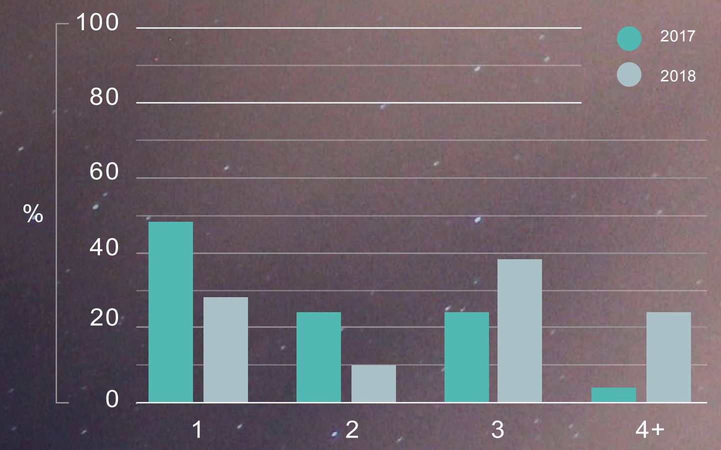
Given deal activity in late 2018 it is fair to say that the debt markets had only half an eye on Brexit. As a consequence of the political and economic uncertainty we anticipate some tightening of terms from lenders' credit and investment committees through 2019. That being said, we remain confident that when the political picture is clearer, asset prices will be able to be agreed and transactional volumes will pick up after any hiatus.

4 | TAX AND STRUCTURING

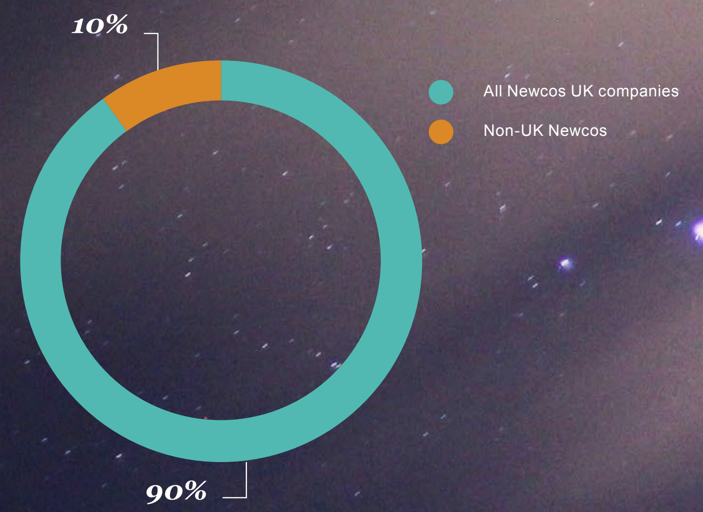
Tax structuring

- Multiple newco structures have become more popular over the past year. This dovetails with the more "normal" levels of bank debt that are shown in the Financing section of this report and reflect the comments in the Equity Terms section regarding investor's loan notes ranking ahead of management loan notes. From a tax perspective only, as tax deductions for interest payments become harder to achieve, multiple newcos are likely to be less important for that reason – although structural subordination for debt ranking purposes nevertheless can remain a driver.
- Unsurprisingly, for this market, UK newcos remain the most popular structure, and the default choice. However, we are seeing a slight trend towards investors looking at Luxembourg or Jersey newcos, even for domestic transactions, where this suits tax requirements for underlying investors or is driven by other factors (e.g. EU regulatory capital requirements).
- Whilst loan notes remain the most popular investor instrument, for tax purposes their advantages are becoming less apparent as a result of the new constraints on interest deductibility, the need to manage withholding tax requirements for some recipients, and interest being subject to tax at the top income tax rates. Preference shares (although not without disadvantages, in particular when looking at the "ordinary share capital" test for entrepreneurs' relief) remain the instrument of choice for US PE investors and are often sought by management rolling significant value into the buyer's structure. Subject to the precise structuring of the preference share terms, their use can also strengthen the balance sheet of a group (in contrast to loan notes). 2018 saw an increase in transactions involving investors holding both preference shares and loan notes, up to 20% from 15% in 2017.

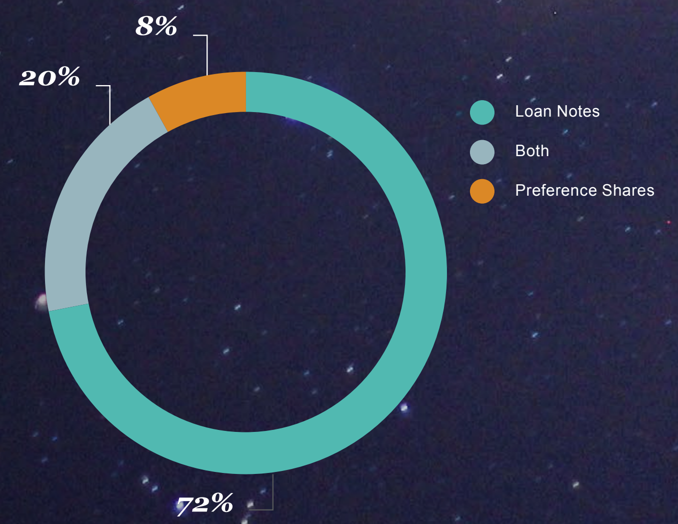
NO. OF NEWCOS IN THE STRUCTURE



JURISDICTION OF NEWCOS



INVESTOR INSTRUMENTS



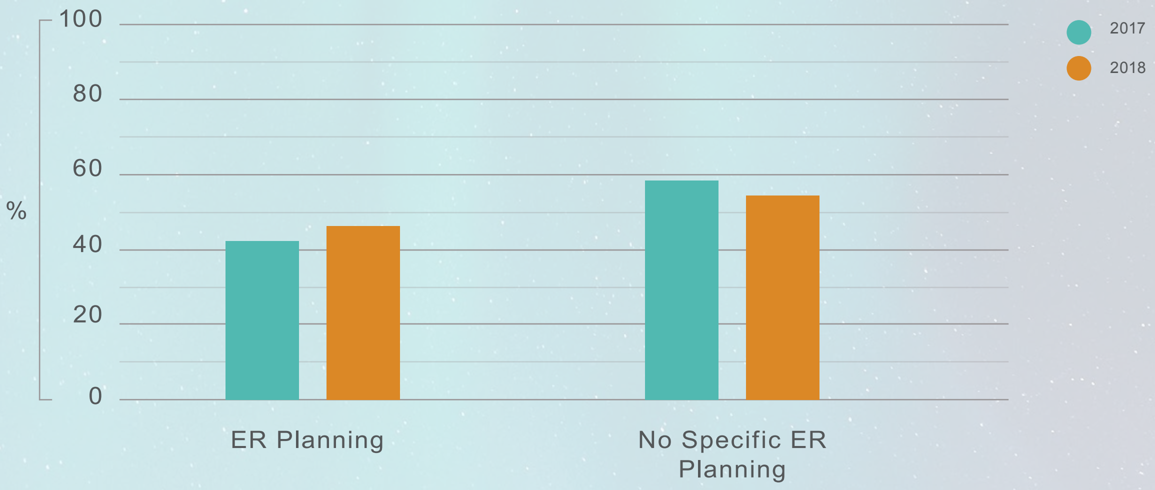
Management incentivisation

- In 2018 entrepreneurs' relief (ER) continued to be a key incentivisation tool for management. However, meeting the qualification requirements for ER is becoming harder – after DOTAS, advisers began to take a more cautious view as to acceptable levels of ER planning, and the Finance Act 2019 changes will make ER even harder to qualify for. As such, we may see a reduction in the number of managers who are able to benefit from ER on each deal with ER limited to certain key members of management, rather than a wider management team. Nevertheless, the benefits of ER mean we expect ER structuring to at least be part of the conversation on most transactions – with management seeking certain rights to ensure qualification for ER. As the Finance Act 2019 changes affect existing shareholdings we may begin to see management asking for ER advice to be "refreshed" in respect of their current shareholdings. For those members of management who wouldn't qualify for ER on a share subscription, the use of EMI options (where possible) may become more popular – EMI options may deliver ER for managers in circumstances where a straight share issue would not.
- IR35 changes (coming into force in April 2020) may affect an investee company's current personal service company (PSC) arrangements – we are starting to see some companies re-evaluating their use of PSCs for individual contractors as a result of these changes.

Tax cover in transactions

- As previously noted, W&I insurance continues to be popular in the market. From a tax perspective W&I insurance has, historically, been a "blunt tool" offering (in practice) little cover to a buyer in respect of known issues. However, as the W&I insurance market has become more competitive we have started to see more advanced tax specific W&I insurance products which take a less rigid approach to areas of tax which are automatically excluded from cover.

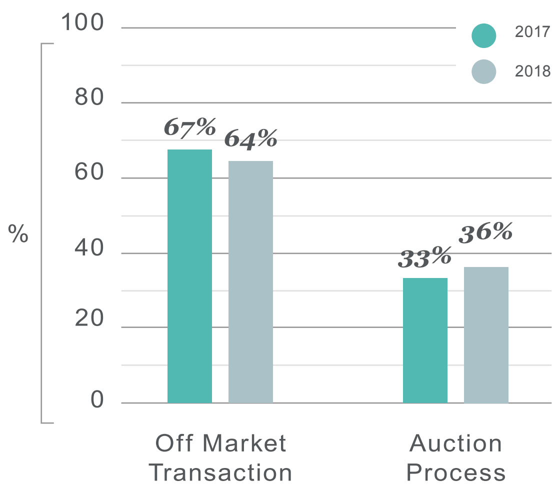
ER PLANNING

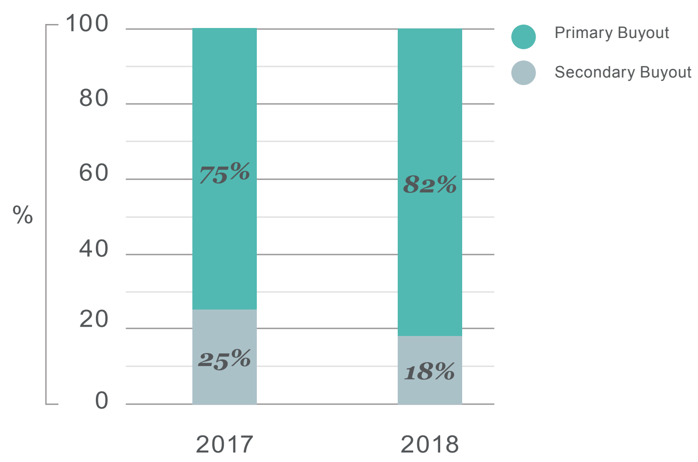


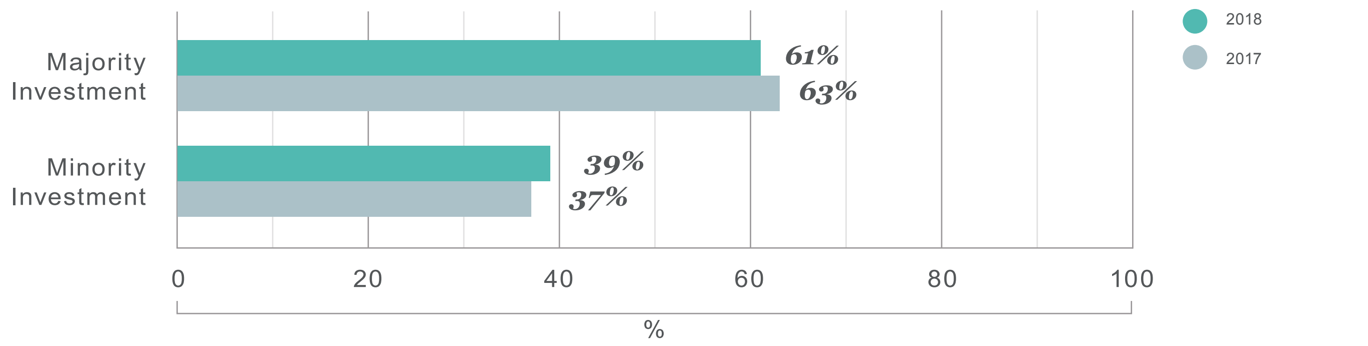
5 | EQUITY TERMS

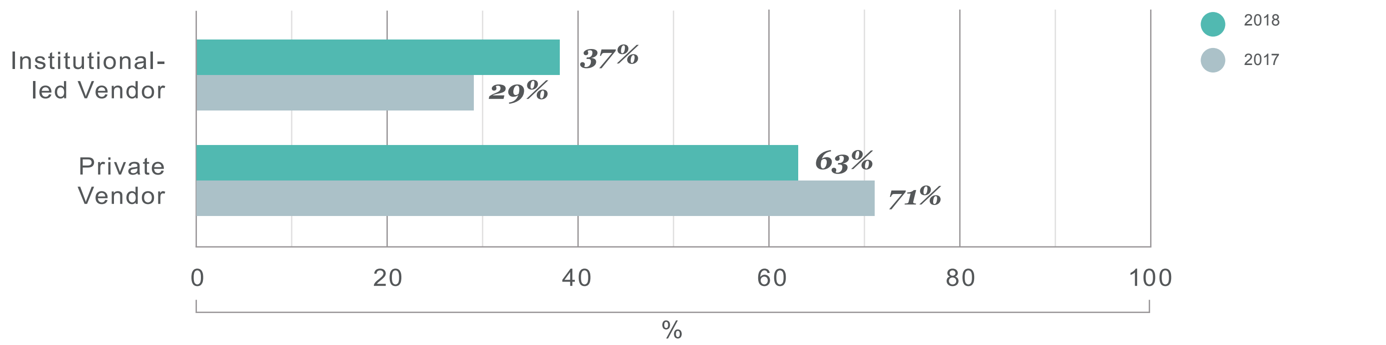
TYPE OF INVESTMENT – OUR SAMPLE

- Continuing on from the position in 2017, we have seen an increase in the number of minority investments (from 37% to 39%) reflecting, in part, the greater number of private equity funds which have been set up with a focus on or flexibility to deliver minority investments.
- Similar to the results from the previous 12 month period, we have seen higher levels of off market transactions than perhaps we might have expected. This may be a sign of investors working harder to pre-empt processes (and to find deals off market through their origination teams) given the high level of competition in auction processes and therefore a much lower success rate when participating in those processes.
- Less competitive processes are also likely to be a feature on lower mid market transactions and the fact that 82% of the private equity investments we saw were primary deals may be another reason for the higher than expected off-market transactions.



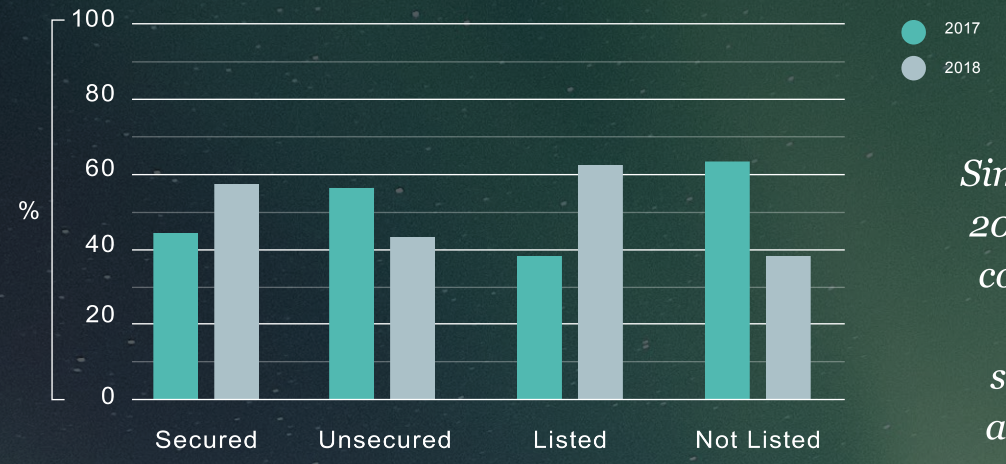


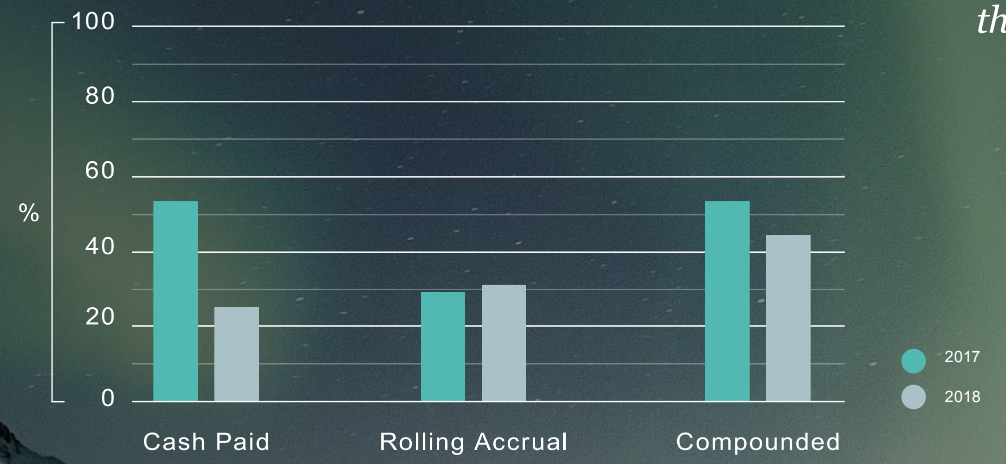




LOAN NOTE AND PREFERENCE SHARE RIGHTS

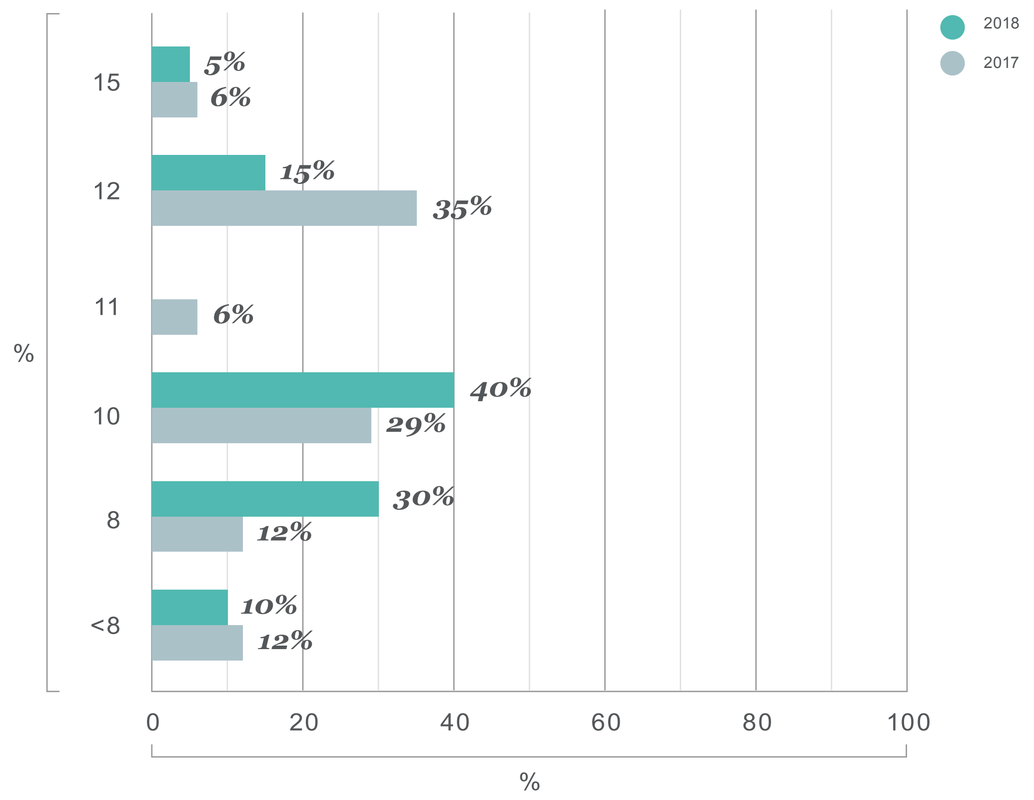
- We have seen an increase in loan notes being secured (enabling them to rank ahead of ordinary creditors in a downside scenario) and a greater number of deals with investor loan notes being listed (usually on TISE) to secure favourable tax benefits. Often, these decisions are specifically fund-driven.
- Similar to the results in 2017, typical loan note coupons are between 8% and 12%, with some outliers above and below, and with coupon accruing and compounding rather than being cash paid.
- The slight increase in the number of transactions where investor loan notes rank ahead of manager notes reflects a shift in approach from certain investors, who have offered a higher price but with investor debt ranking ahead of management.
- We have also seen funds that have adopted an integrated preferred share model where they will expect a prior ranking loan note or share with a minimum redemption return, but with a quid pro quo that management's shareholding (and therefore potential upside) is greater than would be the case on a more typical PE deal. This is principally a US model but we have seen UK funds explore this to make their proposals more competitive.



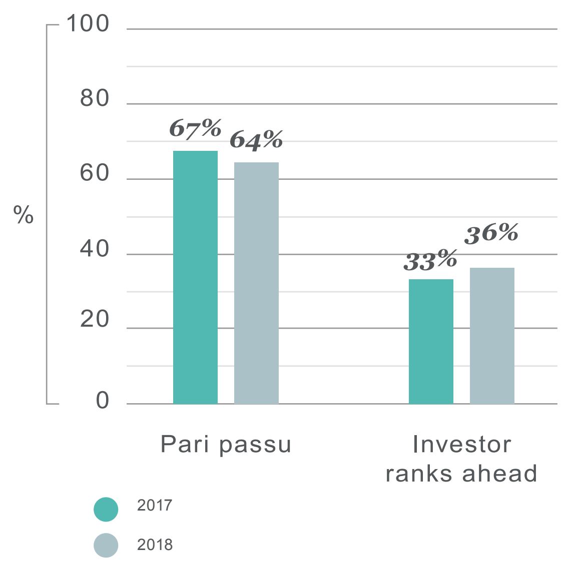


Similar to the results in 2017, typical loan note coupons are between 8% and 12%, with some outliers above and below, and with coupon accruing and compounding rather than being cash paid.

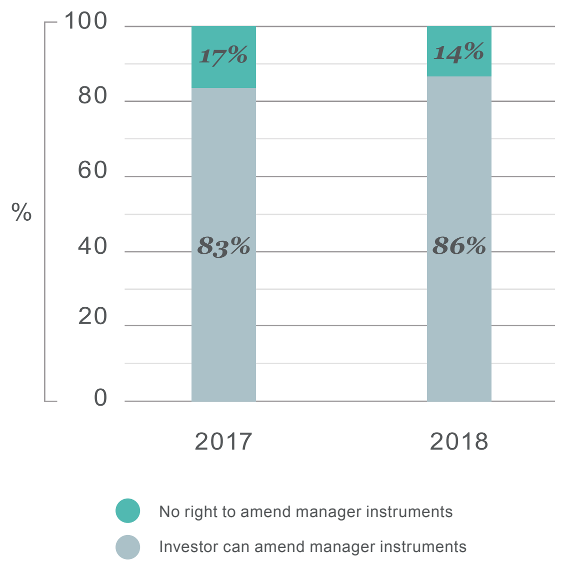
LOAN NOTE COUPON



LOAN NOTE RANKING



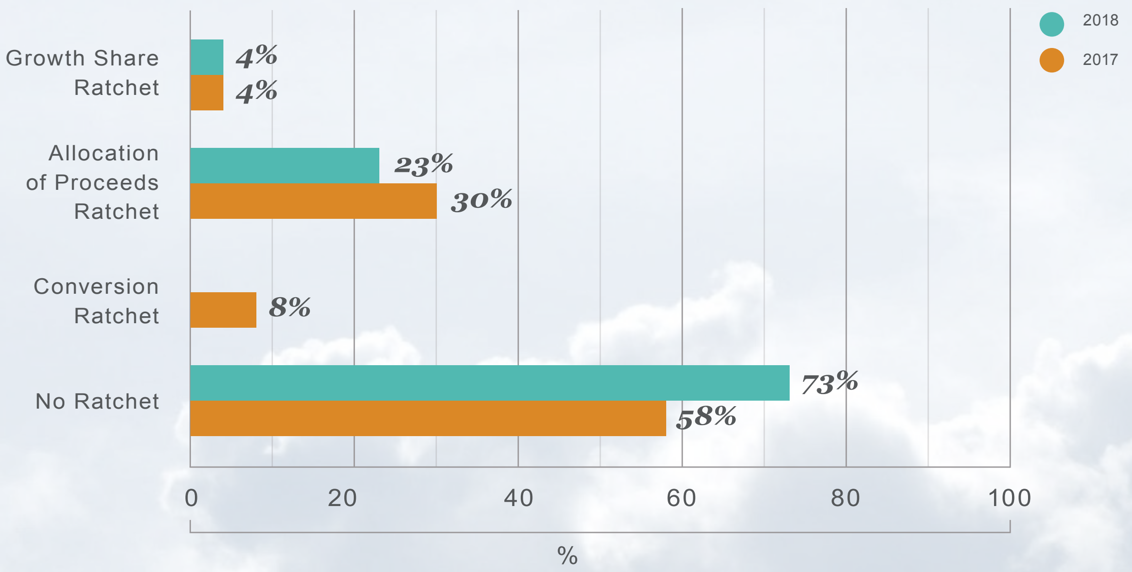
AMENDMENTS



ECONOMIC RIGHTS

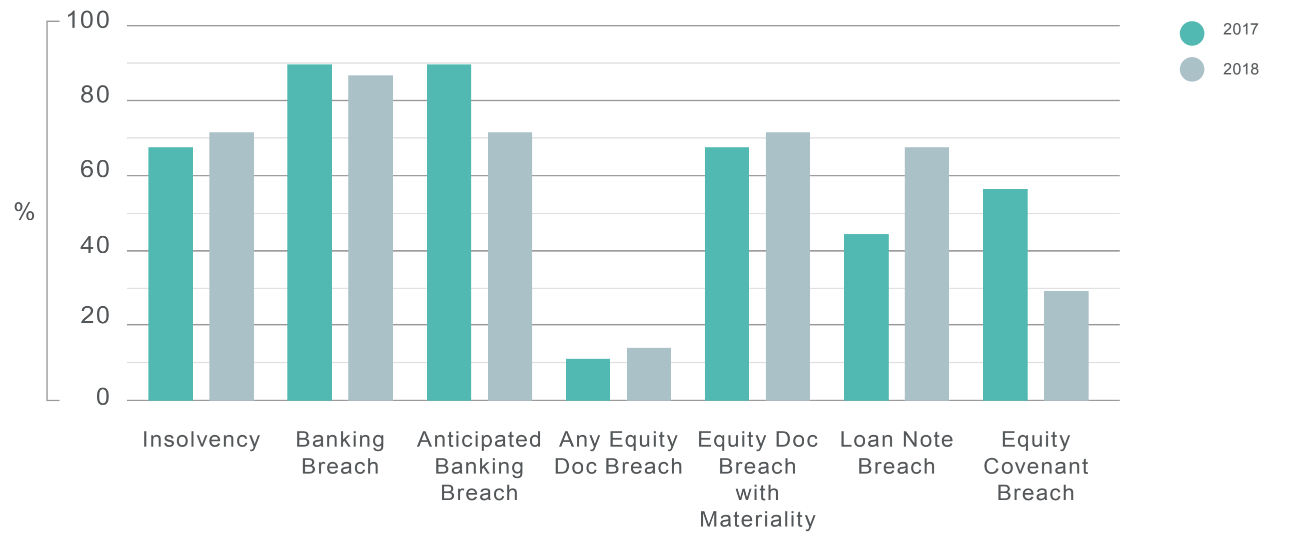
- Our results show that there have been even fewer deals in 2018 with ratchets than in 2017. Again, where a deal does contain a ratchet, the most common way of structuring this is though a simple allocation of proceeds on exit above certain agreed hurdles. The continued problem with ratchets is their complexity from a drafting point of view (often leading to subsequent disputes between the investor and management on their interpretation which can be a significant distraction on exit) and ensuring they work from a tax perspective.

- Whilst it remains unusual to see specific dividend rights outside of those that apply to any preference shares in the structure (in order to mirror a loan note coupon), we did see a small number of deals employing a participating dividend in favour of the investor, but which only applies if an exit has not been achieved within an agreed timeframe. These participating dividends were generally limited to growth capital investments (particularly where the investor is in the minority), as a tool to incentivise management and the company to deliver an exit and where the investor may not have drag rights to force the issue.

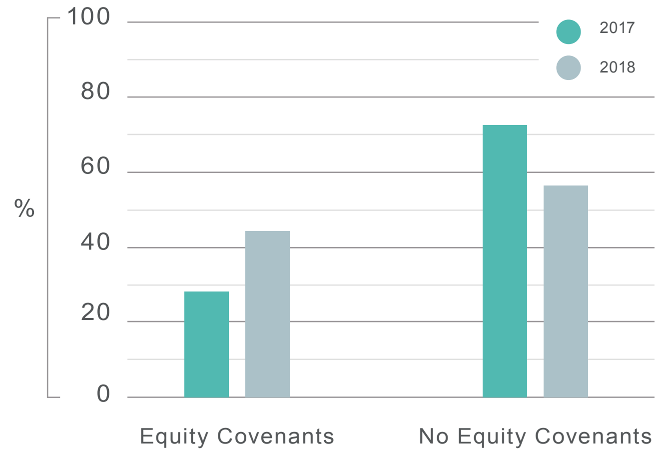


UNDERPERFORMANCE EVENTS AND SWAMPING

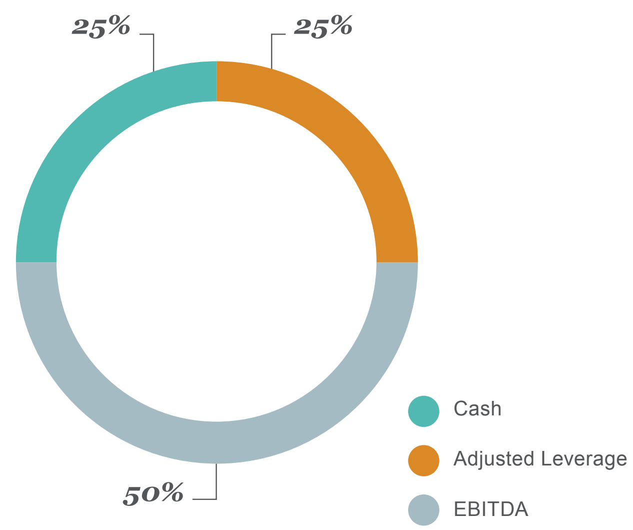
- The position on underperformance trigger events is very similar to the previous 12 month period and is largely as we would have expected. The aim for a private equity investor should always be to ensure the swamping triggers are as clear cut as possible (with no subjectivity) otherwise the exercise of swamping rights can be subject to challenge.



DEALS INCLUDING EQUITY COVENANTS



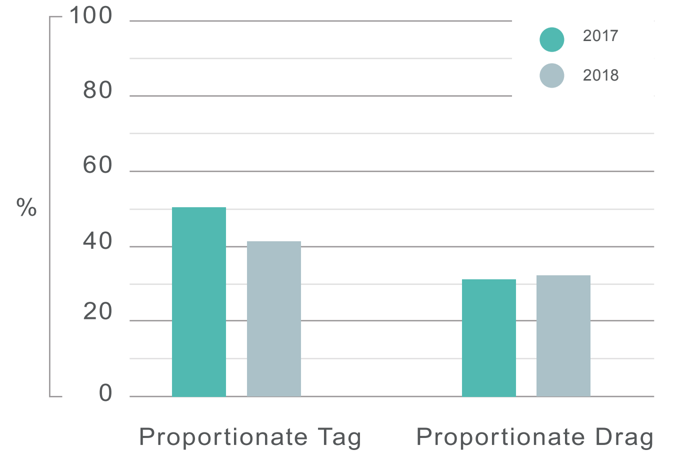
COMPONENTS OF EQUITY COVENANTS

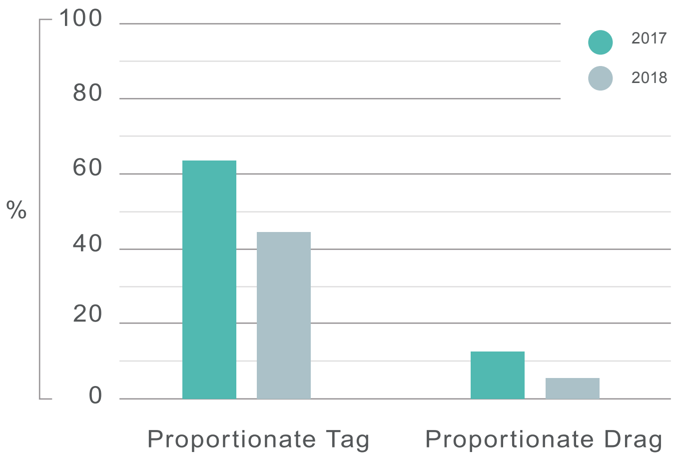


- The fact that equity covenants were not included on a majority of deals may appear surprising, but in such deals investors would typically look to rely on there being an anticipated banking breach as a means to trigger swamping rights and protect their investment.
As with the previous year's results, EBITDA is the most frequently tested equity covenant but often the equity covenant tests will, where there is bank debt, follow those set out in the Facilities Agreement but set to "trip" earlier than the bank covenants.

SHARE TRANSFERS

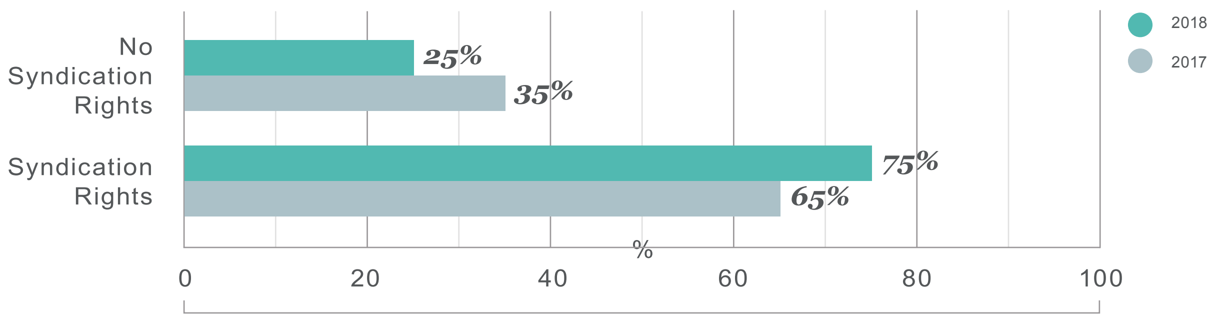
- We have seen a slight reduction in syndication rights on 2018 transactions versus 2017 transactions. Different investors have different requirements when it comes to syndication and many investors in any event choose not to syndicate. From a management perspective though, syndication can be an emotive issue as they want to partner with the investor they have selected to work with and not another. A compromise is to ensure the original investor remains the majority investor and controls all the investor rights.





Syndication can be an emotive topic for management as they have selected an investor they want to work with over other investors

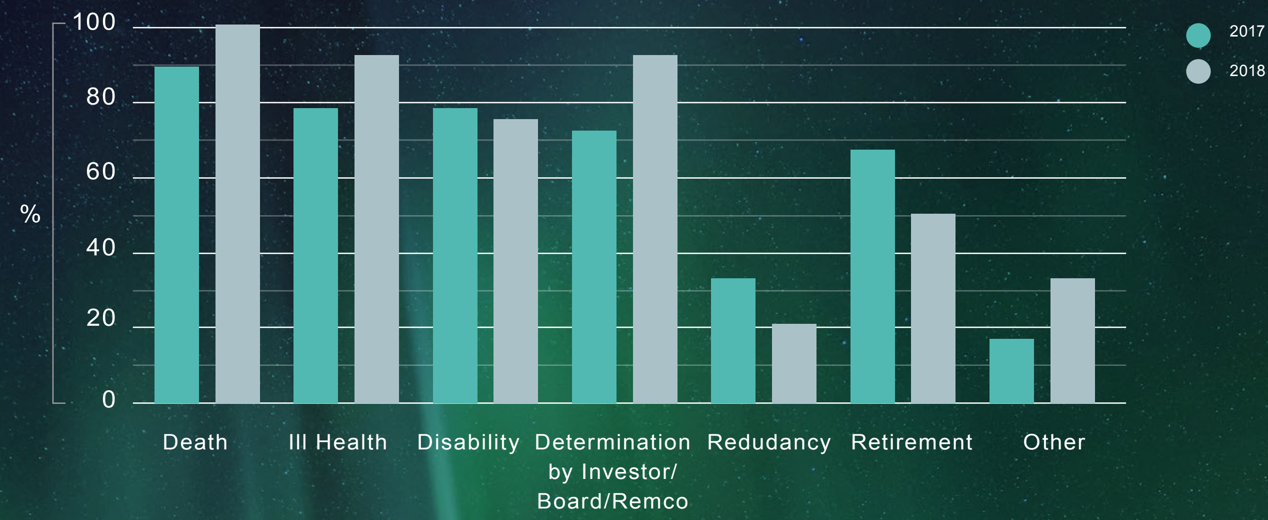
COMPONENTS OF EQUITY COVENANTS



LEAVER PROVISIONS

- Leaver provisions have remained pretty consistent, as can be seen in the graph below again, reflecting the fact equity terms have not, as with acquisition terms, become less investor friendly.

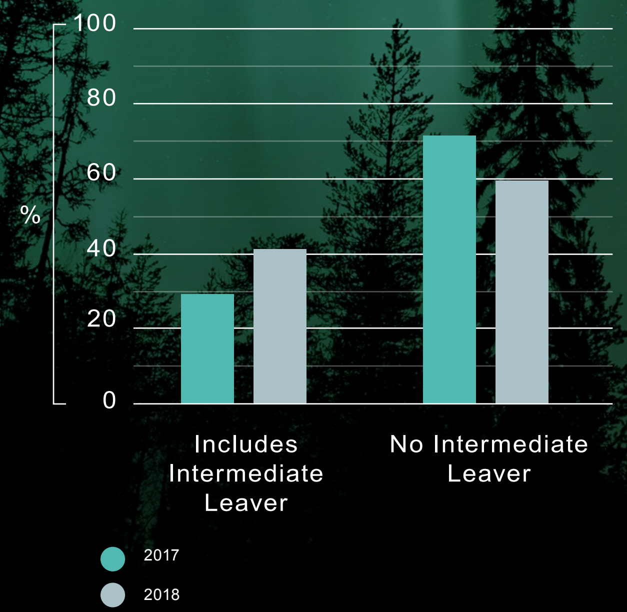
GOOD LEAVER REASONS



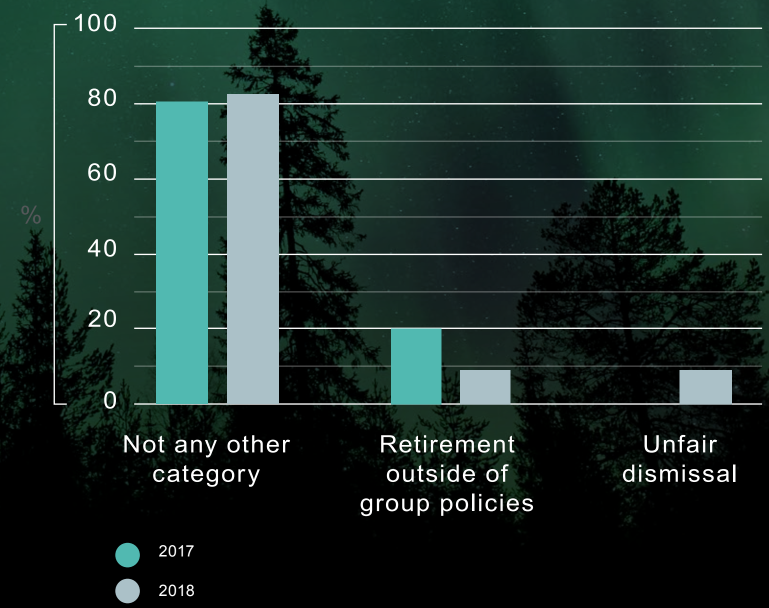
- The concept of intermediate leaver being seen on 40% of our 2018 deals is not unexpected, particularly for competitive auction sales. However, we are still seeing investors take a hard line in the majority of primary deals and requiring managers to rely on the discretionary upgrade of the Board or Remco (see chart).

We are also seeing greater use of a "very bad leaver" concept, particularly as regards "rolled equity", where this could lead to equity being offered up for sale and/ or loan note/preference share coupon being reduced/ eliminated.

CATEGORIES OF LEAVER

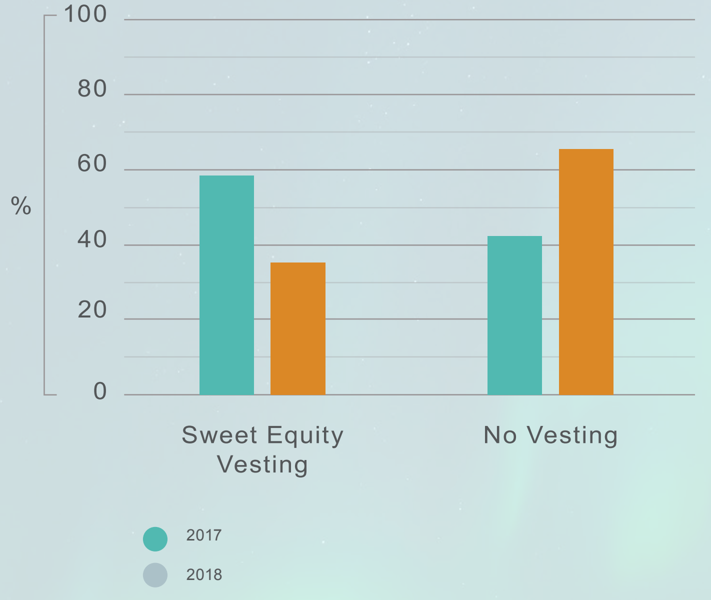


INTERMEDIATE LEAVER DEFINITION



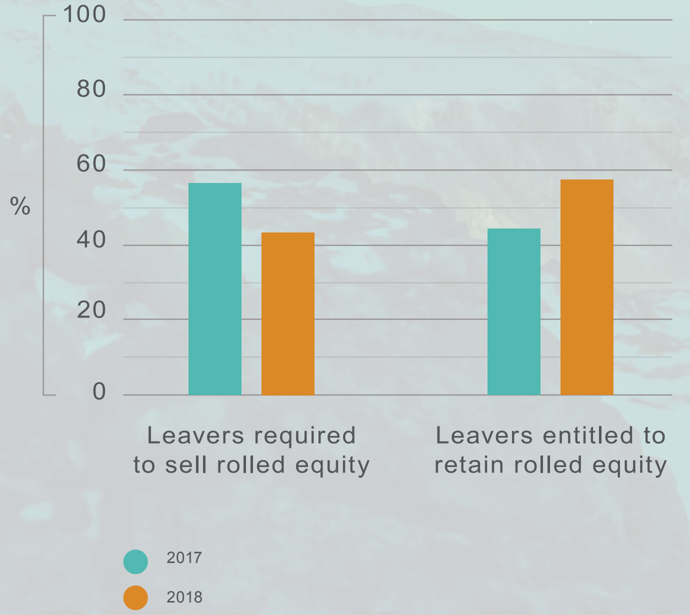
- We noted in last year's report that there was no established market norm as to the treatment of rollover equity on an exit; something which is supported by the reversal of the position we saw last year. It remains to be seen whether this represents a genuine shift in favour of leavers here – our expectation is that this may not be the case, and that in fact investors are looking for clawback of rollover equity (for Bad Leavers at least) more often.

VESTING

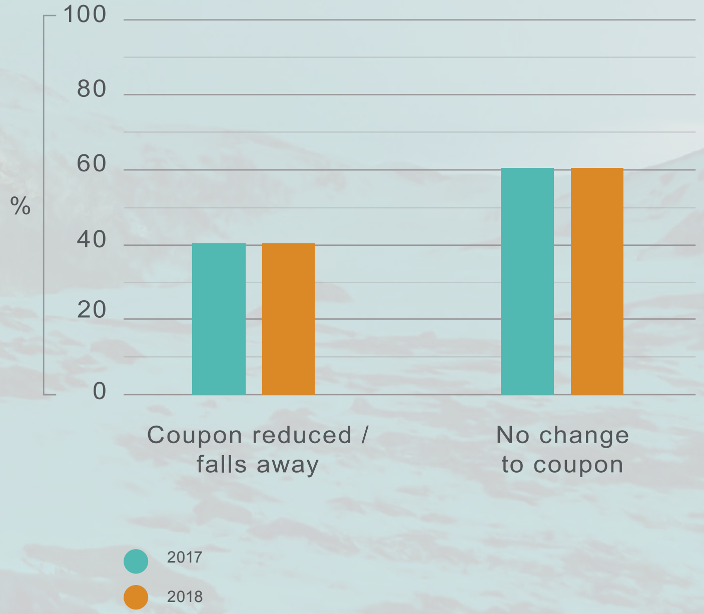


- As was the case in 2017, investors had the right either to reduce or turn off the coupon on a leaver's retained equity instruments on 40% of deals. The treatment of the retained equity was largely dependent upon the classification of the leaver, with the tendency being – as one would expect – that the coupon on equity instruments retained by bad or very bad leavers falls away entirely whereas the coupon for intermediate or good leavers would be reduced or there would be no change.

TREATMENT OF ROLLED EQUITY



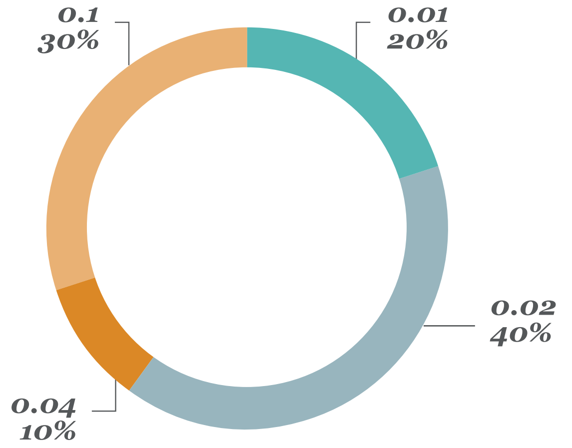
RETAINED ROLLED EQUITY



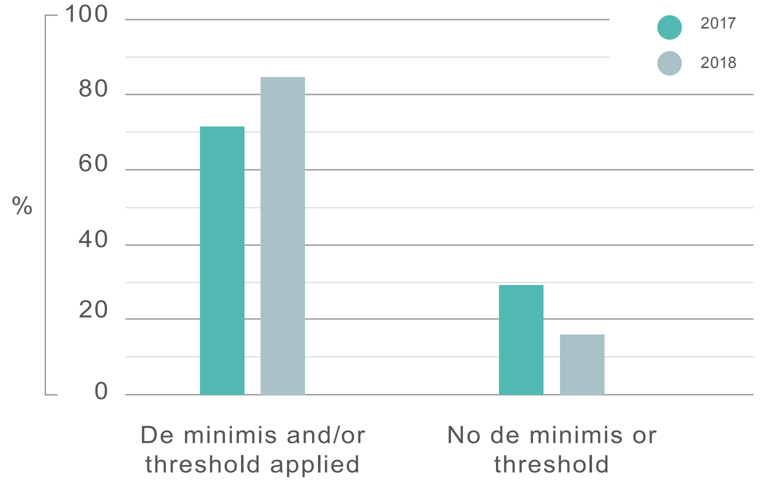
INVESTMENT WARRANTIES

- Liability caps for management in respect of the investment agreement warranties have increased a little when compared to our 2017 deals with 2x salary being the position in a small majority of our 2018 deals. This is as we would have expected.
- A number of private equity investors will also look to Newco / Midco / Bidco to provide warranties in the investment agreement, with the cap usually equal to the total amount of the investment made by the private equity investor.
- Whilst there has been a decline in the number of transactions with no de minimis or threshold, the amount of the threshold and de minimis are still typically low.

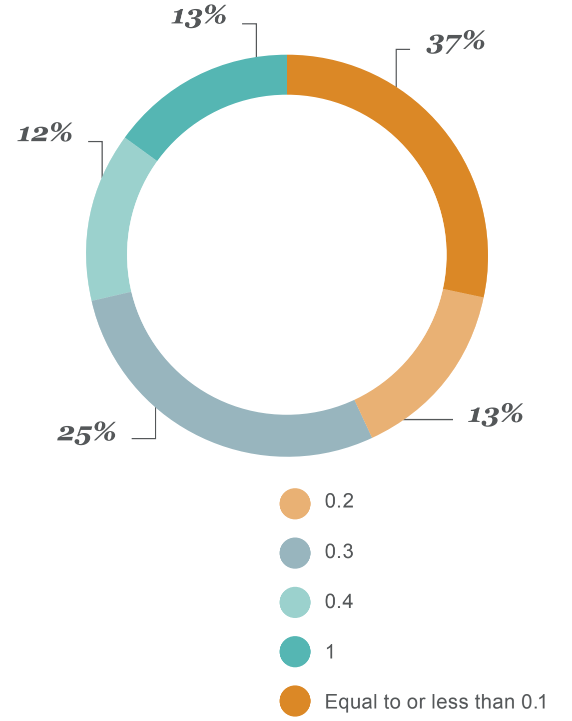
DE MINIMIS (AS % OF PURCHASE PRICE)



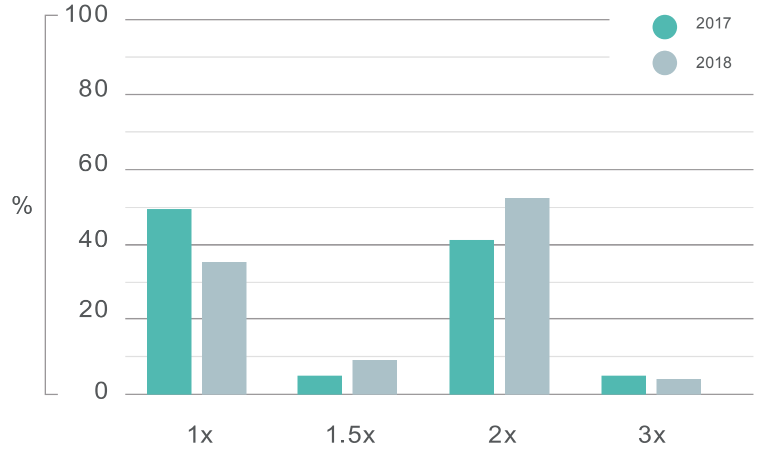
DE MINIMIS AND THRESHOLD



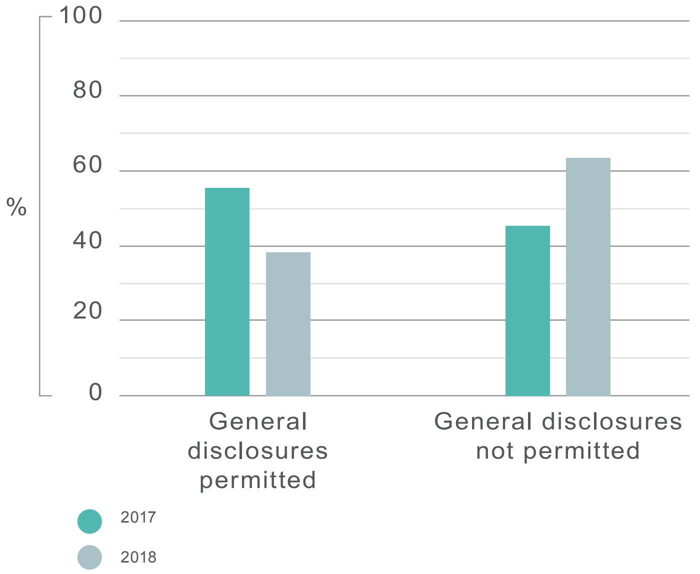
THRESHOLD (AS % OF PURCHASE PRICE)



LIABILITY CAP AS % OF ANNUAL SALARY



DISCLOSURE

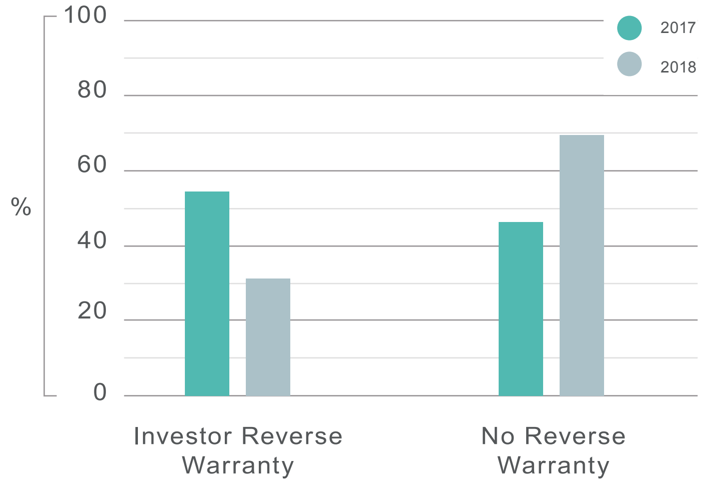


► We have seen a slight hardening in the position for general disclosure against investment agreement warranties. Given the more limited, yet important nature, of the investment agreement warranties, this is not an unreasonable stance for investors to take.

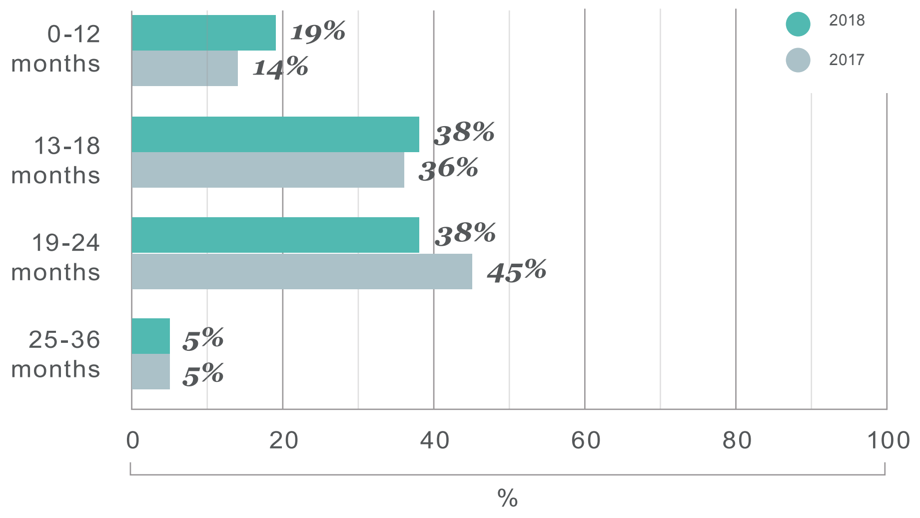
► Claim periods for investment agreement warranties have remained pretty constant with a period of 19 - 24 months being the most common. Often this will mirror the position in the SPA but not always – in our 2018 deals the time period was the same as the SPA 67% of the time, but lower than the SPA claim period in the remainder.

► Reverse warranties are given by the investors to confirm that they are not aware, at exchange or completion, of any matters that constitute a breach of any of the investment warranties. It is somewhat surprising that they were only seen on 31% of deals. However, in practice investors are likely to find it difficult to obtain anything other than nominal damages at court for a breach that they knew about before making their investments, which is perhaps why a specific reverse warranty was not sought by management on a majority of deals.

REVERSE WARRANTY



CLAIMS PERIOD

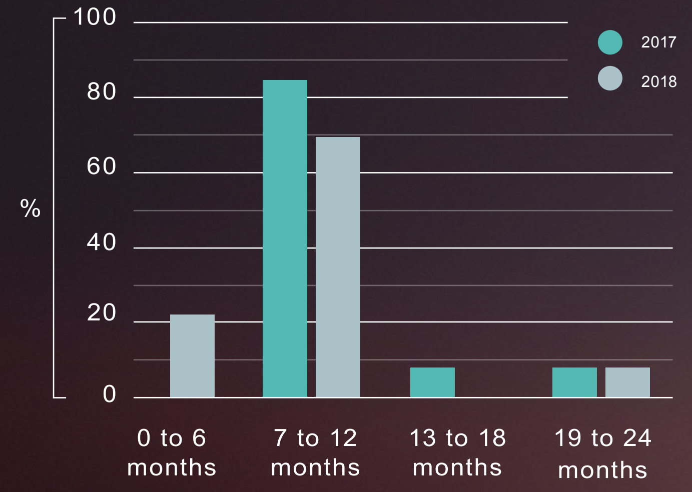


Whilst acquisition terms remain largely seller friendly, investors are continuing to hold the line as regards equity terms

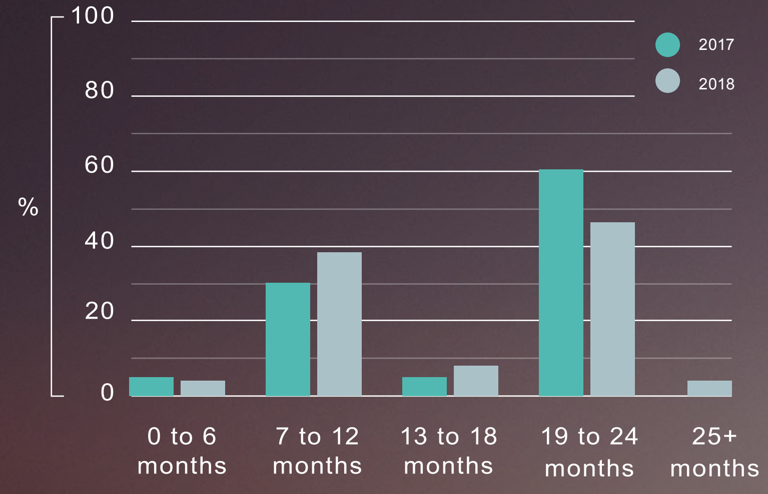
RESTRICTIVE COVENANTS

► For service agreements, restrictive covenants really should be no more than 12 months, otherwise there is a real risk around enforceability. Often the restrictive covenant period will match the notice period and we do see different covenant length periods being adopted for different members of team (as is the case for Investment Agreement restrictive covenants).

RESTRICTIVE COVENANT DURATION (SERVICE AGREEMENT)

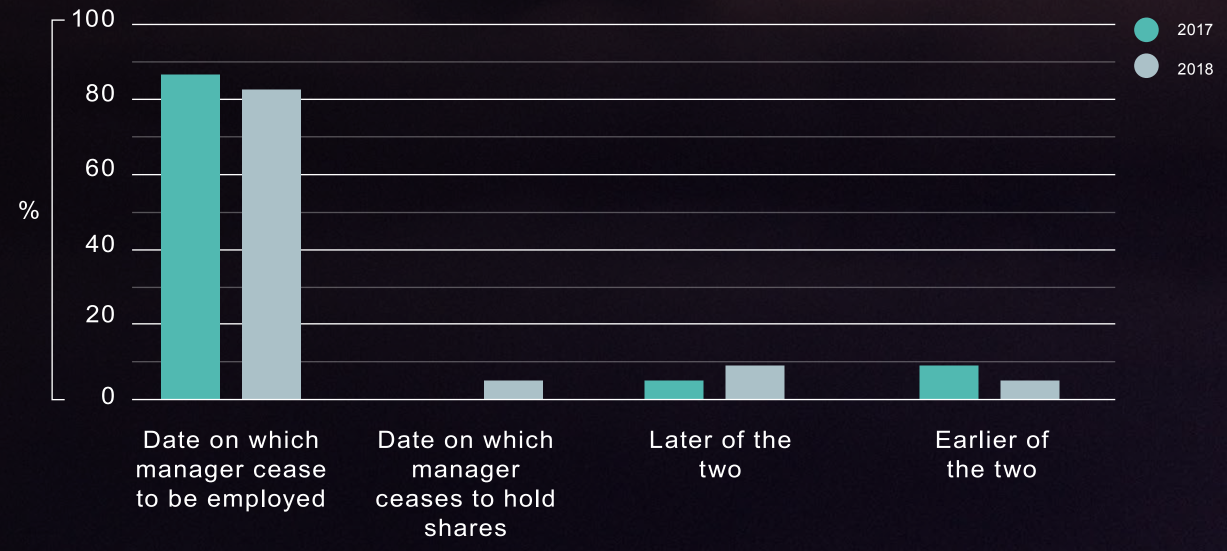


RESTRICTIVE COVENANT DURATION (INVESTMENT AGREEMENT)



► For restrictive covenants in the Investment Agreement, we have seen a slight reduction in the periods for our 2018 deals. Two years is probably the maximum period at which these types of covenants can with a degree of confidence be said to be enforceable. Often on competitive auction processes, management are asking for shorter periods (such as 12 months) or at least looking to have different periods for different members of the management team.

COMMENCEMENT DATE FOR RESTRICTIVE COVENANTS



About us

A selection of our 2018 Mid-Market Private Equity Transactions.

BUYOUT OF CHAMBERS AND PARTNERS BY INFLEXION

Advised Inflexion

ACQUISITION OF DAMOVO BY ELI GLOBAL

Advised Eli Global

INVESTMENT IN RIGHT CHOICE INSURANCE BY LDC

Advised LDC

BUYOUT OF MTHREE BY ECI PARTNERS

Advised ECI

SALE OF SEABROOK CRISPS BY LDC

Advised LDC

INVESTMENT IN ZEDRA GROUP BY CORSAIR CAPITAL

Advised management

INVESTMENT IN UKFAST BY INFLEXION

Advised Inflexion

BUYOUT OF PYROGUARD BY ESO CAPITAL

Advised management

MINORITY INVESTMENT IN HUWS GRAY BY INFLEXION

Advised shareholders

SALE OF CONCEPT LIFE SCIENCES

Advised Equistone and management

ACQUISITION OF RIBA ENTERPRISES BY LDC

Advised LDC

BUYOUT OF WHP TELECOMS BY EQUISTONE

Advised Equistone

INVESTMENT IN MOUNTAIN WAREHOUSE BY INFLEXION

Advised Inflexion

ACQUISITION OF ESTIO BY PALATINE

Advised Palatine

SALE OF KELLING GROUP BY ELYSIAN

Advised Elysian and management

SALE OF DEEP SEA ELECTRONICS TO CALEDONIA INVESTMENTS

Advised shareholders

SALE OF UK POWER RESERVE

Advised Equistone, Inflexion and management

ACQUISITIONS OF ARNOLD LAVER, REMBRAND TIMBER AND NY TIMBER

Advised Cairngorm Capital

SALE OF FIRST SCOTTISH GROUP TO ELI GLOBAL

Advised Souter Investments

SALE OF CLOSERSTILL GROUP

Advised shareholders

A selection of our 2018 Growth and Development Capital Transactions and our Leveraged Finance Transactions.

INVESTMENT IN HUTCHINSON NETWORKS BY YFM EQUITY PARTNERS

Advised YFM

INVESTMENT IN MISSION MARS BY BGF

Advised BGF

NUMEROUS FUNDING ROUNDS IN STARLING BANK

Advised investor

INVESTMENT IN RED SIXTY ONE BY PAR EQUITY

Advised Par

INVESTMENTS IN INNOVATE SERVICES AND CUCINA

Advised Bridges

IMPACT FOOD GROUP

INVESTMENT IN MOUNTAIN HEALTHCARE BY LITERACY CAPITAL

Advised Literacy Capital

INVESTMENT IN WALKER PRECISION ENGINEERING BY BGF

Advised BGF

INVESTMENT IN COLLECTIVWORKS BY PAR EQUITY

Advised Par Equity

INVESTMENT IN AISTEMOS BY PROVEN

Advised Aistemos

INVESTMENT IN DARTMOUTH PARTNERS BY LITERACY CAPITAL

Advised Literacy

INVESTMENT IN PRIMAL PANTRY BY NVM

Advised Primal Pantry

SALE OF BE AT ONE TO STONEGATE

Advised Piper Private Equity

SUPER SENIOR RCF FOR MML CAPITAL'S ACQUISITION OF A CYBER-SECURITY BUSINESS

Advised the lender

NEGOTIATION OF SUPER SENIOR FACILITIES, ALONGSIDE UNITRANCHE FACILITIES PROVIDED BY ARES CAPITAL MANAGEMENT, FOR THE ACQUISITION BY LYCEUM CAPITAL OF TIMICO TECHNOLOGY

ADVISING RBS AS SUPER SENIOR RCF LENDER IN RELATION TO THE SPONSOR BACKED ACQUISITION OF A CRUISE LINER COMPANY BY BRIDGEPOINT CAPITAL

ADVISING HSBC AND PEMBERTON ON FACILITIES FOR THE SECONDARY BUYOUT OF QUOTIENT CLINICAL BY GHO, ON A FULLY UNDERWRITTEN BASIS

NEGOTIATION OF UNITRANCHE AND REVOLVING CREDIT FACILITIES PROVIDED BY EUROPEAN CAPITAL AND CLYDESDALE BANK FOR THE ACQUISITION OF FISHAWACK

£57,000,000 FACILITIES FOR THE RECAPITALISATION OF THE SOVEREIGN PE BACKED BIMM MUSIC SCHOOLS GROUP

ADVISING INFLEXION PRIVATE EQUITY IN RELATION TO UNITRANCHE AND SUPER SENIOR FACILITIES FOR THE ACQUISITION OF CLOSERSTILL MEDIA GROUP

ADVISING ARDENTON CAPITAL IN FINANCING THE ACQUISITION OF W. CORBETT & CO

RECAPITALISATION OF THE SYNOVA OWNED DEFAQTO GROUP

ADVISING RBS AND HSBC IN RELATION TO A PRIVATE EQUITY SPONSOR'S INVESTMENT IN A LEADING UK IT BUSINESS

ADVISING HSBC AND LLOYDS BANK IN RELATION TO A PRIVATE EQUITY SPONSOR'S SECONDARY BUY-OUT OF A BUSINESS CONSULTANCY

ADVISING ECI PARTNERS LLP IN RELATION TO FACILITIES PROVIDED BY LLOYDS BANK PLC TO ACQUIRE A UTILITIES COMPARISON COMPANY

ADVISING HSBC ON THE PROVISION OF BILATERAL FACILITIES IN RELATION TO THE SPONSOR BACKED ACQUISITION OF A PHARMACEUTICALS CONSULTANCY BUSINESS

UNITRANCHE AND SUPER SENIOR RCF RELATING TO THE INVESTMENT IN HUWS GRAY

Advised Inflexion

FACILITIES PROVIDED BY LLOYDS BANK IN CONNECTION WITH THE INVESTMENT BY ECI PARTNERS IN MAKE IT CHEAPER

Advised ECI

ADDLESHAW GODDARD'S PRIVATE EQUITY TEAM

Yunus Seedat
Partner
020 7880 5714
yunus.seedat@addleshawgoddard.com

David Anderson
Partner
0131 222 9808
david.anderson@addleshawgoddard.com

Jemma Clarke
Legal Director
0161 934 6034
jemma.clarke@addleshawgoddard.com

Paul Concannon
Partner, Tax
020 7160 3285
paul.concannon@addleshawgoddard.com

Graham Cross
Partner
020 7160 3081
graham.cross@addleshawgoddard.com

Justine Delroy
Partner, Tax
0161 934 6770
justine.delroy@addleshawgoddard.com

Alex Dumphy
Partner, Banking
020 7160 3221
alex.dumphy@addleshawgoddard.com

Garry Elliott
Partner
0113 209 2263
garry.elliott@addleshawgoddard.com

Laura Falls
Legal Director
0131 222 9807
laura.falls@addleshawgoddard.com

Marc Field
Partner
020 7160 3534
marc.field@addleshawgoddard.com

Andrew Fordham
Partner, Banking
0113 209 2613
andrew.fordham@addleshawgoddard.com

Andrew Green
Partner
0161 934 6716
andrew.green@addleshawgoddard.com

Martin Griffiths
Partner, Tax
0113 209 2047
martin.griffiths@addleshawgoddard.com

David Handy
Partner, Banking
0113 209 2432
david.handy@addleshawgoddard.com

Mike Hinchliffe
Partner
020 7880 5742
mike.hinchliffe@addleshawgoddard.com

Murray Jack
Partner
0141 574 2371
murray.jack@addleshawgoddard.com

David Kirchin
Partner
0131 222 9813
david.kirchin@addleshawgoddard.com

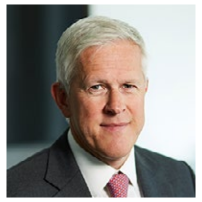
David McEwing
Partner
01224 96 5417
david.mcewing@addleshawgoddard.com

Paul Medlicott
Partner
0161 934 6414
paul.medlicott@addleshawgoddard.com

Richard Oman
Partner, Banking
0161 934 6739
richard.oman@addleshawgoddard.com

Martin O'Shea
Partner, Banking
0161 934 6403
martin.o'shea@addleshawgoddard.com

Nathan Pearce
Partner
020 7160 3981
nathan.pearce@addleshawgoddard.com



Peter Wood
Partner
0113 209 2343
peter.wood@addleshawgoddard.com

Geoff Yates
Legal Director
020 7544 5483
geoff.yates@addleshawgoddard.com

addleshawgoddard.com

Aberdeen, Doha, Dubai, Edinburgh, Glasgow, Hong Kong, Leeds, London, Manchester, Muscat, Singapore and Tokyo*

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