Jamieson Insights:

Market trends over the last 12 months

Jamieson is the leading independent adviser to management teams in the global buyout market. 2014 was another strong year for the firm, acting on 35 deals totalling over £17bn of enterprise value. During this period, we have seen a number of significant trends and themes on deals we have advised on. Stuart Coventry – Partner, Jamieson.

Sale processes

The M&A market remains volatile

Since the beginning of 2014, the international M&A market has remained highly volatile, leading to an increase in aborted processes – disappointing vendors and management teams alike. The reason for this is threefold:

1. **Price** – Unsurprisingly, price remains the single biggest factor that causes processes to fail. The frenzied IPO market has driven vendors' (and their advisers') price expectations to a level not supportable by private equity (PE) bidders. Guidance that first-round bids would need to be at these high multiple levels often resulted in a reduced pool of interested parties and an inability to build sufficient competitive tension back into the process.

2. **Timing** – Timing is another key factor, also linked to the frenzied IPO market. The popularity and volume of flotations was a significant driver for businesses going to sale ahead of their intended timetables. Those that were underprepared or relying heavily on forward-looking profit multiples to justify valuation further fuelled the failure count.

3. **Macro-economics** – Currency and equity market volatility was a key theme in 2014, causing numerous processes to be delayed or aborted. Relatively consistent trends, such as USD strength and the oil price decline, were augmented by a series of specific shocks such as the Swiss National Bank's removal of the CHF/EUR cap and a number of 'mini' equity market crashes during the year.

20%

of Jamieson deals aborted after first-round bids

Timetables are hard to stick to

Market conditions have been such that it is increasingly difficult to run a process to timetable. The deal process, from first round bids to signing, has been elongated. Although this time was halved for deals subject to pre-emptive bids, this is still a relatively long process.

8

average number of weeks to complete a deal following first-round bids

Increase in pre-emptive bids

Bidding parties are becoming increasingly selective in the assets they are targeting. When bidders do participate in processes, they are already highly knowledgeable about the target. The Trainline transaction is an example of a deal that was signed relatively quickly, but had been tracked by its PE suitor for some time.

Significantly, of deals completed, we saw an average of only two bidding parties participating in the second round. Indeed, about a third of our completed deals only progressed with one bidder after first-round bids. The sell-side will often sideline discussions on management terms in these situations due to the pressure to pin down a single bidder to final sale terms.

25%

of our deals were subject to a pre-emptive bid

"The unpredictable nature of processes means that teams need to be prepared to discuss terms in tighter negotiation"

Types of bidder

US private equity was the largest participant in 2014. Almost all UK and European assets we advised on attracted US funds, and where our management teams are UK or European, the deals were always structured as such.

53%

of our deals were completed by a US private equity buyer

Structuring

In the UK the majority of equity funding is structured as shareholder debt, with the management incentive arrangement coming from a small pool of ordinary share capital. The ordinary share capital pool tends to be 1-5% of private equity funding.

Taxation is a crucial part of a management deal and teams should consider all of the options available to them when structuring a deal. Virtually all of our UK deals since the start of 2014 were structured with Entrepreneurs' Relief (ER) in mind for Executive Managers – although this is often limited to four or five individuals. In some exceptional circumstances, some private equity suitors were not happy with specific structuring solutions for managers who didn't naturally meet the 5% economic criteria, however this is not the normal position.

"UK Entrepreneurs' Relief was routinely adopted among Executives and ESS strategy was more laterally adopted"

We saw a move against the use of separate management vehicles (Mancos) used to pool management investment that can assist in facilitating wider ER planning, which was an interesting pre-cursor to the March 2015 budget announcement that outlawed this practice and will now undoubtedly trigger the unwinding of some of these structures.

While ER remains a common theme in structuring UK deals, we have also witnessed a surge in the adoption of Employee Shareholder Status (ESS) schemes. Nearly half of our 2014 UK deals adopted ESS – with virtually all these from the mid-year onward.

This rush to implement ESS is largely due to the uncertainty surrounding the outcome of the UK General Election, as there is some question as to whether ESS will still be available and how it will be impacted. Significantly, we have seen greater willingness to accommodate ESS from North American and Asian private equity houses.

45%

of our UK deals adopted ESS

Reinvestment

Rollover percentage varies by deal and last year we saw a range between 35% and 60% of net proceeds. The average rollover on our deals came in slightly under 50% of proceeds net of tax, which is the benchmark term for private equity investment committees. The focus for managers, however, should be on the quantum of investment, the structure of it and the terms that govern it, as well as ensuring that the investment made matches a manager's personal circumstances.

"We are finding private equity suitors receptive to specific manager circumstances and more accommodating to succession and transition"

Sweet equity economics

The sweet equity percentage will depend on the capital structure, deal size, debt terms, bank leverage, and size of buyout team. However, in the last year the average sweet equity percentage on our deals was approximately 15%, sitting behind an average 11% coupon on the shareholder debt instrument.

There has been some downward pressure in the past year, most likely due to the higher prices being paid for businesses. This led to greater emphasis on looking at the number of sweet participants in the pool, and the projected future proceeds by individual players.

Once widely distributed to employees, sweet equity is being more narrowly focused. Where large groups of managers once received a stub of equity, Employee Benefit Trust pools and bonus schemes are now often being used to incentivise wider management.

"Understanding sweet equity percentage and shareholder debt becomes the most important factor in ensuring private equity and management teams incentives are aligned"

Sweet equity ratchets are increasingly prevalent on deals

The pressure on the sweet percentage offered is reflected in the increase of a ratchet mechanism – often to bridge a gap between expectations. This is also reflective of the type of bidders in the market, for example, ratchets are frequently seen in US deals where PE houses are more accustomed to a tiered-option incentive model and equity linked to performance hurdles. Convergence of US incentives and European deal structures makes for creative ratchet mechanisms, which can be highly attractive to management teams.

62%

of our deals in 2014 have included a sweet equity ratchet mechanism

"The coupon on shareholder debt has reduced. As mentioned the average coupon on our deals was 11%"

The largest interest rate was between 10% and 13% on shareholder debt. This rate is considerably lower than the +15% rates witnessed in 2006-10. Indeed, a number of US private equity houses have, in recent months, proposed structures with sub-10% preferred returns.

Given the changes to tax legislation in the Autumn, it is now common for the institutions to take loan notes and the managers' preference shares to enable them to be sold cum-dividend at capital gains tax rates. Ranking priority can be equalised through appropriate structuring and documentation.

Bank debt

While leverage multiples have been increasing, greater portability of debt structures has resulted in several dual-track refinancing/sale processes being run.

Pricing of senior term debt at 350-400bps is significantly below shareholder debt coupons and few deals have taken up junior debt finance.

4.2x

EBITDA was the average leverage ratio

Leavers

Reinvesting into the institutional strip on the same terms and *pari passu* with private equity suitors has long been the market norm. We have, however, seen some pressure for provisions to be applied that affect a manager's institutional strip value under certain bad-leaver circumstances.

"We have seen a trend to merge the category of good and intermediate leaver, with vesting applying to this broader category"

Leaver provision categories and structuring tends to be specific to the private equity house. Here, the market categorises leavers into three categories: good leavers, bad leavers and intermediate leavers. Vesting – which determines the proportion of a manager's sweet equity that is entitled to market value – is a common term for intermediate leavers. In recent months, we have seen a trend to merge "good" and "intermediate" definitions, with vesting applying to this broader category.

The IPO provision – what is customary?

The IPO frenzy we have seen in the past 18-24 months has led to equity documentation having a greater focus on IPO as an exit route. In addition to customary market-driven lock-in provisions, the recent focus has been on calculation of ratchets at IPOs; further restrictions on sell down until sponsor threshold levels are reached; and treatment of unvested sweet equity post IPO. We expect to see more discussion and negotiation on the "is IPO an exit" debate in the year ahead.

16%

average forecast EBITDA growth over a four-year period by businesses marketed

Business plan growth

While business plans are unique to individual businesses, their markets and their funding requirements, plans should also be unique to the management teams and teams need to ensure that these plans aren't "pumped up" for the sake of a sale process. It is very easy to run a slide rule over a plan and determine the amount of growth required to support a price expectation, but management has to stand behind these plans as they are the party providing the warranties.