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CMS European Private Equity Study 2023

Contents

Introduction

We are delighted to present the second edition of our CMS European Private Equity Study, providing a market update and reflecting on last year's trends based on terms agreed on private equity deals ("**PE deals**") we advised on in 2022. The past year was somewhat challenging for the overall M&A market, including private equity, in light of rising inflation and interest rates, slowing growth, and increased geopolitical tension. However, despite these challenges, there was still plenty of activity in 2022.

In this study, we have analysed data, including the main contractual terms of negotiated M&A documents, from over 100 PE deals CMS advised on. We have also looked into private equity transactions we advised on in 2021 in order to examine market trends and draw comparisons, including between PE M&A deals and trade M&A deals (which we also refer to as "non-PE deals"). Unless otherwise indicated, these results are all based on the deals that we advised on and analysed.

In 2022 the majority of new investments were add-on acquisitions. We also observed a decrease in deal value and a slow-down in exit activities. Following the end of the COVID-19 pandemic, digitalisation was no longer a deal driver, while entry into new markets remained a top priority. However, as was the case in 2021, the majority (23%) of the transactions we analysed involved the Technology, Media and Telecoms ("**TMT**") sector, followed by real estate and construction (18% of all PE deals reviewed) and the life sciences (17% of all PE deals reviewed) sectors.

In line with trade M&A deals, there were more earn-outs when a private equity investor was on the buy-side, a clear sign of the market becoming more buyer-friendly. Also, while Environmental, Social and Governance ("**ESG**") issues are climbing higher on the agenda of PE investors, they are yet to appear specifically as part of the legal due diligence process and in transaction documents.

Across the board we noticed that, also from a contractual risk allocation perspective, the market is turning more buyer-friendly, after a rather balanced 2021. However, PE M&A transactions often do not follow the same trends as trade deals. We have therefore specifically highlighted in our study any material differences that may assist PE players when negotiating with trade buyers/sellers and vice-versa.

While there are adverse economic and political factors impacting the market, we remain optimistic that PE deal activities in Europe will pick up again in 2023 after the slow start during Q1. Despite regulators taking a more interventionist approach on anti-trust issues and foreign investment controls, we predict a rise in transactions arising out of distress turnaround situations, or a need to diversify.

Again, a special thank you to our team of authors, namely Valentina Santambrogio, Jessica Mohaupt-Schneider and Patrick Lühr, who have, as in the first edition, thoroughly analysed the data and summarised the results for this study.

We hope you enjoy reading our study and discover helpful insights into market practice. Please help us improve future editions by providing feedback to your CMS contact or on our website.

Ralf Kurney
Co-Head of CMS
Private Equity Group

Jason Zemmel
Co-Head of CMS
Private Equity Group

Executive summary

- **Deal Activity.** Deal Activity remained very strong until the third quarter of 2022, with a significant drop in the fourth quarter.

- **New investments vs exits.** 2022 saw even fewer exits compared to the year before (8% in 2022 vs. 15% in 2021), indicating that the economic framework for exits has further worsened. 85% of the PE-deals analysed were new investments, while 7% were secondary buy-outs, (i.e. deals with a PE investor on both the sell and buy-side), which is significantly less than in 2021 (16%). The 2021 trend that saw a rise in add-on transactions further accelerated in 2022 (55% of deals in 2022, compared to 44% of deals in 2021).

- **Auctions.** We have seen a decrease in bidding processes in 2022 (26%) compared to 2021 (31%). A likely explanation for this development is that there were significantly fewer exits and secondary buy-outs, meaning less involvement of PE funds on the sell-side.

- **Deal Drivers.** Entry into new markets remained the most common deal driver (64% of all deals). A notable development was that digitalisation was no longer a deal driver. A possible explanation is that tech asset valuations have come under increasing pressure, while another is that many PE funds had already implemented the digitalisation strategies of their portfolio companies in 2020 and 2021.

- **Sector Activity.** Technology, media and telecoms (TMT) remained the busiest sector (23% of the analysed deals), followed by Real Estate & Construction (18%), and life sciences (17%). The latter two were also the sectors which grew the most (life sciences by 7 percentage points and Real Estate & Construction by 3 percentage points compared to 2021).

- **MAC-Clauses.** During the COVID-19 pandemic we saw an increased use of MAC-clauses (15% in 2021), but in 2022 this fell to only 10% of the PE-deals we analysed.

- **FDI-Procedures.** Interestingly, despite the trend in many jurisdictions towards tighter approval regimes for direct and indirect foreign investments ("FDI"), fewer approvals or clearances were actually sought (8%) compared to 2021 (15%). A possible explanation could be that PE investors prefer not to invest in sectors that are heavily regulated by FDI provisions, thereby avoiding future disadvantages when they exit.

- **W&I insurance.** W&I insurance continues to play an important role in PE M&A transactions. The likelihood of W&I being used increases exponentially with deal value, and W&I features more prominently in PE deals than in non-PE deals.

- **Purchase price adjustments.** When it comes to methods of contractually setting the purchase price the buyer pays on completion, PE deals have a marked preference (80%) for locked box (i.e. the purchase price is set upon signing, with no adjustments on completion). From 2021 to 2022, purchase price adjustment mechanisms decreased by roughly 6 percentage points in PE deals (whereas non-PE deals saw the use of purchase price adjustment mechanisms increase by 3 percentage points).

- **Earn-outs.** While the use of earn-out provisions increased by overall 12 percentage points in 2022 compared to 2021 (37% of all PE transactions reviewed), earn-outs were much more common in smaller deals (45%) than in higher value deals (7% in deals over EUR 100m). Looking only at deals where private equity funds or private equity-owned companies were on the sell-side, the use of earn-out provisions drops dramatically, with no earn-out clauses at all in higher value deals and a smaller percentage of earn-out based transactions in lower value deals.

- **ESG**. While ESG considerations are at the forefront of PE investors' minds, they do not appear to have filtered down to the legal due diligence or transaction documents level yet (e.g. as part of the share purchase agreement or the equity documents with management).

- **Non-compete clauses:** In 2022, PE buyers were able to obtain a non-compete provision in nearly 10% more deals compared to trade transactions (72% of PE deals had a non-compete). They also exacted more stringent terms, with 38% of deals including a non-compete for more than 30 months, while only 24% of trade deals had a similarly long time period. It remains to be seen if this trend will continue, as non-solicitation and non-compete clauses are coming under increased scrutiny by competition regulators and their enforceability is called into question.

- **Management Investment Schemes.** While the use of vesting increased compared to 2021, its terms have become more favourable to management, with shorter vesting periods (a time horizon between two-to-three years having gained 17 percentage points over the four-to-five years time range in 2022). 2022 also saw a marked increase in management allocation, with over 40% of all schemes analysed setting aside 5 to 10% of proceeds for management, and over 20% of schemes allocating more than 25% of proceeds. On the other hand, leaver provisions were tightened, with both sweet and strip equity being bought back from bad leavers in more cases (10 percentage points more compared to 2021).

- **Sellers' and buyer's negotiation strength.** Overall, we found that there was little movement in most other deal metrics from previous years. In some instances (e.g. increased use of "tipping" baskets rather than "excess only" baskets), we have seen buyer-friendly developments.

Outlook

Challenging market conditions continue

The macroeconomic difficulties that started in 2022, including rising inflation, quantitative tightening policies from central banks, rising interest rates, ongoing geopolitical tensions and the Russia-Ukraine conflict, are expected to continue through 2023, with many of their effects becoming more prominent.

This is having an impact on both fundraising and M&A activity, with the slow end of 2022 continuing into 2023. To counter this, companies are switching gears and PE funds are on the lookout for opportunistic deals on the buy-side.

"[Interest margin increases] may favour more defensive business models, with high recurring revenues and strong cashflow over high-growth business models with substantial investment needs"

Certain companies may reach "crunch-time", as the full impact of the economic changes in 2022 emerges. PE funds will be focussed on ensuring that their portfolio companies, as well as any targets, are in a position to weather the storm.

"We see that businesses need to prove that they can pass on the rising input costs (energy, material, personnel) to their customers. A lot of the rising costs have only started to impact full-year P&Ls this year, as last year businesses had secured their cost base on existing contracts. Businesses and sectors with low bargaining power on their supply or demand side are expected to see high margin pressure. This is often sector dependent, so we anticipate that deal activity will focus on certain sectors, while other sectors will become more difficult and less attractive for potential buyers."

Sectors

TMT remained a favoured sector in 2022, a trend that is likely to continue in 2023. Healthcare (also a strong performer in 2022 based on our data) and energy (renewables in particular) are similarly considered stable enough to withstand the current climate, if not benefit from it.

Some funds are seeking opportunistic buy-side bargains in sectors which until more recently had been underperforming, such as leisure, consumer products and retail.

"other sectors which have been difficult to transact in appear to be back (oil & gas, restaurants, travel…) after quite a lengthy hibernation"

Others, viewing the market through the lens of the wider geopolitical climate, are eyeing the industrial sector as it shores back from China to Europe.

"Uncertainties between China and the Western world have led to an on-shoring of critical industries. A sector we therefore consider as quite attractive is the semiconductor industry. Large chip-manufacturers have begun re-locating their operations to Europe (e.g. Intel investing EUR 17bn in two chip production facilities in Germany). Sectors which are exposed to this trend are quite interesting."

ESG

In private equity, LPs have fast-tracked the ESG agenda, which is becoming a fundamental part of the wider value creation strategy (to increase multiples at exit). Impact investment is another way to create scaleable, positive change in new investments and existing portfolios.

"ESG is part of our value creation programme with portfolio companies. We consider ESG targets as value drivers, which once implemented also improve costs."

Collecting and validating ESG data has become much easier thanks to the integration of tech tools within existing IT platforms, but the reality is that most PE funds are yet to streamline and maximise their ESG data analysis as a means to improve value creation.

The ESG element is starting to become part of the due diligence process, where funds assess whether a target fits, or has the potential to fit, within the ESG parameters set by their LPs.

"ESG is an important workstream in every acquisition DD process. We also need to understand LPs' position on ESG and then ensure that an asset is ESG compliant"

The ESG Data Convergence Initiative (EDCI), an open partnership of private equity stakeholders committed to streamlining the private investment industry's approach to collecting and reporting ESG data, has made some progress towards making the data collection exercise more consistent, comparable and meaningful. However, EDCI data often is not enough, so portfolio companies must fill in the gaps. This may become more challenging for portfolio companies to prioritise in a difficult macroeconomic climate. It is therefore worth reminding management teams of the importance of ESG reporting, not just for risk mitigation or compliance, but also for value creation and deal sourcing.

"ESG is always a subject in the ongoing discussions with management"

At some point, we expect ESG policies and compliance measures to also feature in the legal due diligence, as well as the acquisition documents and equity agreements with management. We will continue to monitor this as part of our European Private Equity Study.

Tech

Tech is already used by PE funds to deliver data to LPs and regulators, to identify worthwhile investments and talent, and to provide better transparency.

However, tech is generally deployed more at portfolio company level, rather than within the funds themselves. Funds can easily achieve value creation by helping companies upgrade hosting, CRM systems and cybersecurity, which also provides use cases to management teams for more advanced tech solutions. Incorporating in the due diligence process a review of the tech solutions deployed in potential targets seems to be key to identifying and assessing the value-add opportunities on offer.

In terms of AI, while it offers great potential, most companies are still prioritising simpler tasks and perfecting their data collection and data quality processes.

Deal activity

After the peak M&A activity in 2021 and a strong 2022, deal flow seems to have slowed down. As always, many PE players are optimistic and see opportunities in challenging circumstances.

“We expect a slow first half and a much more dynamic second half of the year. Automotive and energy will be significant drivers when it comes to transaction volume. We believe market dynamics in the second half of 2023 will be at pre-COVID levels”

Others are more cautious and expect to see a downward adjustment on previous years’ deal volume. Funds specialising in distressed assets will have a wider choice of targets, but not necessarily an easier time at finding winning investments. This uncertainty may result in a further uptake of earn-out provisions or similar deferred consideration arrangements, a trend we had already observed in 2022.

“The financing challenge is ongoing and this is before any potential impact on liquidity from the current financial crisis. This will lead to a lower level of PE investment activity (as value expectations of vendors will not necessarily reduce accordingly), and may drive the use of deferred purchase price structures or vendor financings”

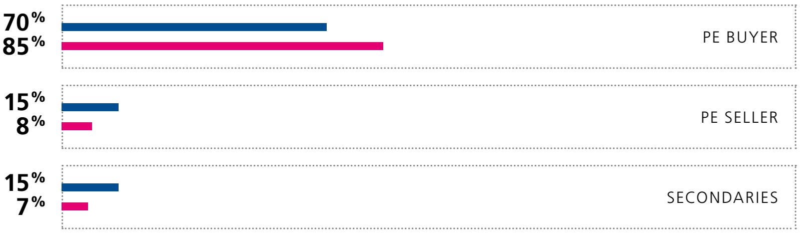
Overview

Deal activity and overall market trends

We had expected PE-led deal volumes to remain strong in 2022 and this has proven to be the case. Despite high inflation, soaring energy costs, rising interest rates and the Russia-Ukraine war, deal activity remained high, although deal activity decreased in the last quarter of 2022.

PE investors continue to prefer new deals to exits. In 2022 85% of the PE-deals we analysed were new investments, 8% were exits and 7% were secondary buy-outs, meaning deals with a PE investor on both the sell and buy-side. This shows that 2022 was not a good year for exits.

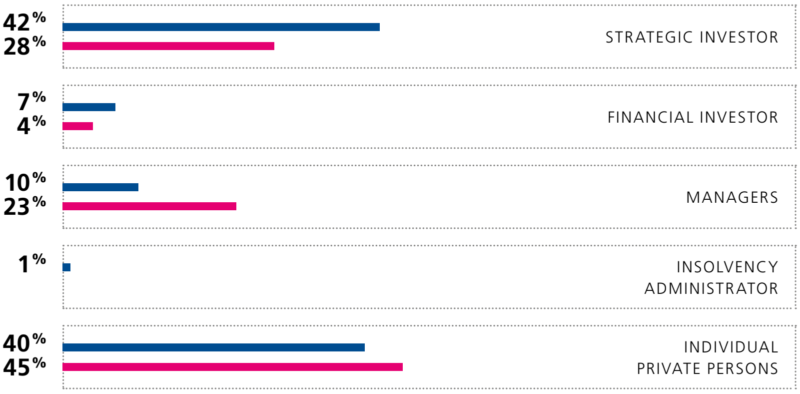
PE M&A activity: new investments, exits or secondary buy-outs



● 2021 ● 2022

With respect to the buy-side PE deals we analysed, sellers were in most cases founders or high net worth individuals, strategic investors and managers. We saw a clear decline in acquisitions from strategic investors and financial investors compared to 2021, as further detailed in the graph.

Sellers' background (PE is the buyer)

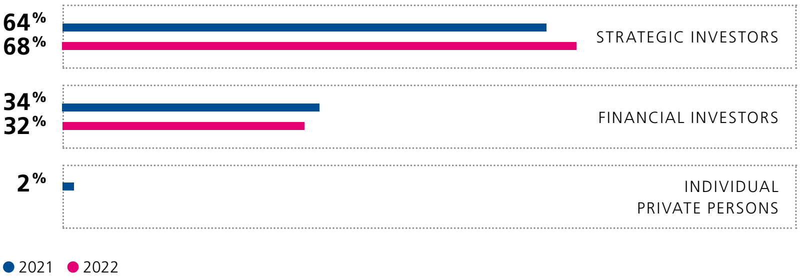


● 2021 ● 2022

100% = all evaluated transactions

In the sell-side PE deals we analysed, buyers comprised strategic investors (68%) and financial investors (32%), as illustrated in this graph:

Buyers’ background (PE is the seller)



100% = all evaluated transactions, multiple nominations possible

Again, almost all the deals we analysed (94%) were structured as share deals (as opposed to asset deals), and in most cases (roughly 70%) the buyer acquired a majority or all of the shares in the target.

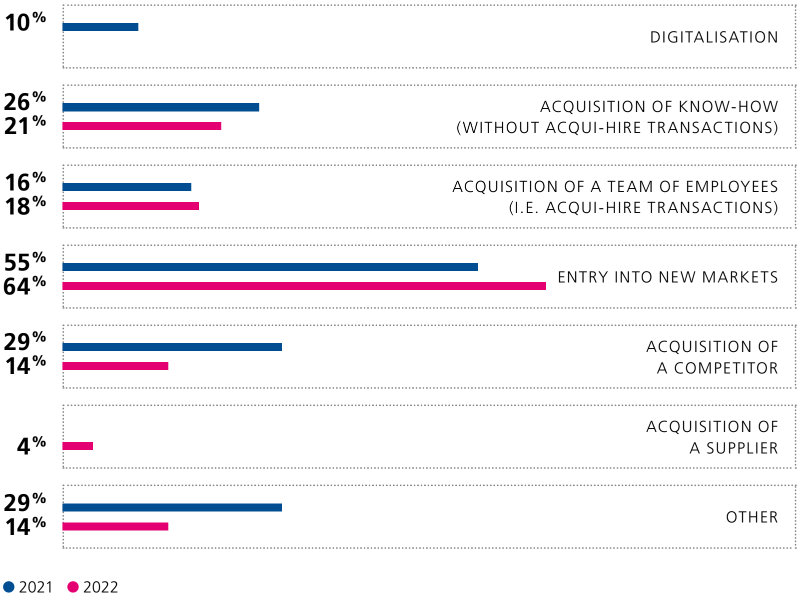
In the buy-side PE deals we analysed, we further noticed that the percentage of add-on acquisitions increased significantly in 2022 compared to 2021 (55% of 2022 buy-side PE-deals vs 44% of 2021 buy-side PE-deals), which shows that PE investors focused on their buy & build strategies.

Was the transaction an add-on acquisition?

Main deal drivers

In 2022 entry into new markets remained the most important deal driver (with a nine percentage points increase compared to 2021), while the acquisition of a competitor became less relevant (decrease of 15 percentage points compared to 2021). Digitalisation was no longer identified as a deal driver in any of the PE-deals we analysed. This could be because buyers' and sellers' valuations of tech assets started to diverge and/or because PE funds already digitalised their portfolio companies in 2020 and 2021. For more details on deal drivers, please see the chart.

Main deal drivers

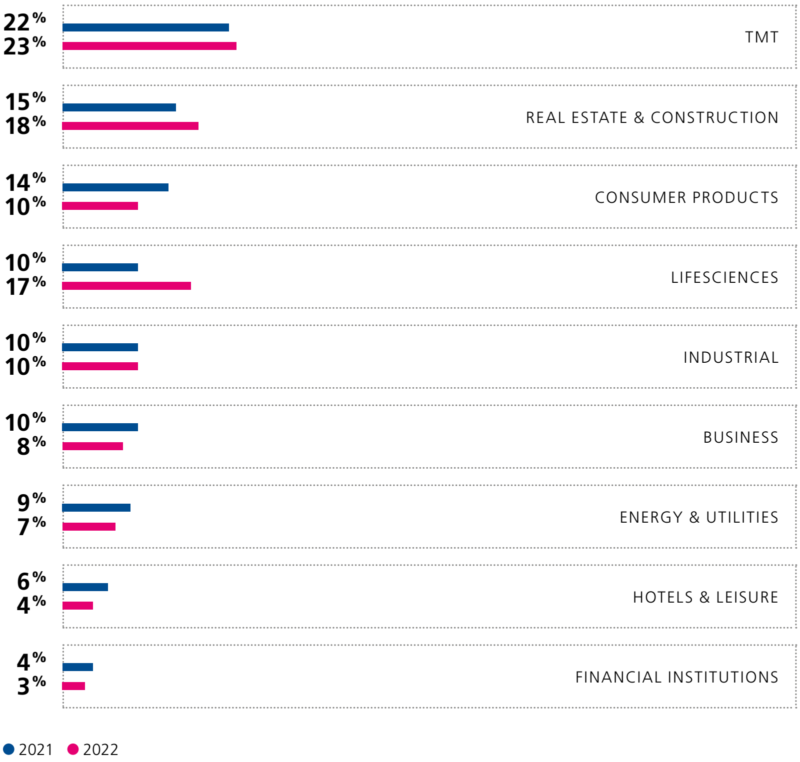


Sectors

Most of the deals we analysed involved the Technology, Media and Telecoms (TMT) sector (23% of all deals we reviewed). The next busiest sectors were Real Estate & Construction (18% of all deals), Life Sciences (17%), Consumer Products (10%), and Industrial (10%).

The sectors that grew most compared to 2021 were Life Sciences (by 7 percentage points) and Real Estate & Construction (by 3 percentage points). We saw a clear decrease in deal activity in the Consumer Products, Energy & Utilities, Hotels & Leisure and Business sectors.

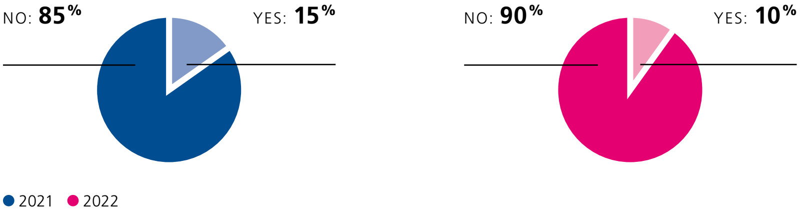
Sector spread for PE deals by number of deals



Use of Mac clauses

In 2021, during the uncertainty of the COVID-19 pandemic, MAC clauses were agreed in 15% of PE deals. However, in 2022, MAC clauses were only agreed in 10% of PE deals.

MAC clauses: time trend



100% = all evaluated transactions

Foreign investment control

With respect to seeking approval for foreign investments in buy-side PE-deals, we have seen a significant decrease between 2021 and 2022.

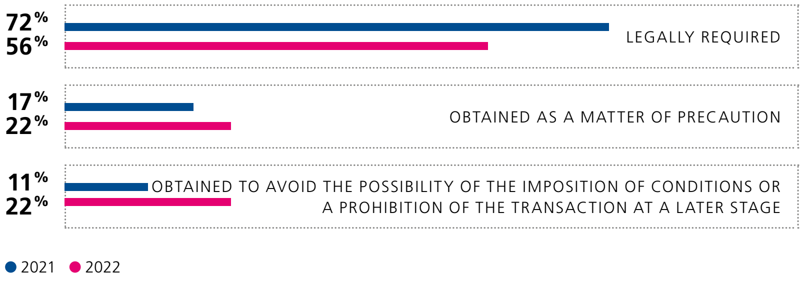
The reason for this could be that PE investors prefer not to invest in sectors which are regulated by FDI provisions, thereby avoiding the disadvantages when they exit.

Were any FDI approvals or clearances sought?

The time from application to receipt of the approval or clearance remained stable (in most cases, up to three months).

We have seen some changes in the reasons for seeking FDI approval, as indicated in the graph.

The FDI clearance/approval was



100% = all deals with any approvals or clearances pursuant to foreign investment control laws sought

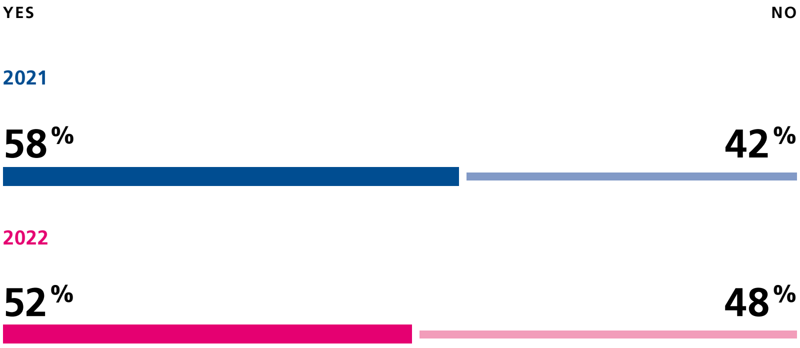
In 2022 buyers were more often seeking approval as a precaution, or in order to avoid future conditions or a subsequent prohibition of the deal.

Transaction Process

Sales via auction fell to 26% of PE deals (from 31% in 2021). This may be due to less PE activity on the sell-side.

We have analysed how auctions or bidding processes impacted the competition between interested buyers and found that, in 2022, 52% of PE negotiations involved several interested buyers. In 2021, this figure was higher (58%).

Were parts of the transaction conducted in parallel with several interested buyers?



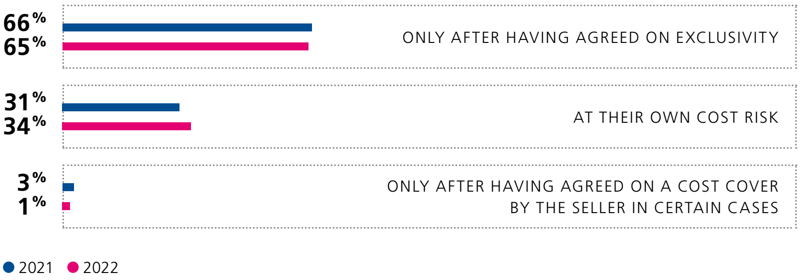
All deals where sale of the target company preceded by an auction or bidding process.

Looking at the preconditions buyers demanded before commencing due diligence (buy-side PE deals only):

- in most cases (64.8% in 2022), the buyer only started due diligence after agreeing on exclusivity with the seller;
- in 34.1% of cases (in 2022), buyers started due diligence at their own cost and risk (and without any assurances from the seller);
- in a few cases (1.1% in 2022), due diligence started after the seller had agreed on some type of cost cover.

The figures are relatively in line with 2021.

Did the buyer commence the due diligence?



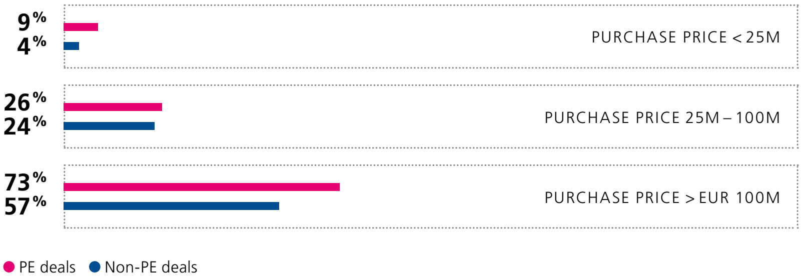
Liability

This chapter of our PE study provides an overview on how sellers most commonly seek to contractually limit their liability in respect of the company or business they have sold and what limitations are most commonly agreed. If warranties and indemnities (W&I) insurance coverage was obtained for the transaction, this has a direct effect on the liability clauses in the sale and purchase documents. This is because the policy will supersede anything agreed between buyer and seller in the contract and in some cases the sale and purchase agreement will be aligned with the policy excess and limits. In other cases, the sale and purchase agreement may simply limit liability to a nominal amount on the basis that, if needed, the buyer will have recourse via the insurance policy. For the purpose of this analysis, unless otherwise expressly stated, PE deals covered by W&I were included as part of the overall PE data pool, which means that the results may be somewhat skewed towards the seller-friendly side as a result of W&I cover (i.e. in the absence of W&I, a more buyer-friendly limitation may have been agreed).

W&I

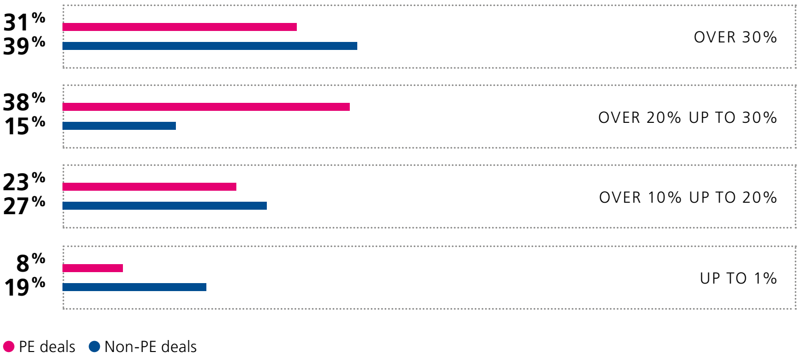
Once again our PE study shows that W&I insurance plays an important role in PE M&A transactions. Our data shows W&I use increases exponentially with deal value, and this is even more the case for PE deals than non-PE deals. Where deal value was more than EUR 100m, W&I insurance was used in 73% of PE transactions in 2022 (stable compared to 74% in 2021), while in trade M&A deals in the same value bracket, 57% used insurance (a considerable increase compared to 28% in 2021).

Deals with W&I insurance by purchase price



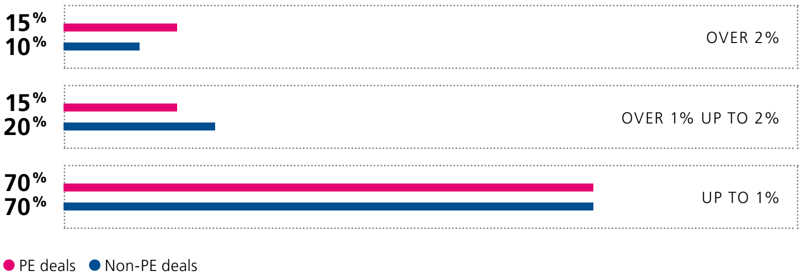
In the majority of cases, the insured sum in PE deals was more than 20% of the purchase price (69% of PE deals compared to 54% of non PE-deals with W&I insurance). In 31% of PE deals, the insured sum is more than 30% of the purchase price (39% in non-PE deals). The level of premium is up to 1% of the purchase price in 70% of the cases (also 70% in non-PE deals) as further illustrated in the chart.

Level of coverage as a % of the purchase price



100% = all evaluated transactions

Level of premium as a % of the purchase price



100% = all evaluated transactions

In the vast majority of cases, the buyer takes on the cost of the insurance policy. Compared to non-PE deals, in 2022 the number of cases in which the seller paid an insurance premium was higher (17% in PE deals in 2022 vs 2% in non-PE deals in 2022 and 7% in 2021). While the split in PE deals remained consistent (both the 2021 and the 2022 data showed 17% for PE deals), non-PE deals saw a significant shift towards the buyer bearing the cost of insurance (81% of non-PE deals in 2020 vs 93% in 2021 vs 98% in 2022). This seems to suggest that, given the majority of transactions reviewed had PE/PE-backed companies on the buy-side, private equity players have been more successful at shifting the cost towards sellers.

Conversely, we have also noticed that where PE was on the sell-side, it was more willing to take on the W&I insurance cost (in 30% of all sell-side deals reviewed), which shows both that the general market was rather buyer-friendly but also how well-known and valued the product is to PE parties, as it allows them to repatriate proceeds quickly and generally smooths the deal dynamics.

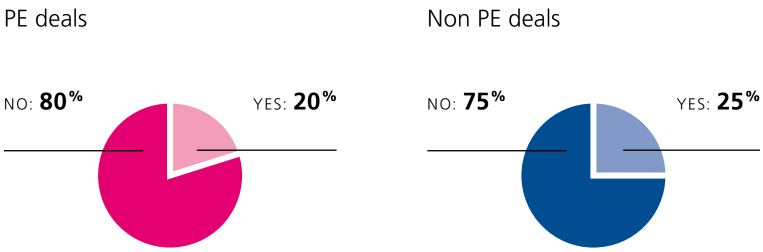
W&I premium paid by?


All PE deals

Only deals where PE is a seller

In the majority of cases, the non-purchasing party (i.e., in most cases the seller(s)) did not bear a portion of the W&I insurance costs. Unsurprisingly, in non-PE deals, the percentage of deals in which the non-purchasing party had to bear a portion of the costs was higher than in PE deals (25% in non PE-deals vs. 20% in PE deals).

The non-purchasing party bore a proportion of the costs?

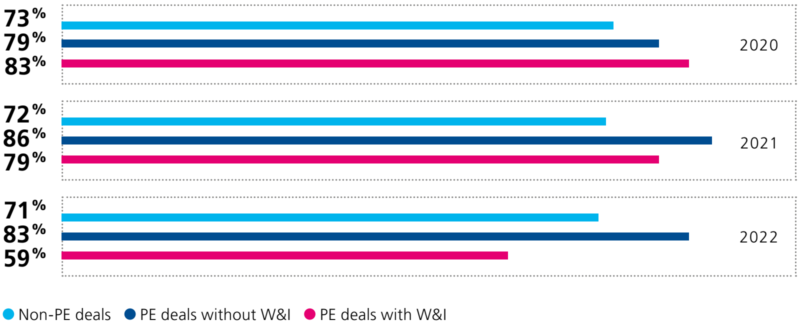

PE deals

Non PE deals

De minimis

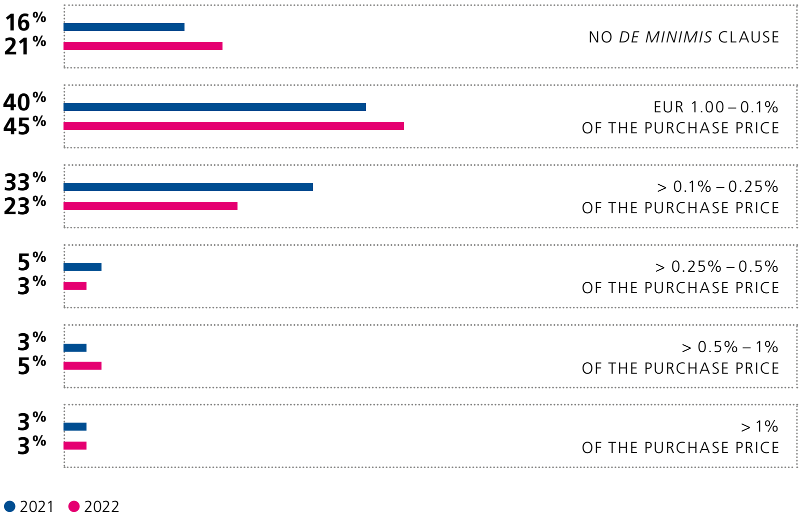
While there had been a slight increase in the use of *de minimis* on PE deals from 2020 to 2021 (from 80% in 2020 to 84% in 2021), this decreased to 79% in 2022. What's more, PE deals using W&I insurance saw a steep decrease in the use of *de minimis*, from 79% in 2021 to 59% in 2022.

Use of *de minimis* trend

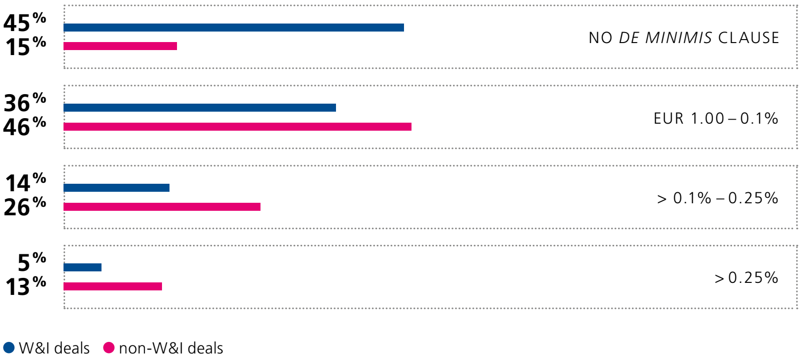


Where a *de minimis* was agreed, the amount was between EUR 1.00 and 0.1% of the purchase price in approximately 45% of the transactions (a slight increase compared to 40% in 2021), and in another 23% of PE deals it ranged between >0.1% and 0.25% of the purchase price (a slight decrease compared to 33% in 2021). In nearly half of PE deals with a W&I insurance (45%) in 2022, the parties did not agree a *de minimis* at all.

De minimis **amount (as a % of the purchase price)**



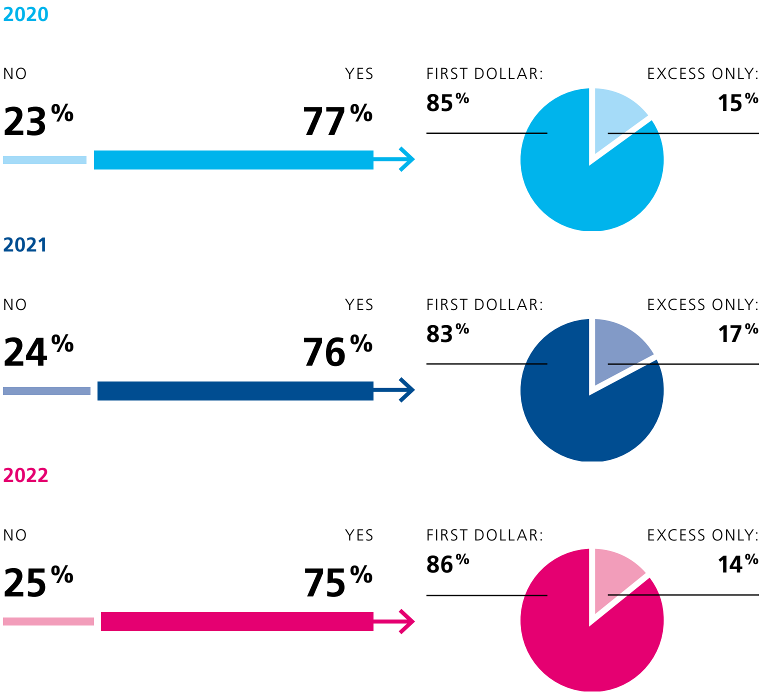
De minimis **amount (as a % of the purchase price): W&I deals vs non-W&I deals**



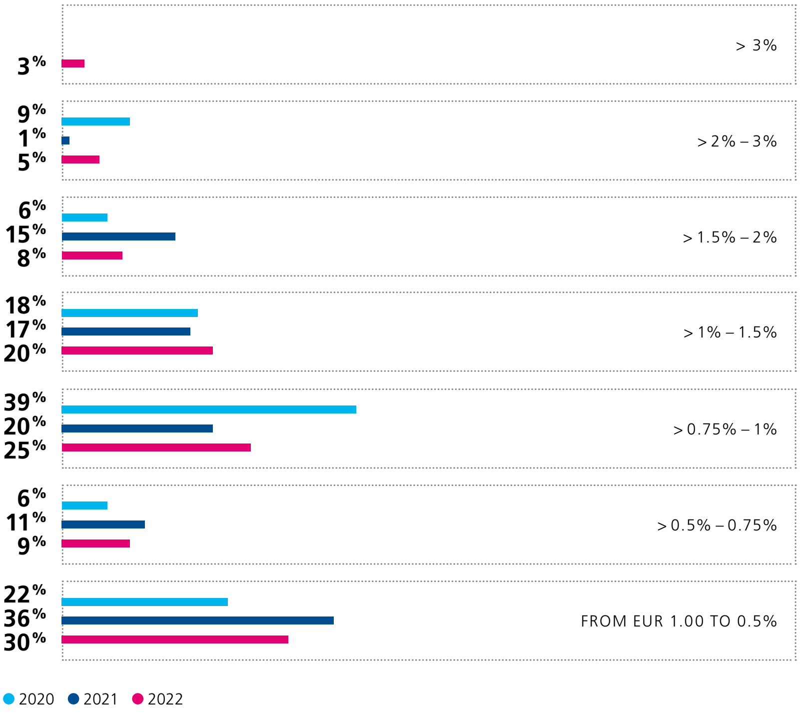
Baskets

The overall use of baskets and also the share of "excess only" vs. "tipping" (also referred to as "first dollar" basket) has remained stable over the past three years. The tendency to use lower baskets, in particular baskets ranging from EUR 1.00 to 0.5% of the purchase price, which we had identified in our last edition, has not continued. In 2022 there have been a few cases in which parties have agreed baskets above 3% of the purchase price. Baskets in W&I deals have been lower than in PE deals without W&I insurance (which might correlate with the fact that baskets are generally relatively higher in deals with a lower transaction value).

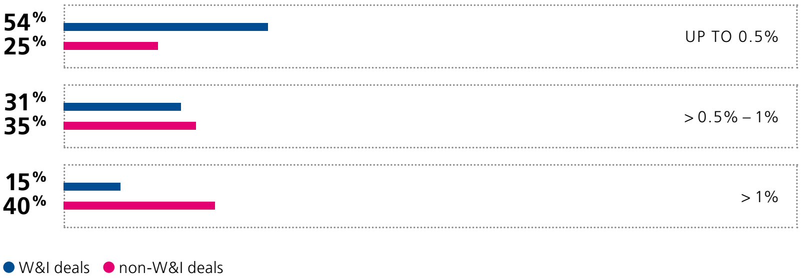
Use of basket trend



Basket amount (as a % of the purchase price)



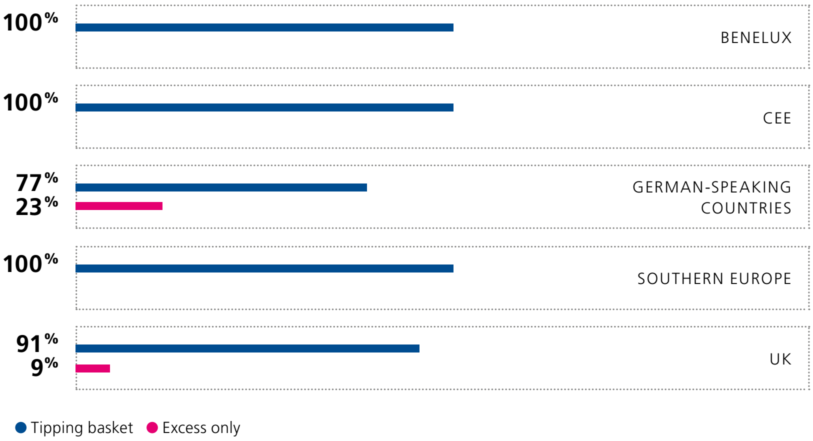
Basket thresholds: W&I deals vs non-W&I deals



100% = all evaluated transactions

The share of "tipping" baskets was significantly higher than "excess only" baskets in all geographies analysed. Interestingly, in 2022, the use of "tipping" baskets even increased compared to 2021, with all of our Benelux, CEE and Southern deals and almost all of our UK deals featuring a "tipping" basket. This could be a reflection of the more buyer-friendly market at the end of 2022.

Excess only basket vs tipping basket by geography

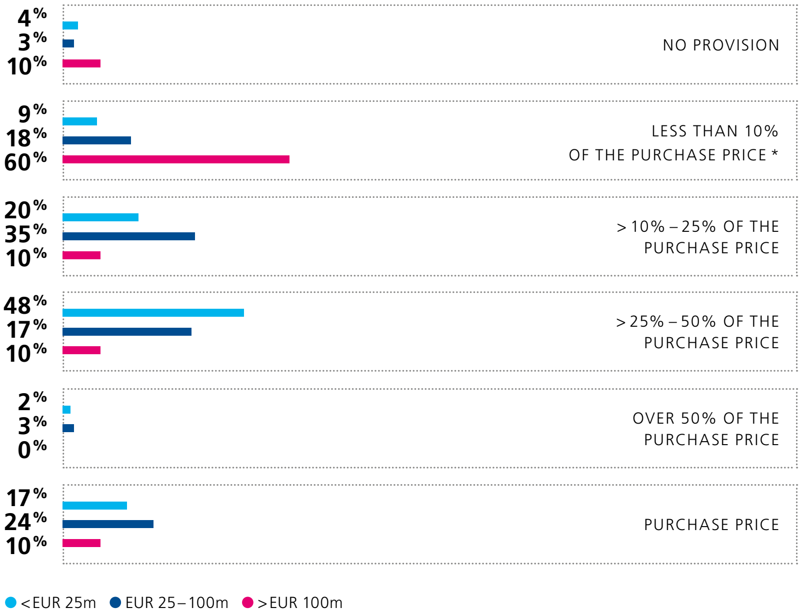


100% = all transactions with a basket

Liability Caps

When it comes to monetary liability caps, the 2022 data confirmed that there seems to be a direct correlation between deal value and cap amount. The higher the purchase price, the lower the percentage of the cap. In 60% of the deals with a purchase price over EUR 100m, the cap was lower than 10% of the purchase price (compared to 54% in 2021).

Liability caps by purchase price

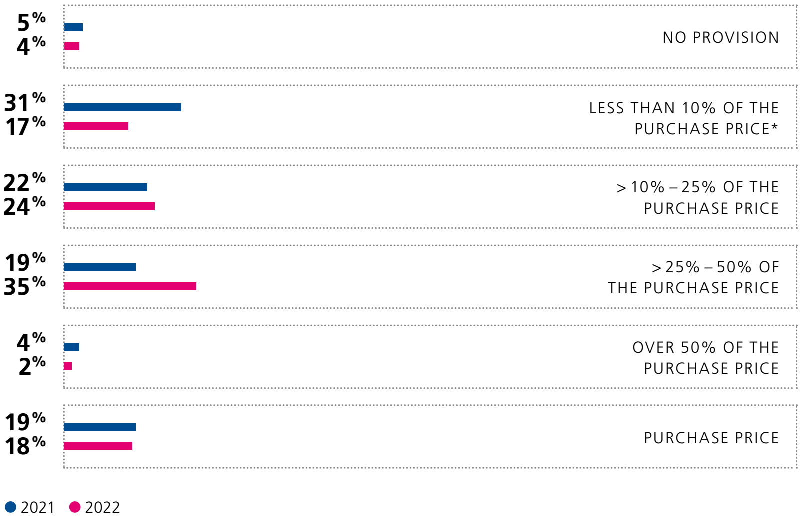


100% = all evaluated transactions

* incl. EUR 1 and 0% of the purchase price caps

While the number of deals with a cap of less than 10% of the purchase price had increased between 2020 and 2021 from 23% to 31%, this dropped significantly to 17% in 2022. One explanation might be the increased use of W&I insurance on deals in 2021 (compared to 2020) and its decreased use in 2022 (compared to 2021).

Liability caps time trend



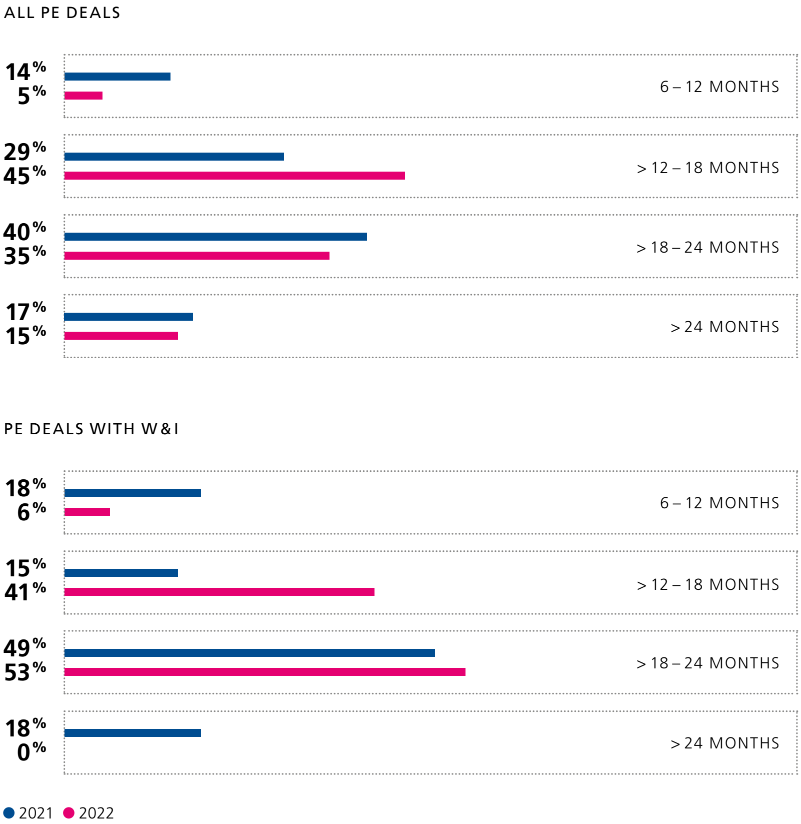
100% = all evaluated transactions

* incl. EUR 1 and 0% of the purchase price caps

Limitation Periods

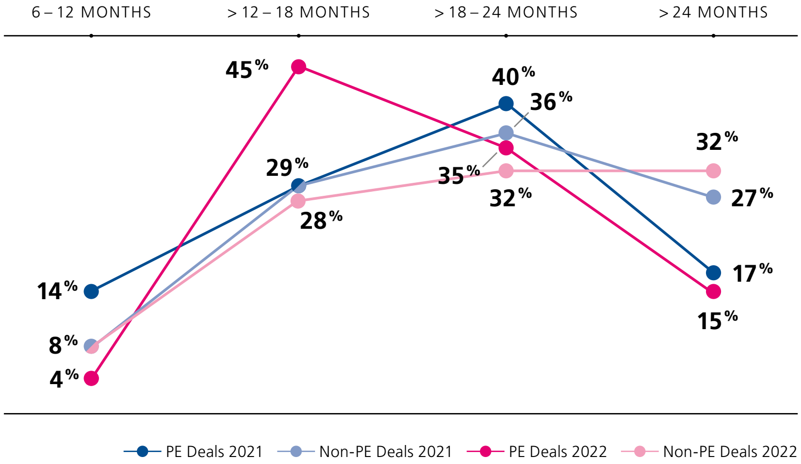
Time limitations are the final key element of a seller's limitation of liability package, particularly if there is no W&I insurance. Although the limitation period for business warranty claims in PE deals were – and still are – shorter than in non-PE deals, in 2021 we saw a trend towards longer time limits on PE deals, compared to 2020, with a 12% drop in 12-to-18-months limitation periods and a 7% increase in each of the 18-to-24-months and more-than-24-months time buckets. Conversely, the 2022 data shows a trend towards agreeing on a 12-to-18-months time limitation in the majority of the cases (45% in 2022 compared to 29% in 2021) with longer limitation periods in deals with W&I insurance.

Limitation periods for warranty claims: time trend



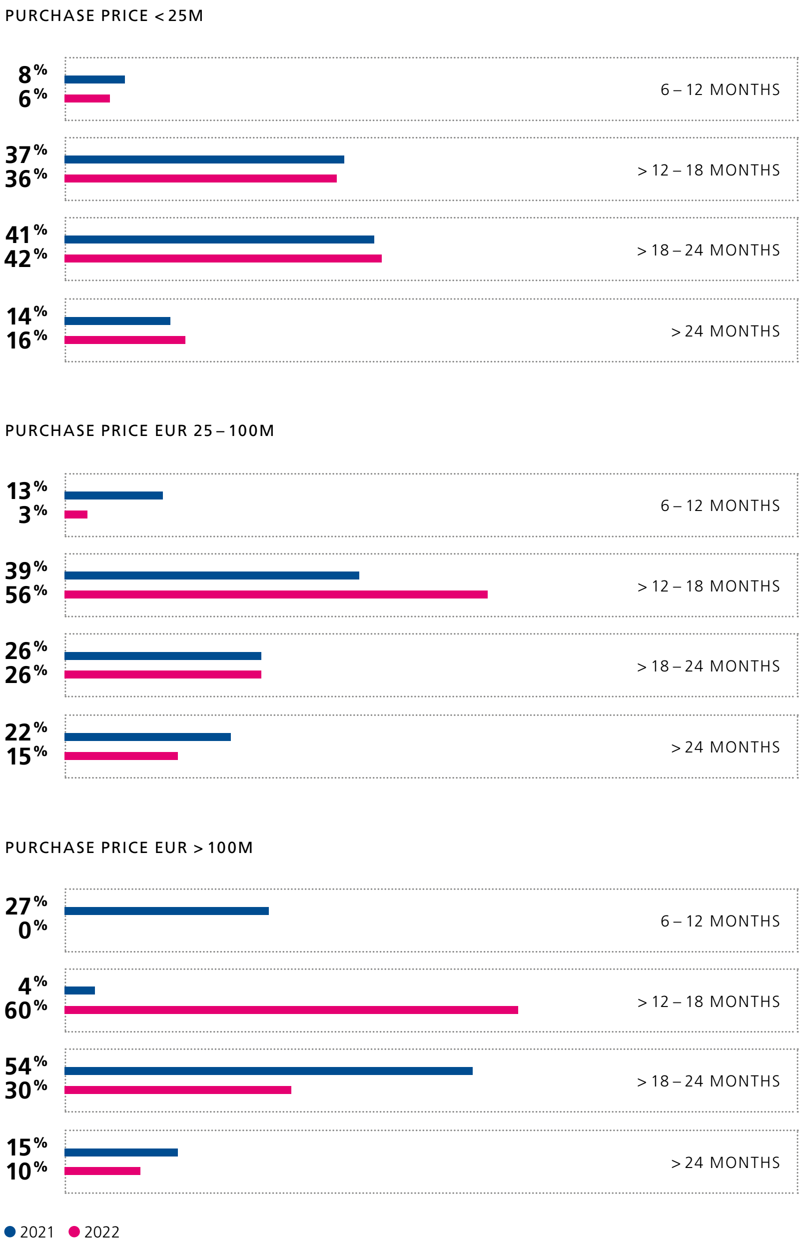
100% = all evaluated transactions

**Limitation periods for warranty claims:
PE deals vs non-PE deals**



Looking at potential differences across deal sizes, the overall trend towards longer limitation periods continued in 2022. However, on deals where the purchase price exceeded EUR 100m, almost 70% of 2021 deals had a limitation period of over 18 months (15% exceeding 24 months), while in 2022 the majority of deals (60%) had a 12-to-18-months limitation period.

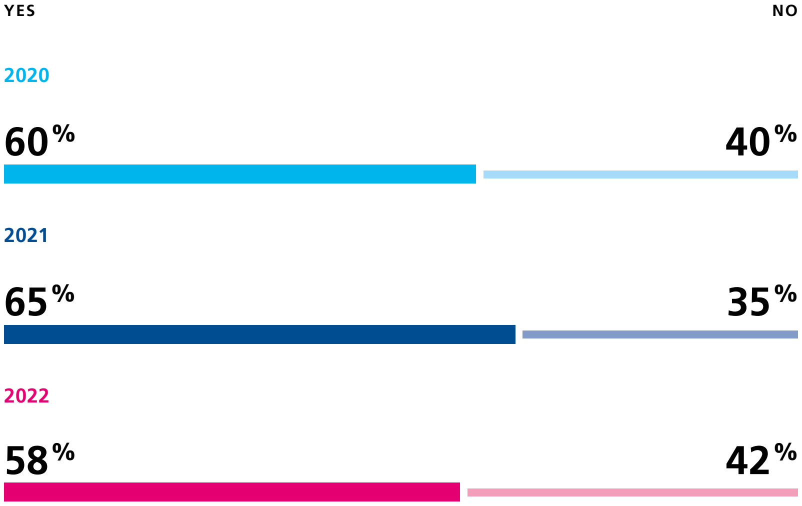
Limitation periods for warranty claims by purchase price



Tax

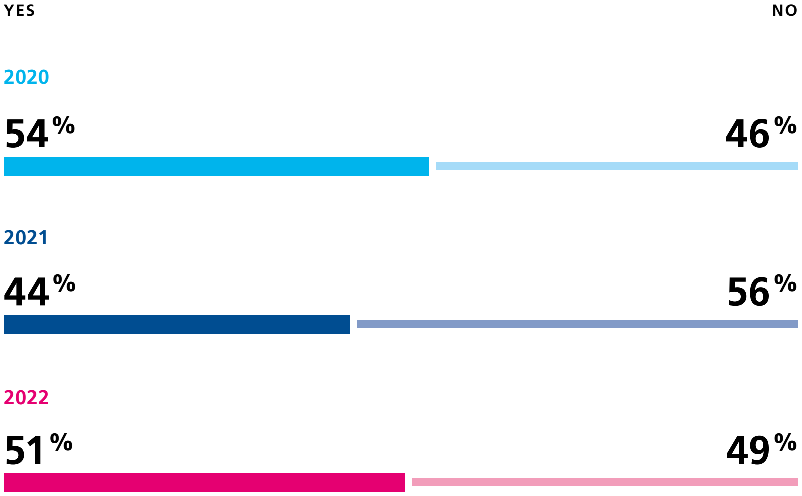
With respect to tax clauses, in 2022 PE deals were almost as likely to include a tax indemnity as non-PE deals (58% for PE deals vs. 61% for non-PE deals). Overall, our data showed that the approach to including a tax indemnity has remained broadly consistent with previous years.

Tax indemnity agreed?

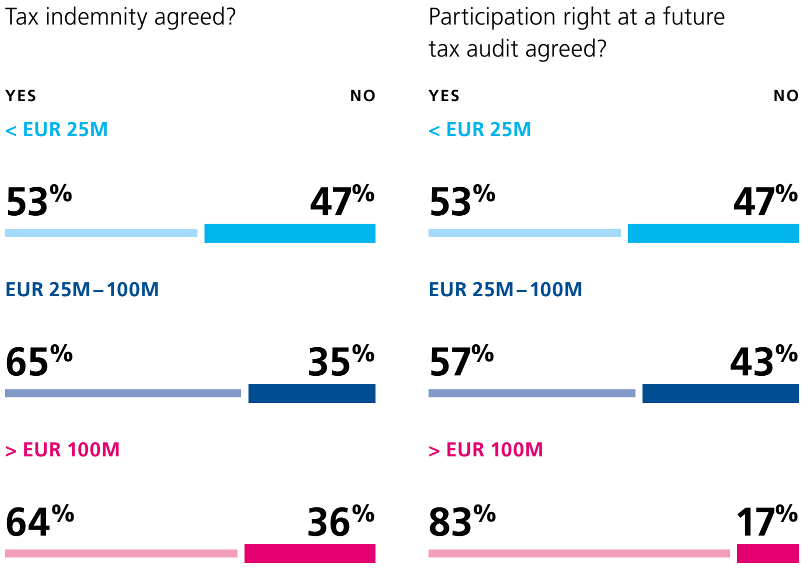


In 2022, sellers were more successful than in 2021 in negotiating the right to actively participate in a future tax audit on the target in a PE deal (51% vs. 44%). Deal value is a significant factor here: in the PE deals we analysed where the purchase price was higher than EUR 100m, the seller had no such right in 83% of cases (88% in 2021), which means there were buyer-friendly terms in most cases. This trend is in line with trade M&A deals, where seller participation rights increased by 2% (from 42% in 2021 to 44% in 2021).

Participation right at a future tax audit agreed?

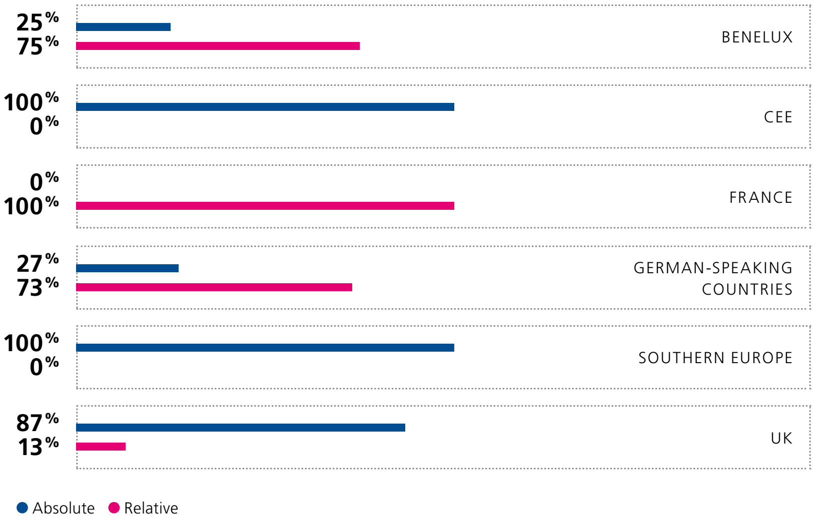


Tax indemnity by purchase price



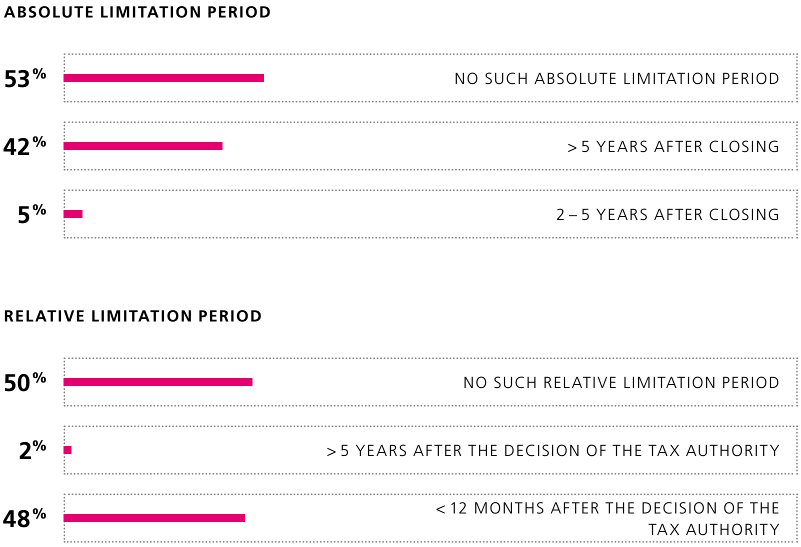
As in 2021, the data reveals a huge difference between geographies with respect to whether an absolute (i.e., a fixed number of years post-completion) or relative (i.e., a certain period of time following the final determination of taxes post-completion) limitation period was agreed regarding the tax indemnity. Whereas an absolute limitation period is still standard in the UK, Southern Europe and CEE, in Germanic countries, Benelux and France, the trend is still to agree to the, buyer-friendly, relative time limitation. The time period agreed for an absolute limitation in most cases was more than five years after completion. In the case of a relative limitation period, the tax indemnity was usually time-barred within a period of up to 12 months after the relevant decision of the tax authority.

Tax indemnity: absolute vs relative limitation period by geography



100% = all transactions with a tax indemnity clause

Tax indemnity: duration of limitation period



100% = all evaluated transactions with a tax indemnity clause.

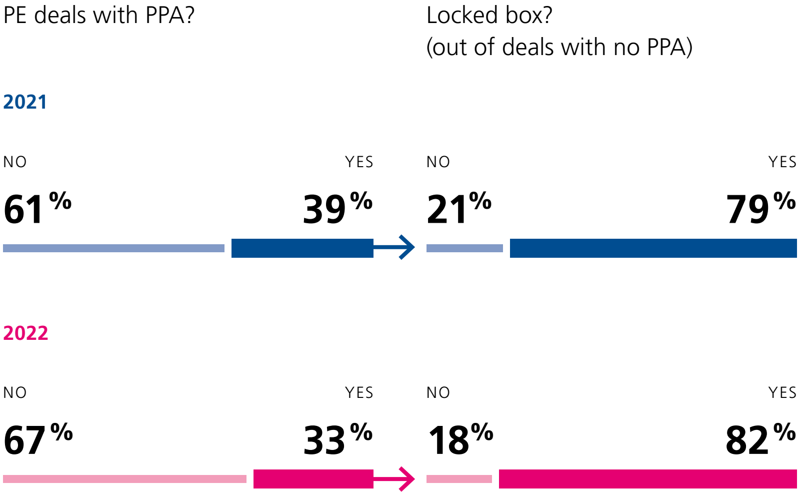
Purchase price adjustments / Earn-out

Purchase Price Adjustments

Purchase price adjustments are not favoured by PE houses, which prefer the certainty and expediency of locked box valuations and, when on the sell-side, are keen to ensure that the price determination mechanism will allow them to repatriate proceeds swiftly following an exit.

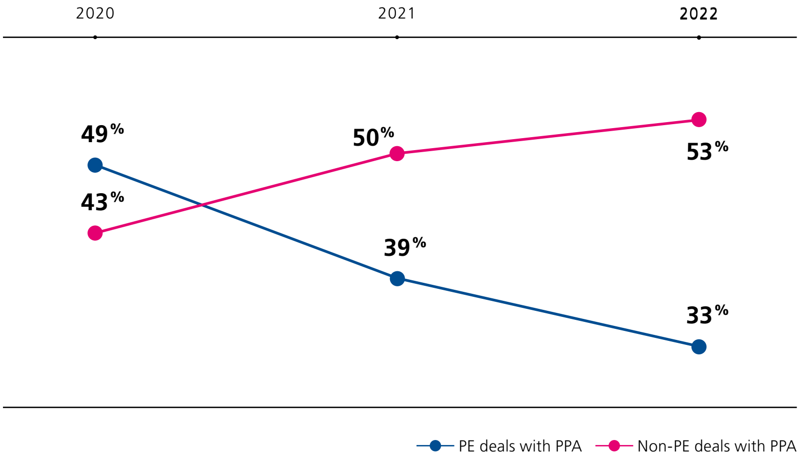
The vast majority of PE deals we analysed in 2022 therefore continues to calculate and fix the purchase price at or before signing. Of those deals with no purchase price adjustment, over 80% were structured as a "locked box".

Purchase price adjustment (PPA)

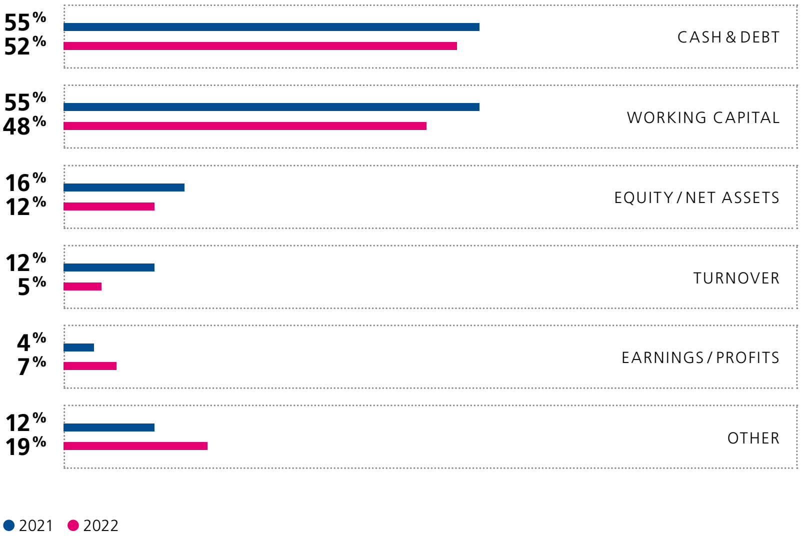


Purchase price adjustments on deals involving a PE buyer or seller have decreased slightly (by 6 percentage points compared to 2021), which is consistent with last year's trend. By contrast, the use of purchase price adjustment on trade deals has seen a small increase of 3 percentage points, which is also on trend with last year.

Purchase price adjustment time trend: PE deals vs Non-PE deals



Where a purchase price adjustment was agreed, as in 2021, the most popular metrics for purchase price adjustment on PE transactions were net debt and working capital. However, there has been a decline in equity/net assets and turnover as criteria, with an increase in earning/profits and "other" categories, as further detailed in the chart below. The most common "other" metrics were EBIT/EBITDA, business-specific KPIs/project milestones, and inventory.

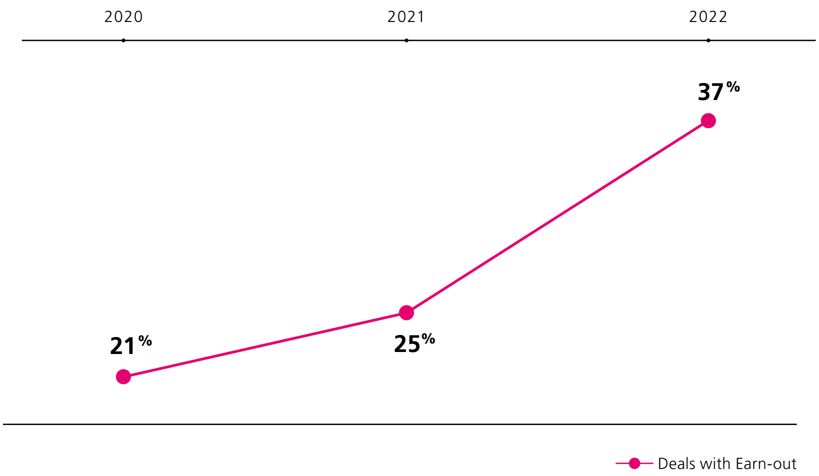

Purchase price adjustment criteria

100% = all transactions including a purchase price adjustment.
Cash & Debt does not include "cash only" and "debt only". Multiple nominations possible.

Earn-out

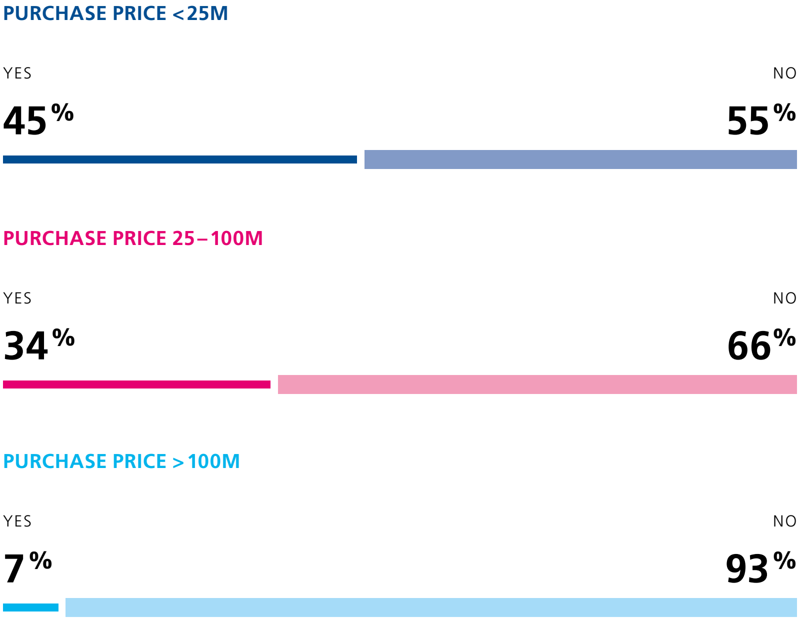
A minority of PE deals continues to use earn-outs as part of the purchase price package, but 2022 has seen a marked increase in earn-out provisions compared to 2021 and 2020, as shown in the graph. This may be due to the fact that 2022 has seen considerably more activity on the add-ons front, which may mean targets were less established businesses or fast growth companies, which prompted a need to confirm valuations over a longer time period.

Earn-out time trend



This explanation for the increased incidence of earn-out provisions is further supported by the stark difference in the use of earn-outs between lower value deals (where earn-outs are more commonplace) and deals with value exceeding EUR 100m, where earn-outs only featured in 7% of transactions.

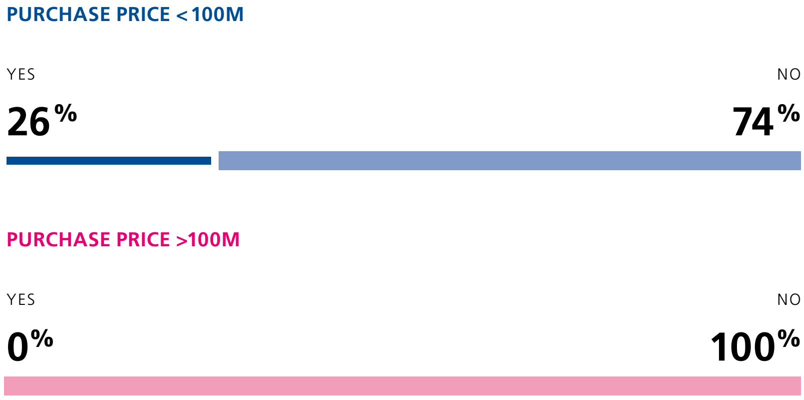
Earn-out by purchase price



100% = all transactions

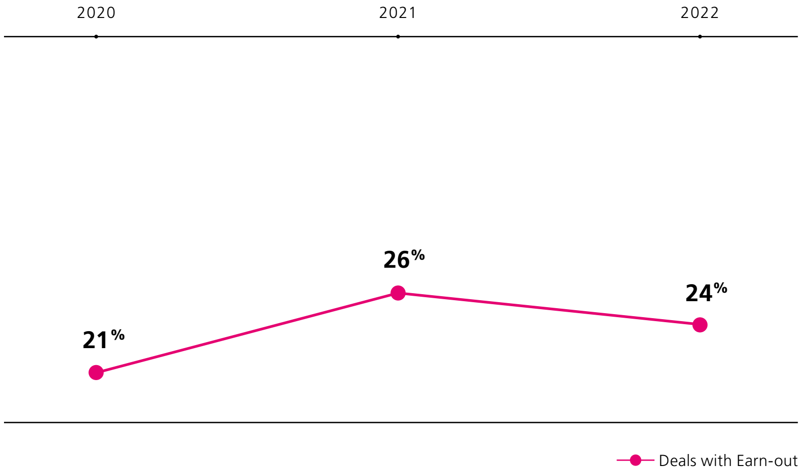
Interestingly, looking only at deals where private equity funds or private equity-owned companies were on the sell-side, the incidence of earn-out provisions drops dramatically. In this category, there were no earn-out clauses at all in higher value deals, and a smaller percentage of earn-out based transactions in lower value deals, as illustrated in this graph.

Earn-out by purchase price: only deals where PE is the seller



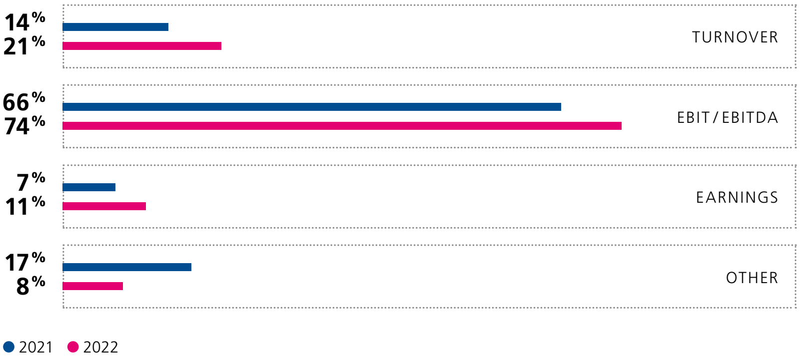
By comparison, trade deals have only seen a slight decrease in the use of earn-outs, and have otherwise remained stable over the last three years.

Earn-out time trend: non-PE deals



Where an earn-out mechanism was used, the most common criteria by a significant margin was EBIT/EBITDA (used in 74% of earn-out provisions, an increase of 8% on the previous year). The next most popular metrics were turnover (21%) and earnings (11%), as in 2021. However, turnover and EBIT/EBITDA were jointly the most favoured (and only) criteria used on deals > EUR 100m.

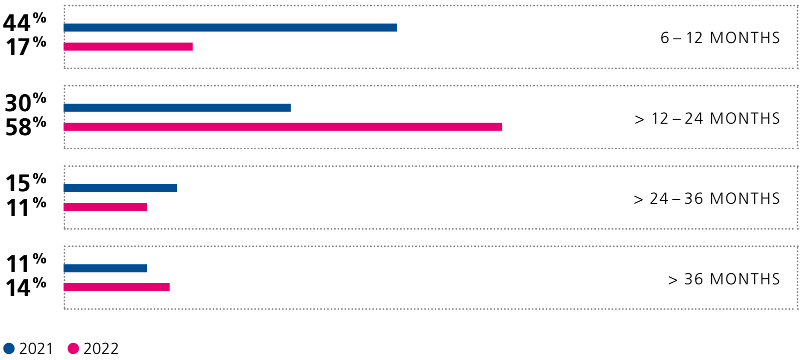
Earn-out criteria



100% = all evaluated transactions. Multiple nominations possible

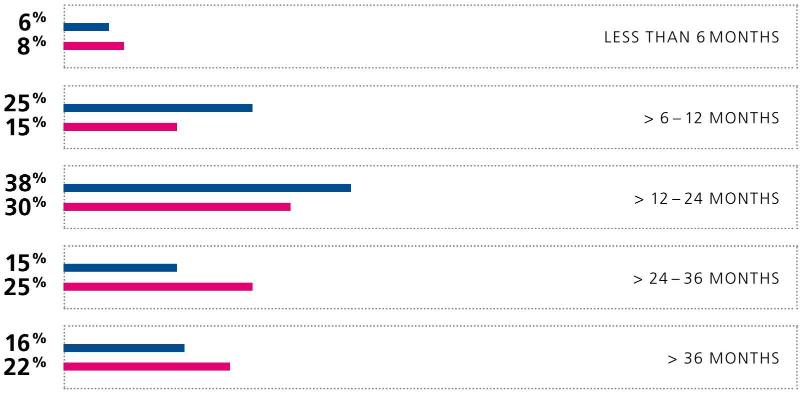
As in 2021, compared to trade deals, the duration of earn-out periods is shorter when private equity players are involved. However, in 2022, 58% of PE transactions had 12-to-24 months as the earn-out period, with the next most popular timeline (17%) being 6-to-12 months (see the "PE deals only" graph for details). By contrast, trade deals have seen longer earn-out periods in 2022, with 24-to-36 months (25%) and periods in excess of 36 months (22%) accounting for the majority of all earn-out transactions (see the "non-PE deals" graph for further details).

Duration of time period for the assessment of earn-out: PE deals only



100% = all transactions including an earn-out clause

Duration of time period for the assessment of earn-out: non-PE deals



● 2021 ● 2022

100% = all transactions including an earn-out clause

In 2022 earn-out clauses remained very prevalent in Benelux and German-speaking countries, as in previous years. The Nordics also proved to favour earn-out provisions, while CEE was the only European region to see a material drop in earn-outs, contrary to the overall trend.

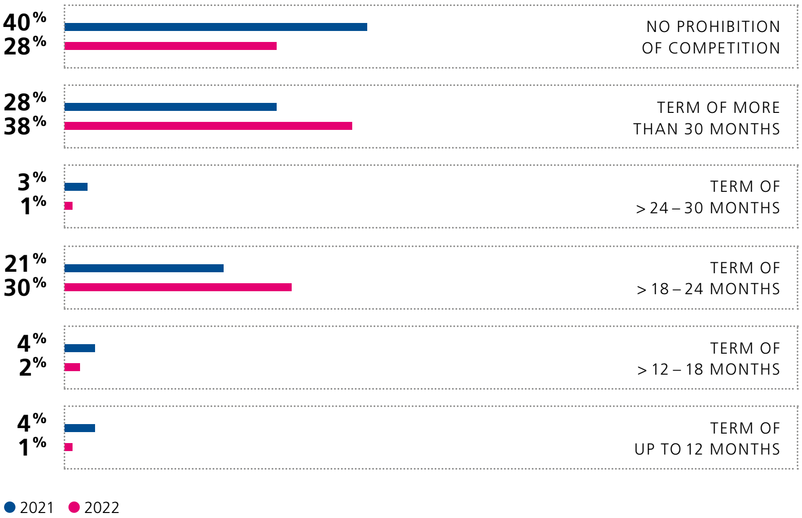
Non-compete and non-solicitation clauses

Non-Compete and Non-Solicitation Clauses

While the use of non-solicitation clauses has remained stable at over 60% and is common place both on trade deals and PE transaction, 2022 seems to have seen a shift when it comes to non-compete clauses.

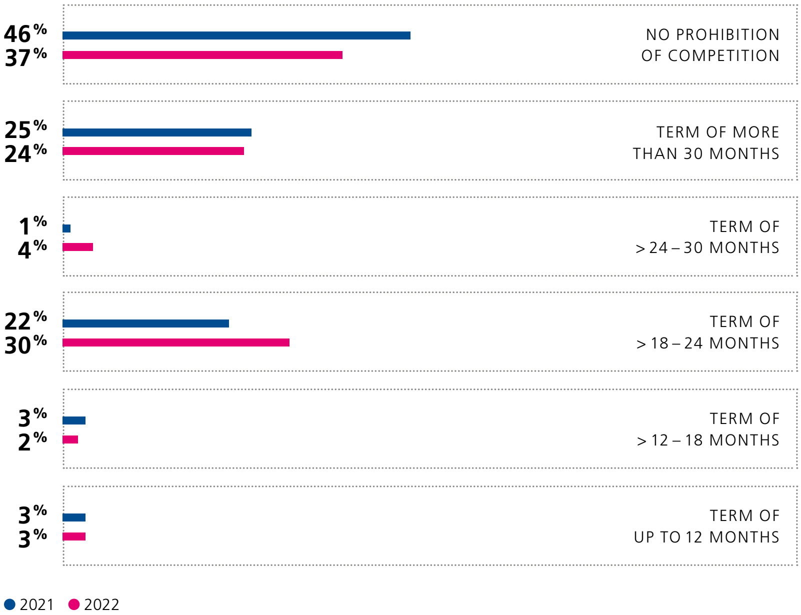
Bearing in mind that 2022 saw 85% of the transactions we reviewed having PE on the buy-side, PE players obtained a non-compete provision in nearly 10% more deals compared to trade transactions (72% of PE deals had a non-compete). They also exacted more stringent terms, with 38% of deals including a non-compete for longer than 30 months, which was the case in only 24% of trade deals.

Duration of non-compete clauses: PE deals only



100% = all evaluated transactions

Duration of non-compete clauses: non-PE deals



100% = all evaluated transactions

Management incentives

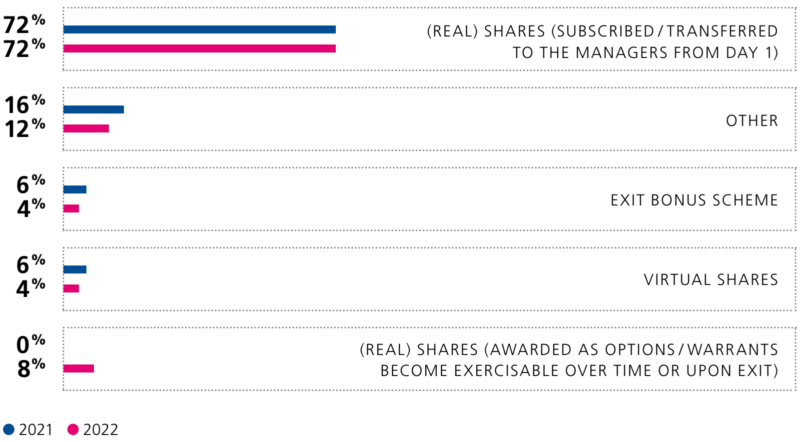
Overview

In the vast majority of deals (81%), the existing management team stayed on to work for the portfolio company.

Of those 2022 deals that had a management incentive scheme, 80% were structured as a share scheme and required managers to pay an amount in consideration for the shares they received in 89% of all schemes. Last year, most schemes used no external valuation to determine the consideration payable. This shows that in most European jurisdictions, share schemes are more tax efficient than cash bonuses and that in order to take advantage of tax breaks, managers must pay for the shares they receive.

Nevertheless, managers enjoyed more favourable terms for their investment (compared to ordinary shares) in 88% of cases in 2022.

Management incentive scheme structure

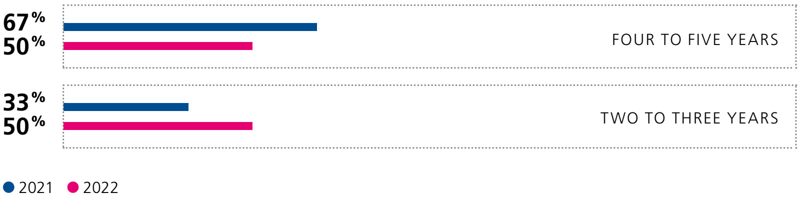


100% = only deals with management incentive scheme

Vesting

Compared to 2021, 2022 has seen an overall shortening of the vesting time periods, with 17% more deals only requiring two or three years to full vesting.

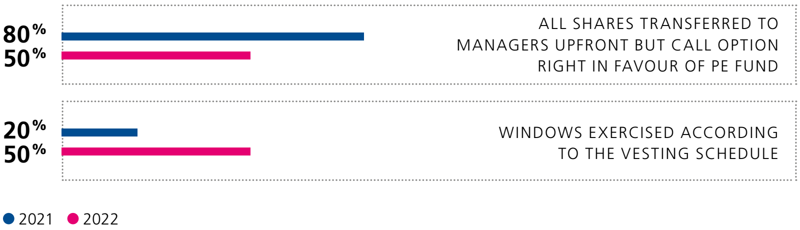
After what time period will all shares granted to the manager become fully vested?



Only deals with management incentive scheme, shares and vesting

In 2021, 80% of deals saw shares transferred to managers upfront and then secured with a call option in favour of the PE fund. In 2022, 50% of all schemes subject to vesting used options or otherwise deferred transfer of the shares according to the vesting schedule.

How was vesting secured?

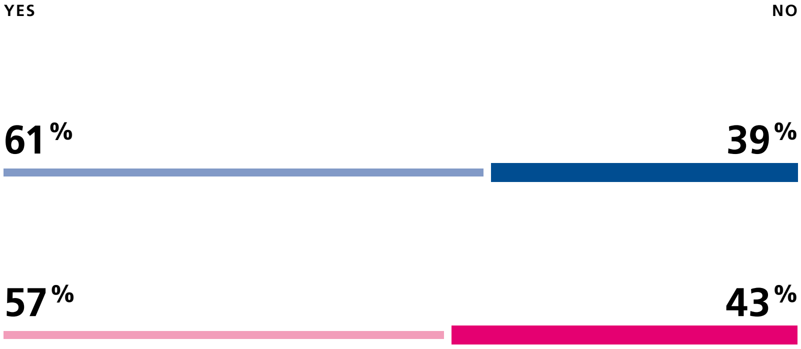


Only deals with management incentive scheme, shares and vesting

Rollover

Top executives were required to rollover in over 57% of transactions, which is a slight decline compared with our 2021 data, but remains consistent with management teams being retained in the majority of transactions.

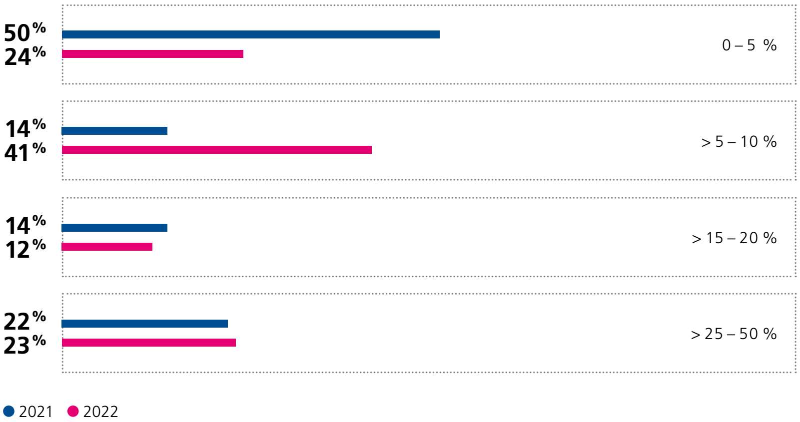
Selling managers required to re-invest a percentage of their sale proceeds in the target



Economic Terms

In 2021, half of all incentive schemes reviewed allocated only up to 5% of proceeds to management. However, 2022 has seen a marked increase in management allocation, with over 40% of all schemes analysed setting aside 5 to 10% for management, and over 20% of schemes allocating more than 25% of proceeds, as further detailed in the graph.

Percentage of share capital or proceeds allocated to the managers

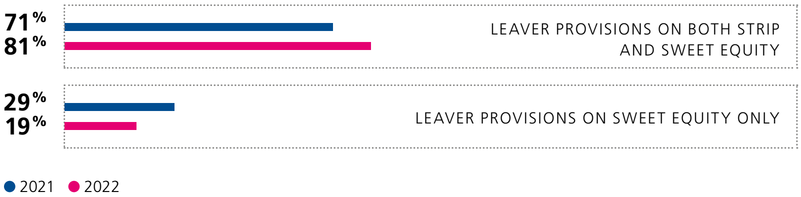


Only deals with management incentive scheme, shares and vesting

Leavers

As in previous years, most management incentive schemes were subject to leaver provisions (more than 60% in 2022). Over 80% of schemes applied leaver provisions to both sweet equity and strip, which indicates a less management-friendly standard.

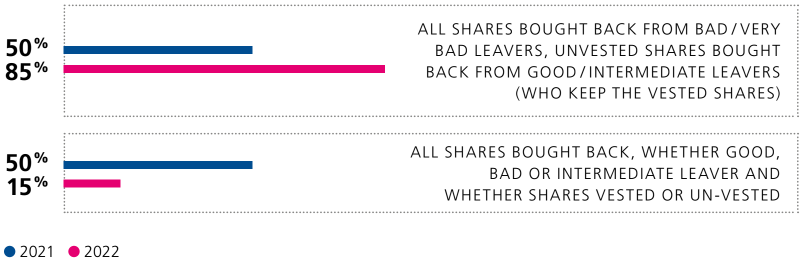
Leaver provisions apply only to the sweet equity or also the strip (ordinary) equity?



Only deals with management incentive scheme, shares and subject to leaver provisions

In terms of consequences for leavers, 2022 saw a more unequivocal trend towards all shares being bought back from good/intermediate leavers, including the vested ones. Only a minority of schemes allowed good leavers to keep vested shares.

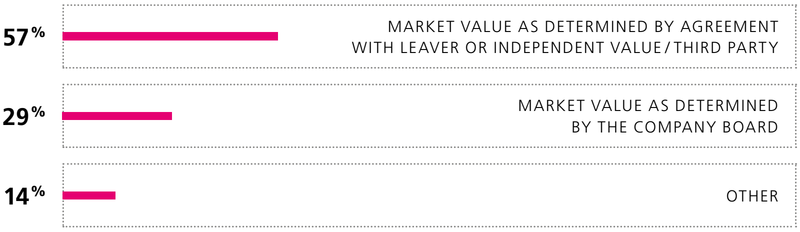
Are all shares bought back when a manager becomes a leaver or only the unvested portion?



Only deals with management incentive scheme, shares and vesting

With regards to the price at which leaver shares are bought back, the approach for shares held by good leavers is in 57% of schemes more favourable to managers. This is because the market price has to be agreed or determined by an independent valuer/third party. In nearly 30% of cases the company or the board determines the market value.

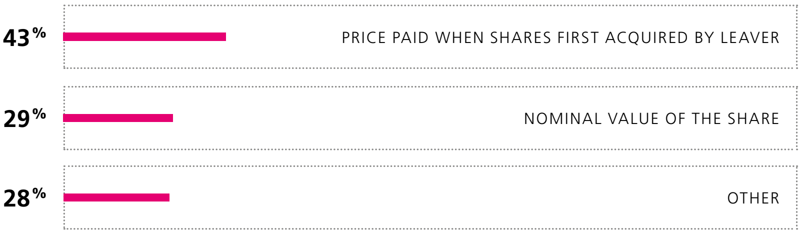
At what price are the shares of good leavers bought back at?



Only deals with management incentive scheme, shares and subject to leaver provisions

When it comes to buying back the shares of bad leavers, in 43% of schemes the price is not punitive, allowing managers to at least recover the amount they paid for the shares. In 29% of the schemes we reviewed, shares were bought back at nominal value, which may be less than what the manager paid to acquire them.

At what price are the shares of bad leavers bought back at?

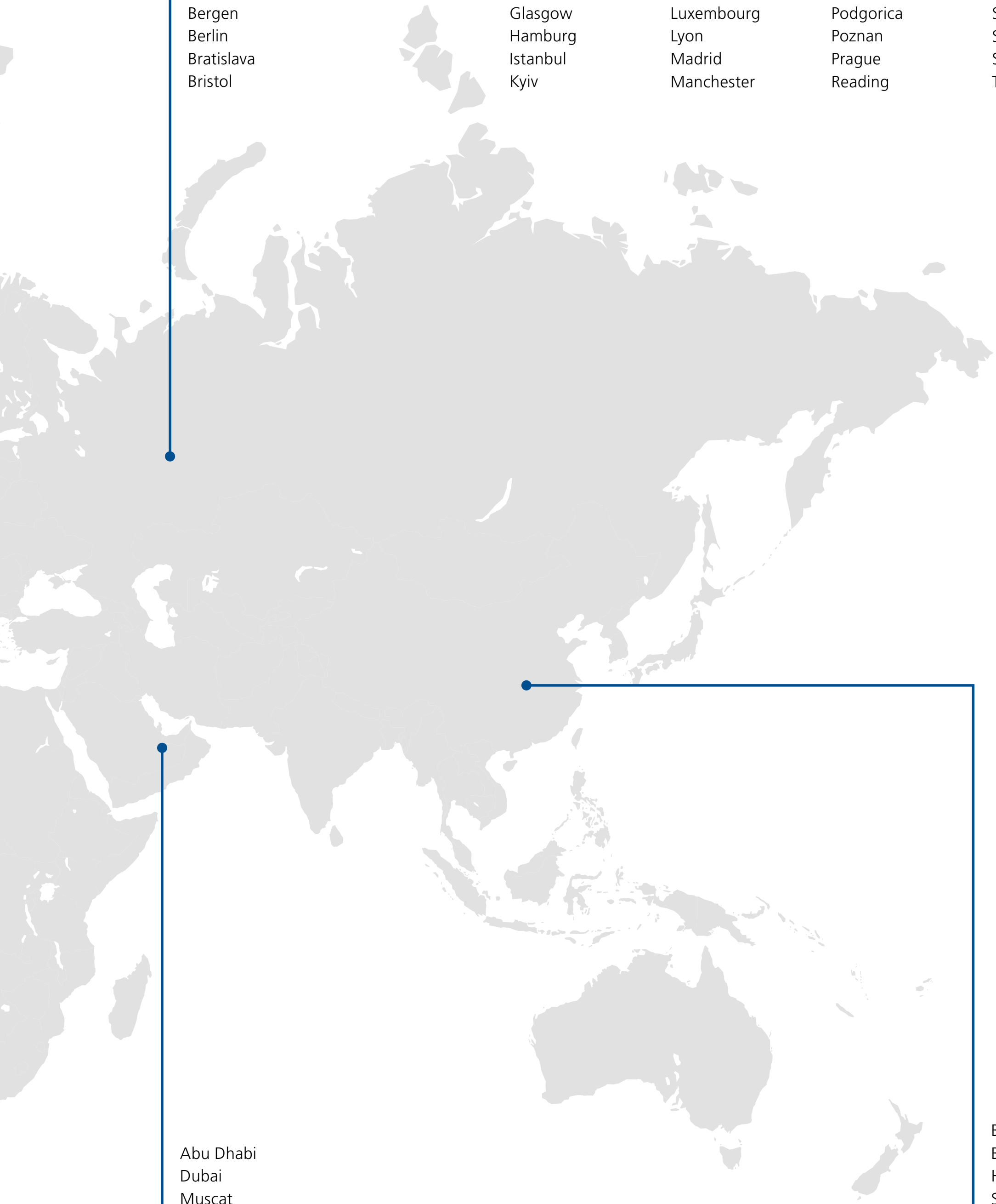


Only deals with management incentive scheme, shares and subject to leaver provisions

Global reach, local knowledge

Europe

Aberdeen
Amsterdam
Antwerp
Barcelona
Belgrade
Bergen
Berlin
Bratislava
Bristol
Brussels
Bucharest
Budapest
Cologne
Duesseldorf
Edinburgh
Frankfurt
Funchal
Geneva
Glasgow
Hamburg
Istanbul
Kyiv
Leipzig
Lisbon
Liverpool
Ljubljana
London
Luxembourg
Lyon
Madrid
Manchester
Milan
Monaco
Munich
Oslo
Paris
Podgorica
Poznan
Prague
Reading
Rome
Sarajevo
Sheffield
Skopje
Sofia
Stavanger
Strasbourg
Stuttgart
Tirana
Vienna
Warsaw
Zagreb
Zurich



Middle East

Abu Dhabi
Dubai
Muscat
Tel Aviv

Asia-Pacific

Beijing
Brisbane
Hong Kong
Shanghai
Singapore

Glossary

Basket

the agreed aggregate minimum amount of (likely) losses due to one or several breaches by the seller of the sale and purchase agreement that the buyer must reach to assert any claims against the seller for the loss suffered. There are two common types of baskets: (i) an "excess only" basket (also called a "deductible"), whereby the buyer can recover only that proportion of any warranty claim or claims that exceed(s) the basket threshold; (ii) a "tipping" basket (sometimes also called "first dollar"), whereby the buyer can recover the whole amount claimed once it has a claim or claims that reach the basket threshold.

Cap

the upper monetary limit of the seller's liability to the buyer under the sale and purchase agreement. Above the cap amount, a buyer will have no recourse to the seller (except in the case of fraud by the seller).

De minimis

the agreed minimum amount of (likely) losses due to a breach by the seller of the sale and purchase agreement the buyer must reach to be able to assert any claims against the seller for the breach of such warranties. This means that if the amount which can be claimed due to the breach is less than the agreed minimum amount, then the claim is automatically excluded. The seller is thereby protected from potential liability for small claims.

Earn-out

the provision providing for an additional purchase price to be paid after completion of the sale and purchase, depending on whether certain conditions are fulfilled, typically by reference to certain key performance indicators of the acquired business over an agreed period after completion. This allows the seller and buyer to share the risks and rewards of business performance following completion.

Hurdle

a threshold often expressed as an internal rate of return percentage or other metric to measure the return on the PE fund's investment that management must meet in order to participate in the increase in value of the business, i.e. management becomes entitled to proceeds only if the minimum return on investment threshold is met.

Leaver Provisions

the circumstances in which a manager ceases to be an employee of a company, and the consequences to that manager's participation in the management incentive scheme. There are two main types of leavers: (i) "Good leavers" are usually employees who leave their employment for good reasons (e.g. death or disability), whereas (ii) bad leavers are usually employees who leave in circumstances justifying their dismissal (e.g. fraud, failure to perform to agreed standards) or in similar situations. If the management incentive scheme is structured as a share scheme, good leavers are usually either allowed to keep their vested shares or their shares are purchased backed by the PE fund at their fair market value, whereas bad leavers must usually return all their shares for a nominal amount or at cost.

Locked box

the mechanism of fixing the purchase price payable on completion by reference to the target group's balance sheet position (i.e., its net debt and working capital) at an agreed point in the past (the "locked box date"). It is an alternative pricing mechanism to completion accounts.

Purchase price adjustment

(also referred to as “completion accounts” or “closing accounts”) the adjustment of the purchase price payable by the buyer for the target business by reference to the target company’s debt and cash position, its working capital, or overall net asset position at completion. Under this construct, the buyer pays an estimated amount of the purchase price at completion and then an ad hoc set of accounts is prepared as of the completion date. Once adjustments are calculated, if any, either the buyer or the seller may have to pay an amount to/back to the other. The parties to the M&A agreement thereby achieve certainty that the final purchase price reflects the actual debt, cash, working capital or net asset position at completion.

Ratchet

an anti-dilution protection mechanism in which the equity stake held by founders, managers and/or employees may be altered depending on the occurrence of various future events post-investment, e.g. the matching of forecasts and projections or the investor’s target return.

Rollover

the process by which certain equity holders in the target company (including founders and key members of the management team) carry a portion of their ownership stake over into the new equity capital structure put in place by the acquiring private equity firm in lieu of receiving cash proceeds.

Strip

the aggregate capital provided by private equity investors when acquiring a new company. This may be equity, (shareholder) loans, or a combination of the two. Managers may be offered the opportunity to acquire these same equity and/or debt instruments (“strip”), and pay the same (full) price for them as the PE fund.

Sweet equity

shares in the target company issued to founders, managers and key employees, usually for a price that is nominal or otherwise lower than the price of the other “strip” (ordinary) shares.

Vesting

the process by which an employee, investor, or co-founder is rewarded with shares or stock options, but receives the full rights to them over a set period of time or, in some cases, after a specific milestone is hit. This isusually established in an employment contract or a shareholders’ agreement.

W&I insurance

transaction insurance purchased by either the buyer or seller to cover against financial loss that may arise from a breach of warranty and/or claims under certain indemnities given by the seller(s) in a sale and purchase agreement. If the buyer takes out W&I insurance, its primary recourse in case of claims will be to the insurance. If the seller takes out the insurance, the seller will remain liable to the buyer, but will be able to claim back from the insurance.

Warranties vs indemnities

Warranties protect buyers from unknown issues they may become aware of after the contract is signed and/or the transaction completes. A breach of warranty will only give rise to a successful claim in damages if the buyer can show that the warranty was breached, and that the effect of the breach is to reduce the value of the company or business acquired. The onus is therefore on the buyer to show breach and quantifiable loss.

An indemnity is a promise to reimburse the buyer for a particular type of liability, should it arise. The purpose of an indemnity in an acquisition context is, broadly speaking, to shift the risk of a particular event or matter to the seller and to allow the buyer to recover on a pound-for-pound/euro-for-euro basis if the liability occurs. Indemnities are often used where a warranty may not allow a buyer to recover, because the buyer is already aware of a specific issue at the time the contract is being signed.

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