What's Market? Technology

Technology M&A Trends Report: 2011

Pinsent Masons

Introduction

In 2011 Pinsent Masons advised on over £340 million of mid-market M&A transactions in the Technology Sector. By studying the details of these transactions, our Corporate group has been able to highlight some emerging, key trends within the sector that we expect to continue into 2012.

These are explored in more detail in this report and centre around five areas:

Concern with valuations

Buyers and sellers continue to be concerned with accurate valuation mechanisms, with around 80% of the deals we surveyed containing either a performance related price adjustment mechanism or some kind of a locked box or asset measurement structure.

Higher levels of value protection

We are generally seeing higher levels of value protection through proportionately larger warranty caps amongst the deals at the smaller end of the mid-market value range (between £5-10 million), with the percentage then decreasing as the deal value increases.

Focus on incentivising management

On deals involving equity investments management incentivisation structures have almost invariably been implemented. However, legal drivers such as entrepreneur's relief tax planning for capital gains on share disposals will continue to impact on this trend over the next 12 months.

Lengthening deal timetables

Deals are taking longer to complete, with, generally speaking, timetables lengthening as the value of the transaction increases. However, we found that smaller deals (below £5 million) seem to take disproportionately longer to complete, most likely due to the plurality of parties (clubs of individual angel investors, institutional investors and founders) involved.

Peaks in March and December

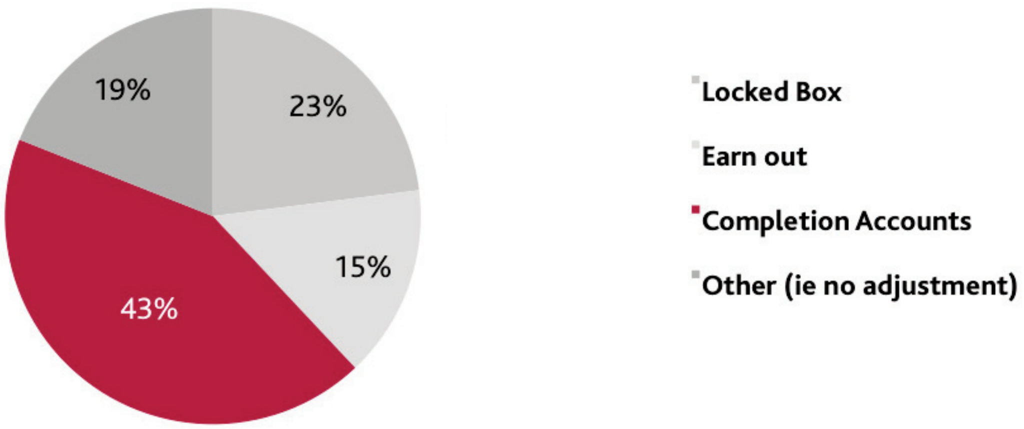
The months of March and December were the busiest in terms of M&A activity in the Technology Sector, both in volume of deals completed and aggregate deal values. These peaks were undoubtedly driven by a desire to complete acquisitions and disposals before tax, accounting and calendar year ends.

Andrew Hornigold
Sector Head, Technology

Concern with valuations - price and price adjustments

- **Completion accounts – over 40%** of the deals we surveyed had a completion accounts mechanism.
- **Locked Boxes** – approximately **one quarter** of the deals we surveyed had a locked box consideration mechanism.
- **Earn outs – over one in ten** of the deals surveyed had an earn-out pricing mechanism.

Price mechanisms

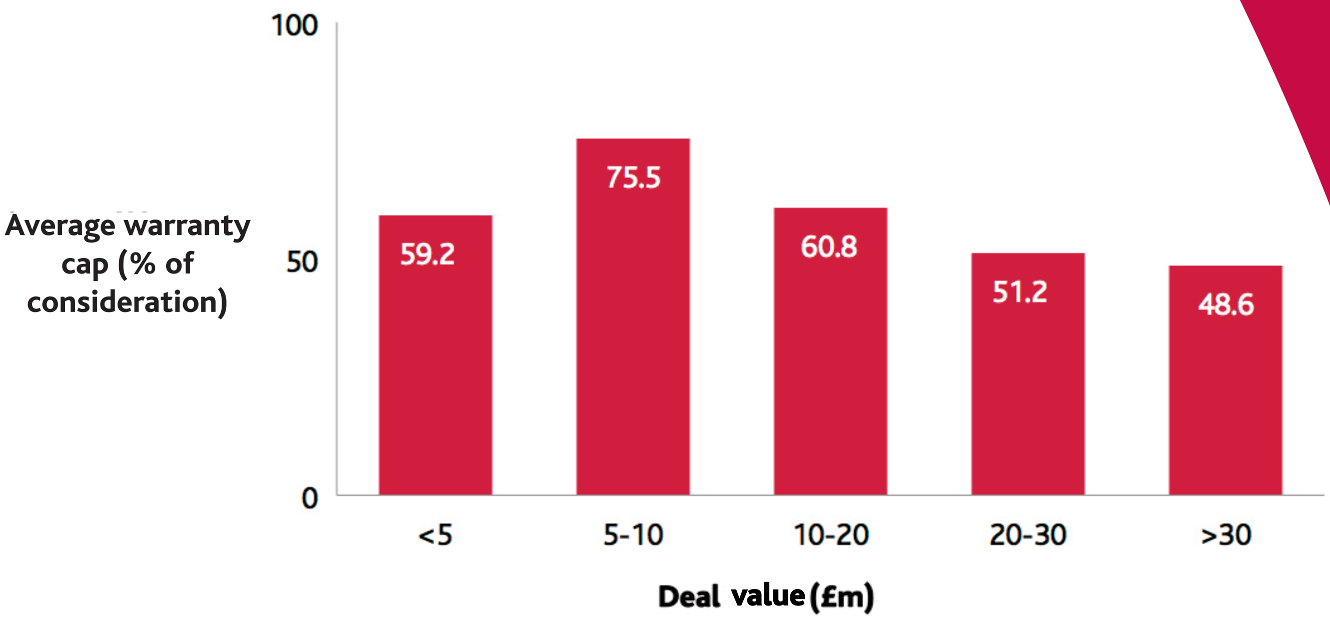


Conclusions:

- Buyers are still concerned about **target valuations** and **accurate pricing.**
- Although buyers are, in general, in a strong negotiating position given the economic climate, sellers have frequently been able to negotiate **upfront pricing models** such as **locked boxes** meaning that buyers are looking for alternative means to protect value post-completion (see below).
- Earn-outs are being used across all deal value ranges though predominantly on acquisitions of **technology services businesses** where the premium paid over underpinning asset values tend to be higher and businesses are more focussed on the performance of key personnel.

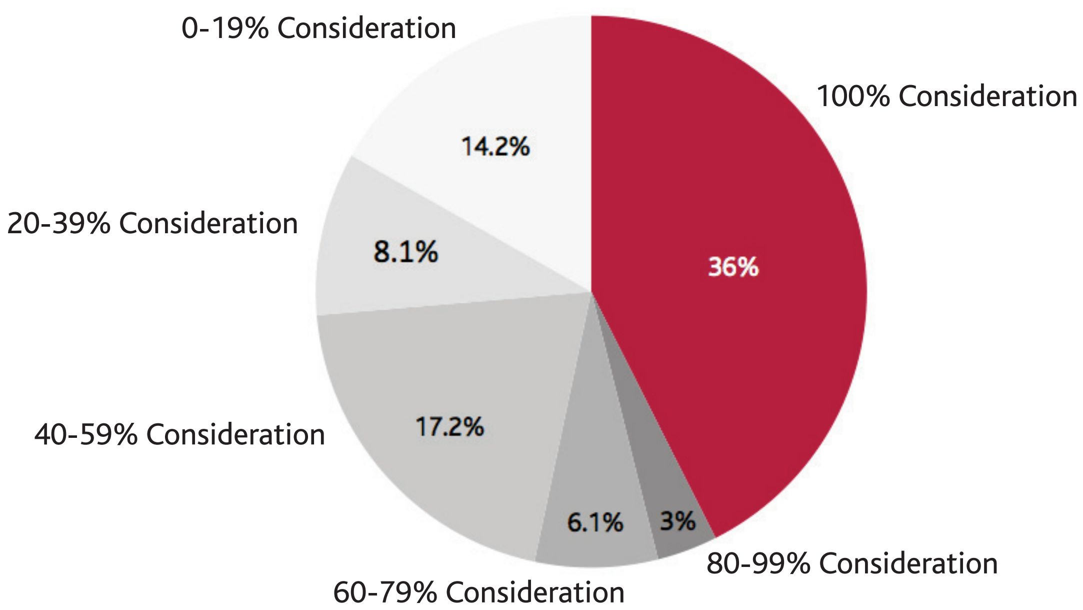
Value protection

- **Warranty caps** – broadly speaking we are seeing average warranty caps across all deal ranges settling somewhere between **50-75% of consideration paid.**



- **Escrow accounts** – escrow accounts were used in approximately one quarter of the deals we surveyed. The amount placed in escrow varied considerably from deal to deal, depending on the specific risk addressed by the escrow mechanism.

Warranty cap analysis



- **Warranty and Indemnity insurance** – one in ten of the deals we surveyed used a warranty and indemnity insurance policy, and on all occasions this was a buyer-side policy. W&I policies were most prevalent in deals with values exceeding £10,000,000.

Conclusions:

- Buyers remain concerned to protect value and mitigage the risk of a weak sellers' covenant for potential post-completion claims.

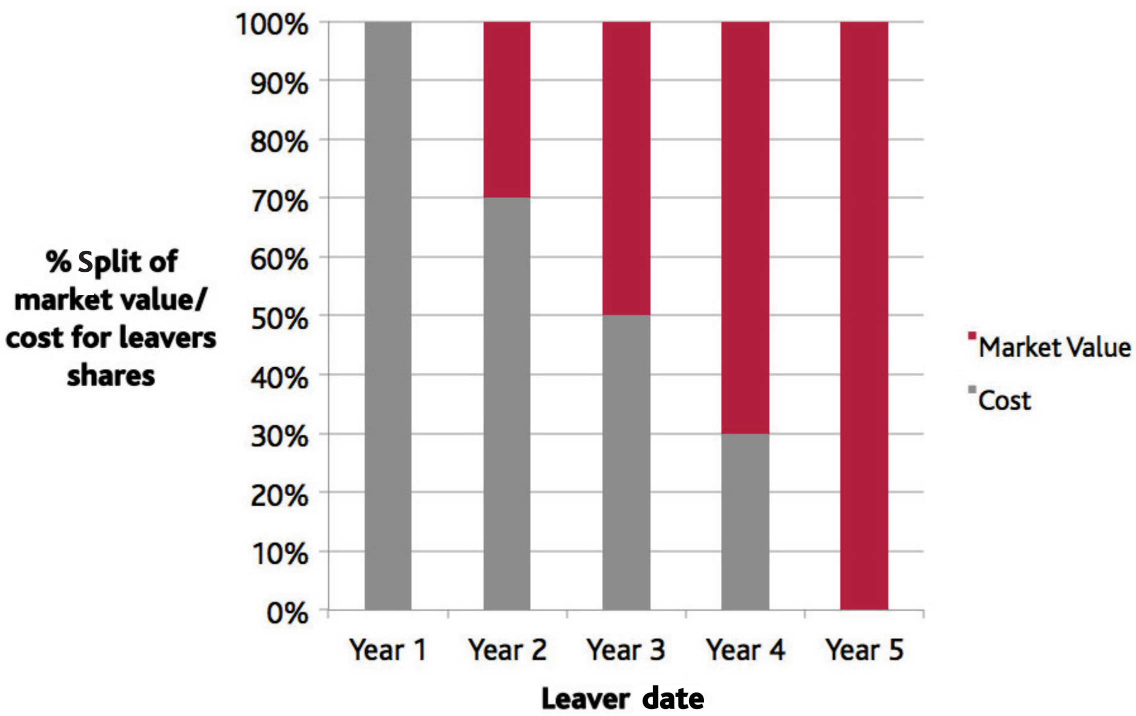
- The impact of W&I insurance on transaction costs and timetable means that parties do not generally see the use of these policies as a viable means to address gaps in warranty cover on smaller value deals.

Management considerations

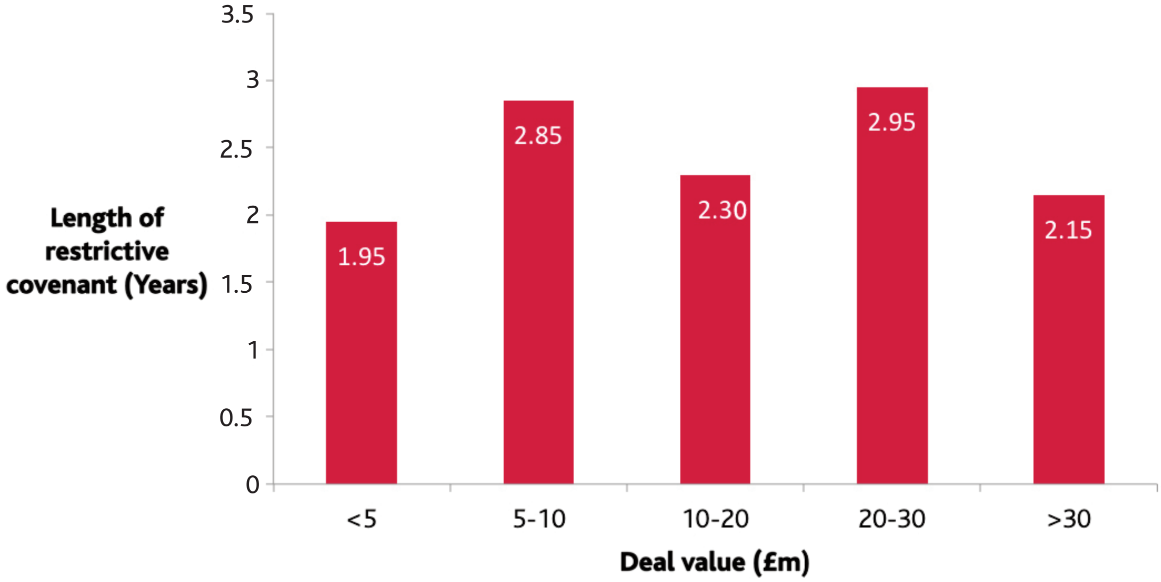
- **Vesting of management shares** – all of the deals we surveyed which involved an element of management equity participation in the buyer vehicle were structured so that management's equity was subject to vesting provisions of some kind.

- **Title vesting** – some deals were structured so that, in the event of manager shareholders ceasing to be an employee of the buyer's group, they would be required to transfer some, if not all, of their shares back to the company or to a replacement manager/warehousing arrangement. The extent to which management were able to retain a proportion of their shares (i.e. vested shares) varied from deal to deal in accordance with the particular economic and commercial drivers.

- **Economic vesting** – in addition to title vesting provisions, we have seen provisions covering the price management would be entitled to receive upon a forced transfer of their shares in the event of becoming a leaver. Again, the specific details of pricing varied from deal to deal but a typical economic vesting profile would operate as follows:



- **Restrictive covenants –** these are also seen as being important for purchasers in protecting value post-completion. We have seen the average length of restrictive covenants on the deals in each value range as follows:



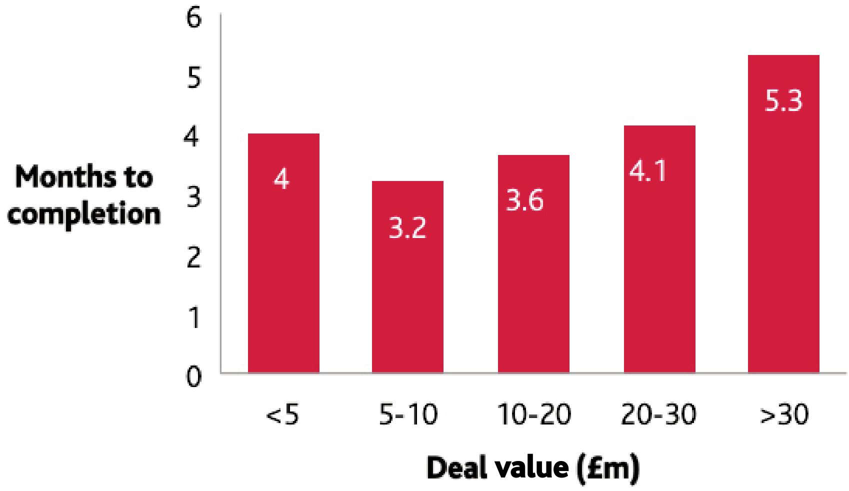
Conclusions

- Managers should take legal and other professional advice early on in the transaction process to negotiate the provisions of vesting provisions with investors. In particular, the timing of any forced sale of shares under leaver provisions may impact on the availability of **entrepreneurs relief**, a key consideration for managers thinking about how to minimise taxable gains on a disposal of shares.

- It is interesting to see that restrictive covenants are hovering around the **2-3 year mark**. Three years has always been the generally accepted maximum length of restrictive covenants in a sale and purchase context, although **new employment and competition law developments** may lead to a reduction in the length of restrictive covenant periods towards **2 years.**

Deal timetables

The following bar chart illustrates average deal timetables from instruction of lawyers to completion of the transaction across various deal value ranges:



Conclusions:

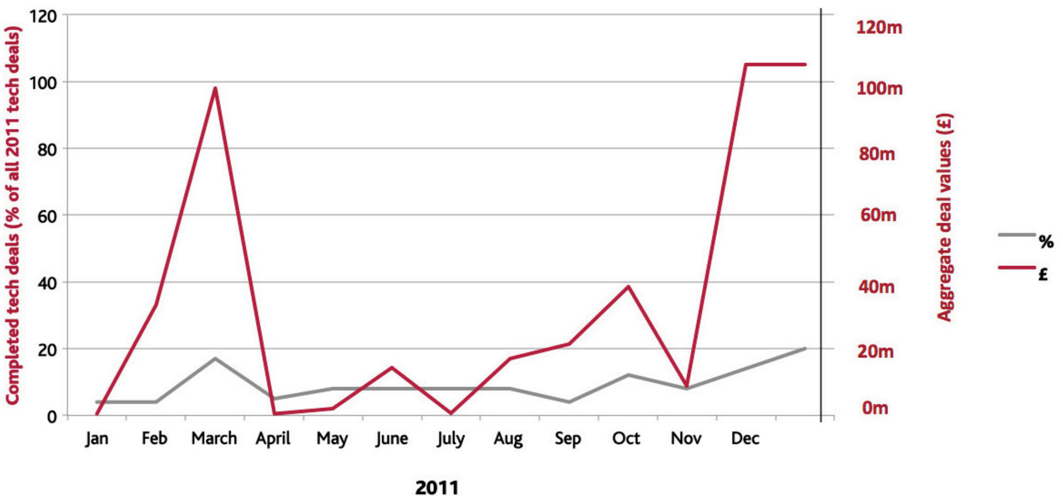
- The increased use of larger **bank acquisition facilities** in connection with the higher-value deals and the increased likelihood of **warranty and indemnity insurance policies** being put in place on those deals have impacted on timetable.

- At the lower end of the scale (typically early stage/start up funding rounds), deals were difficult to complete swiftly due to the **plurality of parties and stakeholders** involved in these transactions (founders, institutional investors, angel investors etc).

- More generally, timetable slippage has been seen due to **due diligence issues** coming to light once transaction negotiations have commenced - forward planning and pre-deal preparation and seller side due diligence audit can help deal with issues up front and assist in maximising deal value and avoid delays.

Volumes and values

We analysed the number of Technology Sector M&A deals we completed each month through 2011 (as a percentage of all deals we completed throughout the year) as well as the aggregate value of the deals month on month. The results are set out in the following graph:



Conclusions:

- We can clearly see the effect that **the end of the tax year** and **the end of the calendar year** had on the levels of tech M&A activity, with both deal completion rates and aggregate values of those completed deals peaking at the end of March and in December.

- After a slow start in January and February, **Mid-market** M&A deal activity in 2011 in Q2 and Q3 remained at constant levels.

- We found that activity in the smaller, **start up and early-stage** end of the market (deal values of <£5 million) remained at constant levels throughout the entire year.

About Pinsent Masons

Pinsent Masons has focused on the Technology Sector for more than 15 years. Acting for some of the world's largest technology businesses, we provide sector-focused expertise and experience. We understand your issues and priorities and we can partner with you to achieve your strategies and position your business for long-term success. We are able to deliver a full range of legal solutions to meet all the needs of ICT businesses.

Our clients include FTSE 100 listed and international software and services, communications, internet, media and content and hi-tech manufacturing businesses operating all around the world as well as large private and fast growing VC backed technology companies.

Whilst we support the largest corporates, we also work with many smaller businesses supporting them from the early stages of their fundraising and IP development and exploitation through to exit, providing operational as well as strategic advice.

In 2011 our Corporate Group acted on over 190 corporate transactions, over 30 of which were for clients operating in the Technology Sector.

Highlights of 2011 in the Technology Sector include:

- Advised **Vislink Plc** on the acquisition of the entire issued share capital of Gigawave Limited
- Advising **Equifax Inc** on the acquisition by one of its UK subsidiaries, Equifax EUA Limited, of the entire issued share capital of Workload Financial Business Consultants Limited
- Advising **Lloyds TSB Development Capital Limited** on the Management Buy-Out of Ufi Limited
- Acting for **Lloyds Development Capital Limited** on the Management Buy-Out of Kirona Group Limited

We hope you find this report interesting and useful. If you have any queries please contact a member of our Technology Sector Team or your usual Pinsent Masons contact:

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