CUATRECASAS

Market Trends in Iberian Private Equity Transactions

2020 Edition

Spanish market outlook 2019

Market trend overview

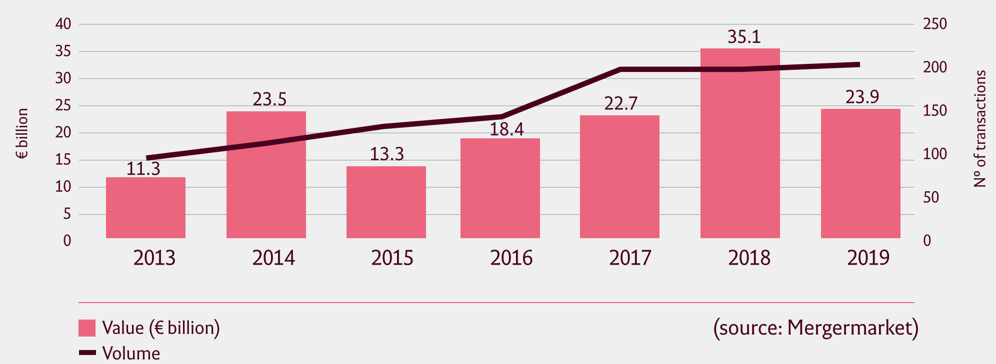
After an incomparable 2018, when the Spanish market reached a milestone both in value and volume of transactions, the market slowed down in 2019, particularly in investment value.

The Spanish private equity sector has been growing consistently in recent years

However, the Spanish private equity sector has been growing consistently in recent years and is still recording robust figures. Apart from exceptional periods such as 2014 and 2018 (see graph below), its growth trend continues.

Sources such as Mergermarket and TTR confirm this trend, by tracking a similar volume and value of deals, despite applying different criteria for assessing transactions

2013-2019 Spanish Private Equity transactions

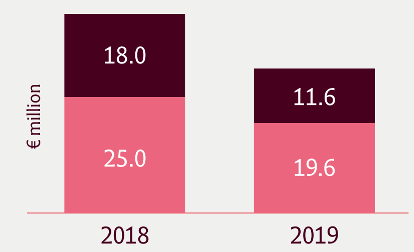


(source: Mergermarket)

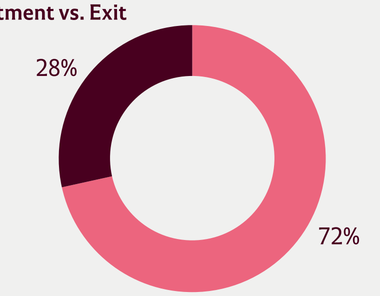
According to the data registered by Mergermarket in Spain, there were 204 deals with a total value of €23.9 billion, representing a 3% increase in the number of transactions and a 32% decrease in the value of those transactions. The compound annual growth rate (CAGR) over the last five years is 13.4%.

Compared to 2018, the slowdown we saw in 2019 is reflected both in investments (22% decrease) and value of exit transactions (35% reduction). Exit transactions reduced their weight compared to the preceding year and represented 28% of the deals, while 30% of the exits were secondary buyouts in 2019.

Value of private equity transactions in Spain 2018 vs 2019



Volume of private equity transactions in Spain in 2019 Investment vs. Exit



Investment
Exits

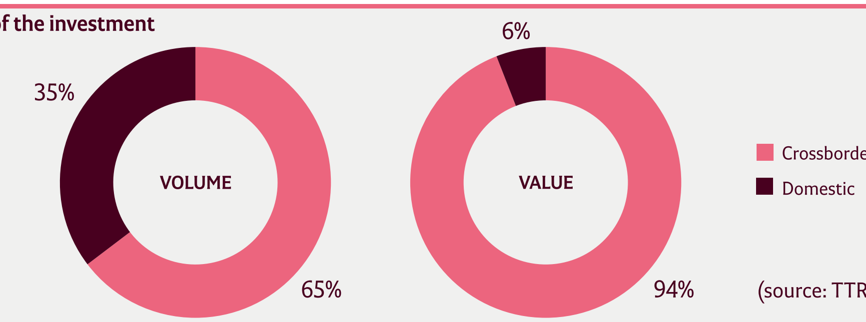
(source: Mergermarket)

Source of the investment

Crossborder transactions led the market again in 2019. As reflected in TTR, they represented over 94% of total investment value and a 65% share based on volume.

This shows that international investors focused on bigger deals, while national investors invested in a higher percentage of smaller transactions. This is also confirmed by the estimated data gathered by the Spanish Venture Capital & Private Equity Association (ASCRI), which shows that international investors represent 81% of the market by value and 17% by volume.

Source of the investment



(source: TTR)

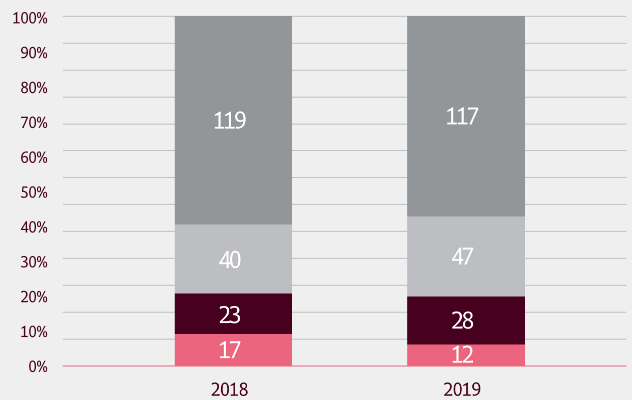
Type of transactions

Size

Based on the size of the transactions, it maintains a similar weight for number of deals between different ranges.

There was a drop in larger transactions (over €500 million). It registered five fewer transactions, and they have lost relative weight in terms of value compared with last year's figures (67% in 2019; 84% in 2018).

Size of private equity transactions in Spain by volume (2018 vs 2019)



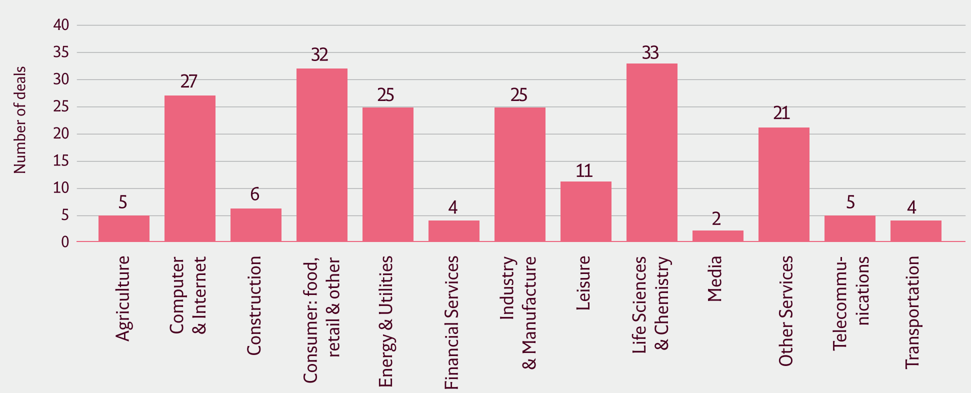
(source: Mergermarket)

Industries

Regarding industries, sources such as Mergermarket, TTR and ASCRI show similar figures.

Life sciences/healthcare/cosmetics is still the industry with the higher number of transactions. Other sectors, such as consumer/food, computer/internet, energy, and manufacturing, were also active in terms of number of transactions.

Target Industry



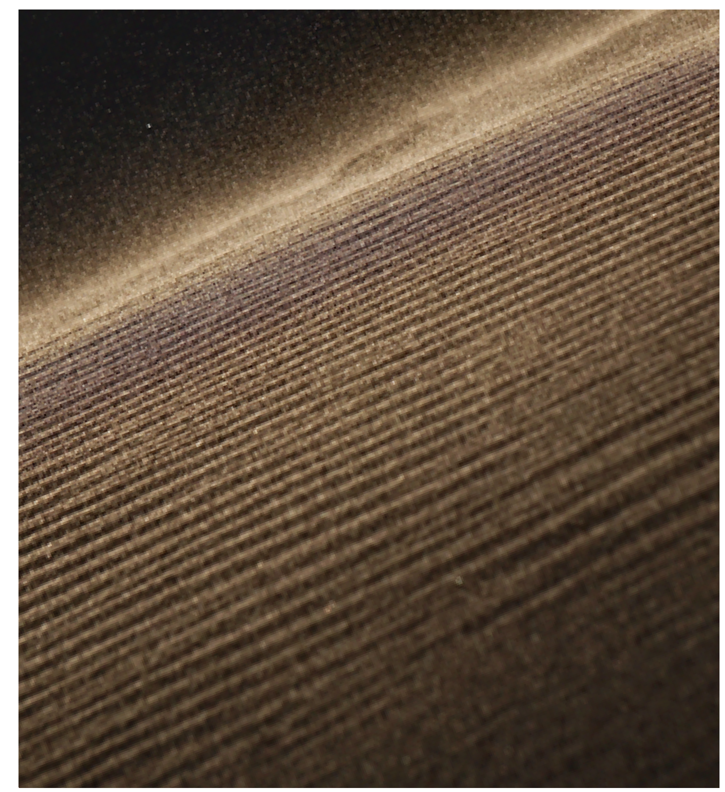
(source: Mergermarket)

ESG and SRI

ESG strategies and sustainable, responsible investing are expected to be a growing trend in the years to come

Beyond market analysis by type of transaction or sector, we should highlight another trend that is growing in importance and visibility, and quickly developing in the private equity sector: the integration of environmental, social and governance (ESG) aspects and the focus on responsible investment, as reflected in the Responsible Investment Guide for Venture Capital & Private Equity in Spain, published by the Spanish Venture Capital & Private Equity Association (ASCRI), 2020. In addition to being contributory factors in returns on investment and access to capital, they can help to identify potential risk and opportunities in a transaction or a company. ESG strategies and sustainable, responsible investing are expected to be a growing trend in the years to come.

Although Spain is providing examples of good practices, there is still some way to go: the United Nations-supported Principles of Responsible Investment (PRI) currently have 68 Spanish signatories out of a total 2,698 worldwide.



Market Trends in Spain

Significant trends in Cuatrecasas deals

Study overview

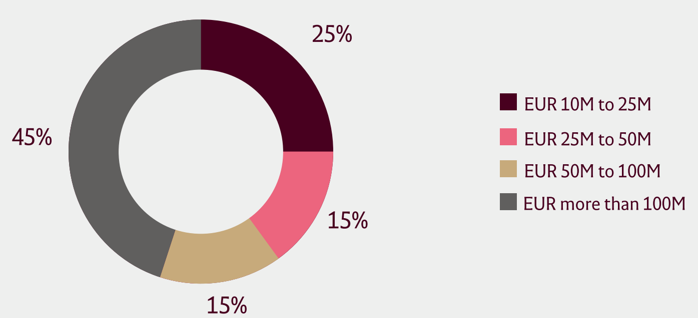
This study, an overview of market trends in private equity transactions in Spain, analyzes the most significant deals on which Cuatrecasas advised.

The study analyzes 34 private equity deals signed in 2018 and 2019 with transaction values over €10 million. It does not include venture capital transactions, as they have their own features and market trends. Unless otherwise specified, all the charts include the figures for 2018 and 2019.

Despite the slowdown in investment value that the Spanish market saw in 2019, almost half of the transactions on which Cuatrecasas advised in 2019 were deals valued at over €100 million, which is significantly higher than in previous years, when most deals had a transaction value between €10 and €50 million.

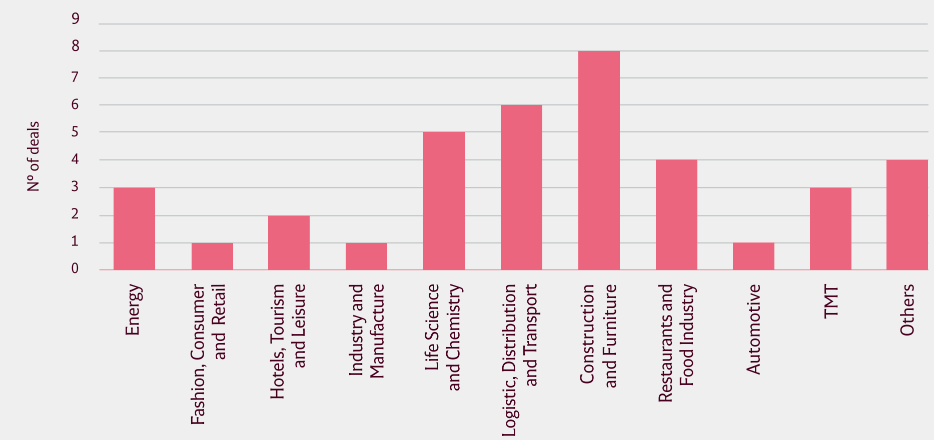
In 2019, almost half of the transactions were deals valued at over €100 million

Transaction Value in 2019



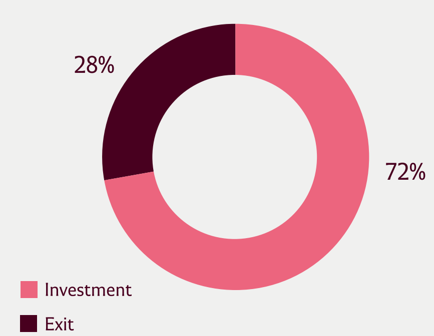
The investment was again very diversified among different sectors, with construction and life science being the most active in 2019. The energy sector, which was very active in previous years (mostly in 2017), dropped off in 2019, with only one transaction, but this was still over €100 million. Even though we have been very active in advising private equity funds on renewable energy transactions in 2019, deals structured through asset purchase agreements or share purchase agreements whose sole purpose was to acquire a company with a solar plant have been excluded from this study.

Target Industry

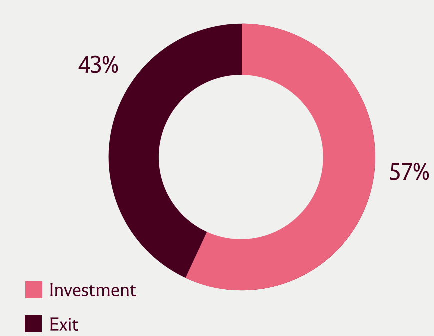


Exits grew and represented almost half of the deals in 2019. However, compared to 2018, when 80% of the exits were secondary buyouts, in 2019, only in one deal did a private equity firm sell its investment to another private equity firm.

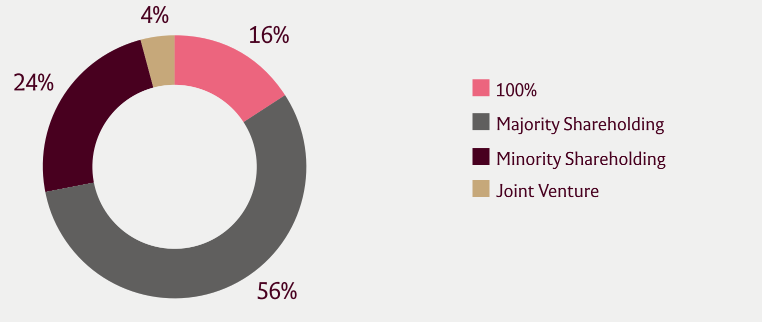
Investment vs. Exit 2018



Investment vs. Exit 2019



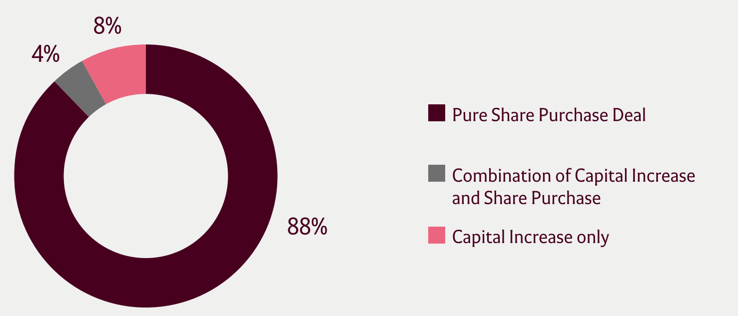
Majority vs Minority



In 2019, there was a significant increase in exits

When a private equity fund invests, the most typical transaction continues to be that it buys 100% of the capital stock of the target company or takes a majority shareholding through a pure share purchase deal. This contrasts with venture capital transactions, where pure share purchase deals are rare and usually take a minority shareholding in the company through a capital increase.

Investment Structure



In 32% of transactions, instead of buying a majority shareholding directly, the private equity fund bought the target company through an SPV and then the seller (or some of the sellers) reinvested in the SPV, usually through a capital increase. This happens for many reasons, but mainly for tax, indebtedness and regulatory reasons.

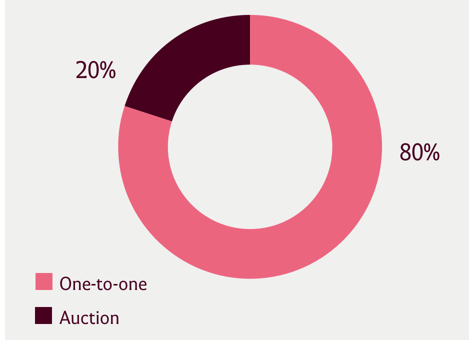
Deal Process

In 2019, there were fewer auctions than in 2017 and 2018

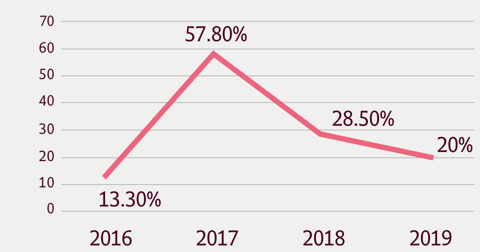
As in other jurisdictions, such as the UK, in 2019, the number of private equity transactions run as actions decreased (20%) compared to 2017 and 2018, when 57.80% and 28.50%, respectively, of the deals were beauty contests with multiple potential bidders.

If we focus only on exit transactions, the percentage of transactions using an auction process increased considerably to 43%, but this figure is far from the two-thirds we saw in the previous two years.

Auctions Process

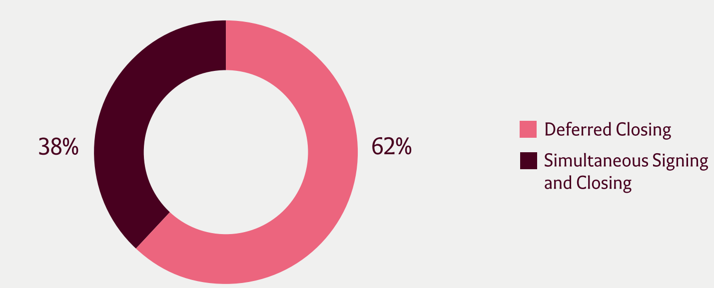


Auctions Process



Most transactions (70% in 2019) had a deferred closing, almost always due to the fulfilling of conditions precedent.

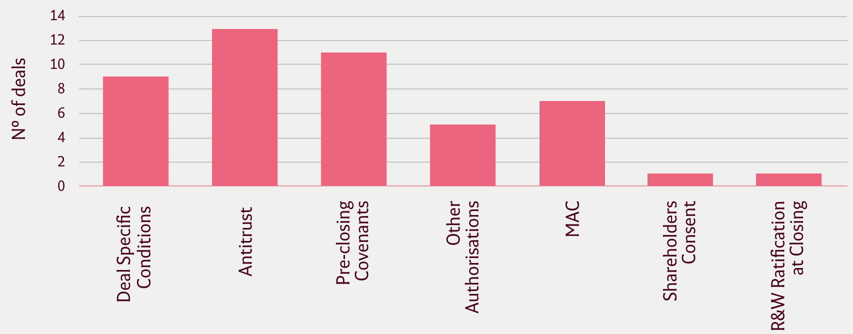
Simultaneous Signing and Closing vs Deferred Closing



Almost half of the transactions requiring antitrust clearance included a hell-or-high-water provision

The transactions included a range of conditions precedent, the most common being (i) approval by the antitrust authorities; (ii) other regulatory authorizations; (iii) fulfillment of pre-closing covenants (such as corporate restructuring, carve-outs, repayment of credits or termination of contracts); (iv) absence of MAC during the interim period; and (v) more ad hoc conditions precedent related to the deal, third-party waivers (lenders or other side's consent due to change of control clauses), execution of agreements (financial agreements, shareholders agreements or others), fulfillment of financial agreement conditions, delivery of specific documents, and lack of legal proceedings or court rulings that may jeopardize the transaction.

Types of CPs



In 2019, almost 30% of transactions included a break-up fee in case the closing does not occur or there is a breach of the closing obligations

In 2019, there was a significant increase in the use of break-up fees in case the closing does not occur or there is a breach of the closing obligations. The percentage of the purchase price to be paid as a penalty varies, but it never exceeded 15% of the purchase price, and it was usually below 10%. In half of the transactions, the breaching party had to pay the penalty, and in the other half, it was agreed only in favor of the seller.

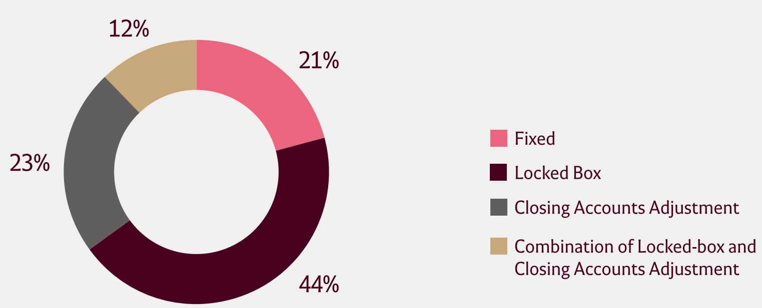
The use of conditions subsequent was low (approximately 10%), mostly because once the transaction is closed and the property transferred, returning to the stage before the purchase was completed is difficult.

Consideration and Pricing Mechanisms

As in traditional private M&A transactions, completion accounts and locked-box are the two pricing mechanisms typically used, together with the fixed price.

Although both mechanisms have their pros and cons for both parties, completion accounts adjustment has been considered buyer-friendly, while locked-box has been considered seller-friendly. However, in recent years, the use of the locked-box mechanism has significantly increased and has been consolidated as the most used pricing mechanism, regardless of whether we are in a sell-side or buy-side transaction.

Pricing Mechanism



Locked-box mechanism was used almost twice as much as the closing accounts adjustment

Pure locked-box was used in 44% of transactions, while closing accounts adjustment in 23% and fixed price in 21%. Lately, it is becoming more frequent to see a mechanism combining locked-box and completion accounts (12%).

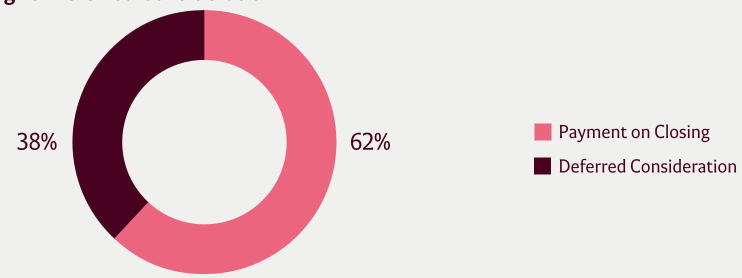
As the financial risk transfers to the purchaser on the locked-box date within the locked-box mechanism, and because the purchaser can benefit from the profits generated from that date while the price is paid at closing, the seller will try to seek compensation (usually by using equity tickers typically structured as a fixed daily rate). Although this practice was previously infrequent in Spain, during 2018 and 2019, it was used in 25% of the deals, always with an interest below 10%.

Seller's liability under leakage compensation is usually capped at the amount of leakage effectively received. In 18% of transactions, leakage was increased by the agreed interest accrued from the date of leakage (usually around 5%). The most common limitation period is 6 to 12 months.

Even though the locked-box mechanism has become the most used pricing mechanism, the completion accounts mechanism was still agreed in 35% of the deals (if a combination of locked-box and closing accounts adjustment transactions are included), in which net debt and working capital were the most widely used financial parameters for the post-closing adjustment.

Net debt and working capital were used in 75% of the deals as the financial parameters for the post-closing adjustment

Payment on Closing vs. Deferred Consideration

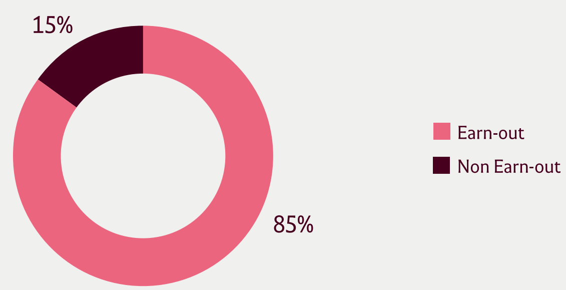


Up to 38% of transactions included payment of deferred consideration and, of these, 85% of them were earn-outs (all of them if we focus only on 2019). The percentage of deferred consideration being earn-outs has increased considerably over the past few years. When an earn-out is agreed, there are sometimes covenants to protect the seller, but this is infrequent.

Sixty-six percent of the earn-outs agreed in 2019 were linked to the disinvestment of the private equity fund.

In 2019, all the deals that included payment of deferred consideration were earn-outs, with 66% of them linked to the disinvestment of the private equity fund

Deferred Consideration



Warranties

R&W are negotiated in SPAs under standard M&A practice. The agreed remedies for a breach of R&Ws are the buyer's only remedy against the seller in case of breach of fundamental warranties or business warranties. When there is more than one seller, their liability was usually joint or individual, or a combination of both (individual for the fundamental warranties and joint for the business warranties). The joint and several liability was hardly seen.

Unlike venture capital transactions, where indemnification can sometimes be in cash or, at the investors' discretion, the target company's shares, warranty payments in private equity transactions are almost always cash.

In 80% of transactions with a deferred closing, the seller was deemed to repeat the representations and warranties on completion.

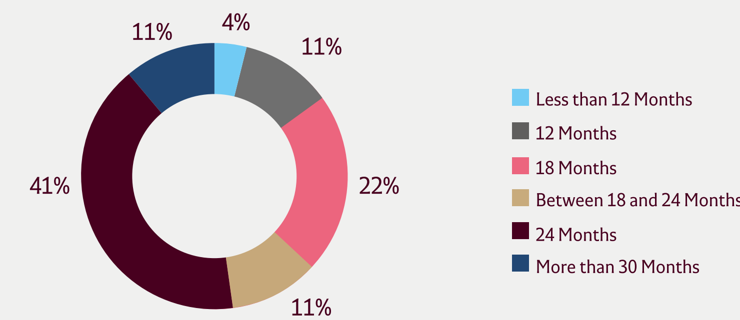
Warranty Limitations

SPAs are usually limited quantitatively and temporarily. However, those limits are different depending on whether there is an investment or an exit and whether W&I insurance is taken out.

Twenty-four-month limitation period became the most used

The 24-month limitation period became the most used (41% of transactions), following the trend that started in 2018. It is common practice to subject specific issues to time barring as provided by law or regulations, mainly in tax, labor and social security matters, but it is also common in criminal, environmental, administrative, data protection and anti-corruption matters, as well as damages related to the breach of a fundamental warranty.

Limitation Period



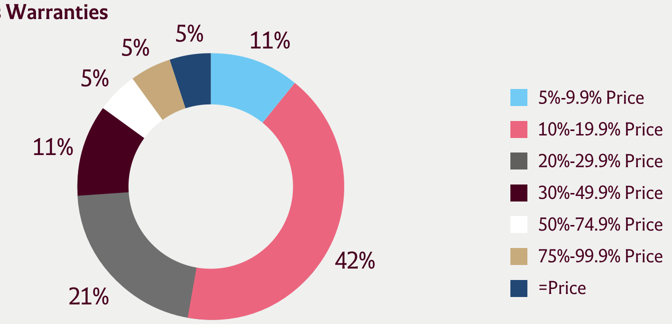
The most used liability cap for business and tax warranties was 10% to 20% of the purchase price

There are usually upper and lower limits on monetary limitations.

Liability for business and tax warranties was generally capped (usually under 50% of the purchase price), in contrast to fundamental warranties, which were either limited to the purchase price or not limited at all. The most common liability cap for business and tax warranties was between 10% and 20% of the purchase price.

In more than 85% of the exit transactions, either a W&I insurance was agreed, or the private equity fund did not provide any reps other than the fundamental warranties

Liability Caps-Business Warranties



All transactions in which the seller does not grant reps other than the fundamental warranties were either private equity funds' exits, or transactions in which a W&I insurance had been agreed. In all transactions the private equity fund was investing in, the industrial seller granted business and tax warranties (unless a W&I Insurance was agreed).

Regarding lower limits (and excluding W&I transactions and clean exits): (i) the seller was not obliged to indemnify for losses if the amount, considered individually, was less than a certain amount (de minimis exclusion or de minimis amount), and (ii) all the deals included a basket.

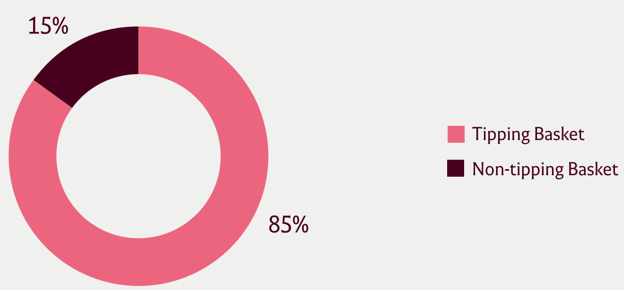
Unless the seller did not give business warranties or a W&I insurance is agreed, all the deals had lower and upper limits

In these cases, the seller will not be liable for damages unless the aggregate amount of the claim, together with all the claims (each over the de minimis amount), exceeds the basket.

In the cases where a basket is agreed, 85% took the form of tipping baskets and 15% of non-tipping baskets. If we focus only on 2019, this percentage rises to almost 92%.

The basket amount grew slightly in 2019, but it is still usually below 1% of the purchase price (0.8% on average) and de minimis below 0.1% of the purchase price (0.07% on average).

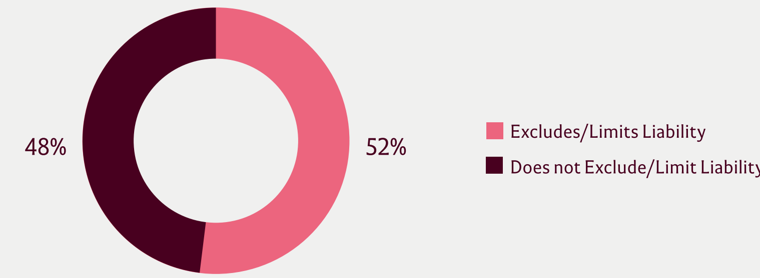
Types of Baskets



Buyer's Knowledge

In Spain, the impact of a buyer's actual or deemed knowledge on claims for breach of warranties is usually negotiated under SPAs. Up to 67% of the SPAs stated whether the buyer's knowledge of an inaccuracy in a representation and warranty limits the seller's liability for breach of warranties. Of this 67%, 48% of transactions did not include limitations on the buyer's remedies if the buyer was previously aware of an inaccuracy or breach. In the other 52%, the buyer's knowledge excluded or limited the seller's liability.

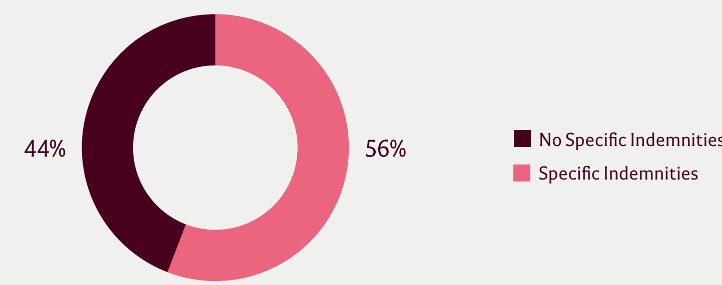
Effect of Buyer's Knowledge



Specific Indemnities

Specific indemnities are ad hoc indemnity remedies negotiated when the risk of a specific loss is high, but not 100% certain. They are not usually subject to any limitation and do not have to follow the claim procedure negotiated under the SPA. Specific indemnities were included in 44% of transactions for several reasons.

Specific Indemnities

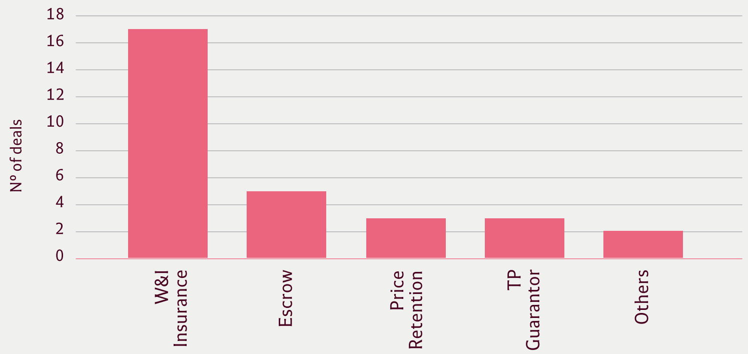


Buyer's Remedies Against Seller's Liability

To seek security against the seller's liability, including a buyer's remedy in the SPA is common . However, although more than 92% of SPAs included a buyer's remedy in 2018, in 2019, this percentage dropped off to 76%. Regarding classic buyer's remedies, escrows continued to be most used.

However, one of the clearest trends is the increased use of W&I insurance. Used in half the transactions since 2018, it is becoming the most used buyer's remedy in private equity.

Types of Sellers' Guarantee



W&I Insurance

W&I insurance continued to be used in half of the transactions in 2019 and not only within the framework of an exit

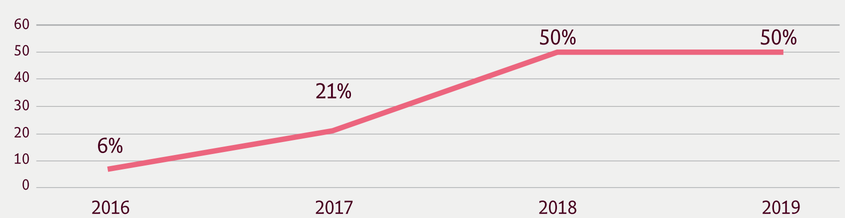
Since 2016, the Spanish market has started following the new trend emerging in the M&A market worldwide: seeking warranty remedy through W&I insurance.

In 2016, it was used only in 6% of transactions; in 2017, this increased to 21% of deals; and in 2018 and 2019, this rose to 50%. All were buyer-side policies and in most cases negotiated within the framework of an auction process or exit transaction.

Seller-side policies do not tend to be the best option because of the general exclusion of actual knowledge. But sellers often want to control and shorten the process. That is why there is sometimes a "seller-to-buyer flip," meaning the seller starts the process of negotiating the policy, but the purchaser finalizes it. This is common in auction processes. W&I insurance has become important in the private equity sector, as it allows the private equity fund to make a clean exit while disinvesting.

In 70% of the W&I insurance in 2019, the seller made a clean exit (which means it did not grant any business warranty). Consequently, if there is any inaccuracy in the seller's R&W, the buyer's only remedy will be against the W&I insurer under the W&I policy: the buyer will not have any action against the seller. However, in a clean exit, it is common for the purchaser to have an action against the seller in cases of fraud, wilful misconduct and breach of fundamental warranties.

W&I Insurance



The seller made a clean exit in 70% of the W&I insurance in 2019

W&I insurance coverage depends on the policy negotiated, but usually it does not include:

- matters the insured party has actual knowledge of (i.e., matters discovered during the due diligence (DD) process);
- matters outside the DD scope;
- anti-bribery, anti-corruption, anti-money laundering, and anti-tax evasion warranties;
- fines and penalties (at least criminal penalties);
- purchase price adjustment and locked-box mechanisms;
- forward-looking warranties;
- environmental liability;
- transfer pricing, and joint and several tax liability for belonging to a corporate group;
- asset's condition;
- product liability; and
- seller's covenant or commitment related to managing the business during the interim period.

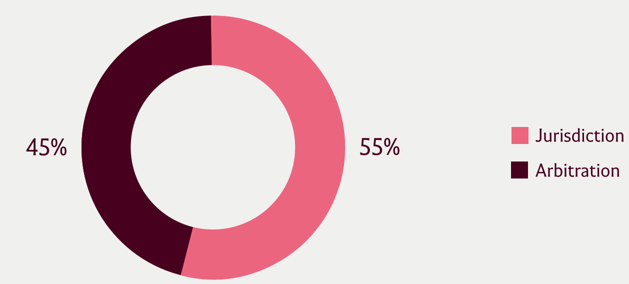
Dispute Resolution

In 35% of transactions in 2019, parties chose arbitration

In 45% of transactions carried out in 2018 and 2019, the parties opted for arbitration as the dispute resolution mechanism to resolve conflicts arising from the agreement but observing a big decrease in 2019 from 2018 (35% vs. 57%).

The most common seat of arbitration continued to be Madrid. The arbitration proceedings were mostly managed by the Court of Arbitration of the International Chamber of Commerce ("ICC"), or by the Madrid Court of Arbitration.

Dispute Resolution

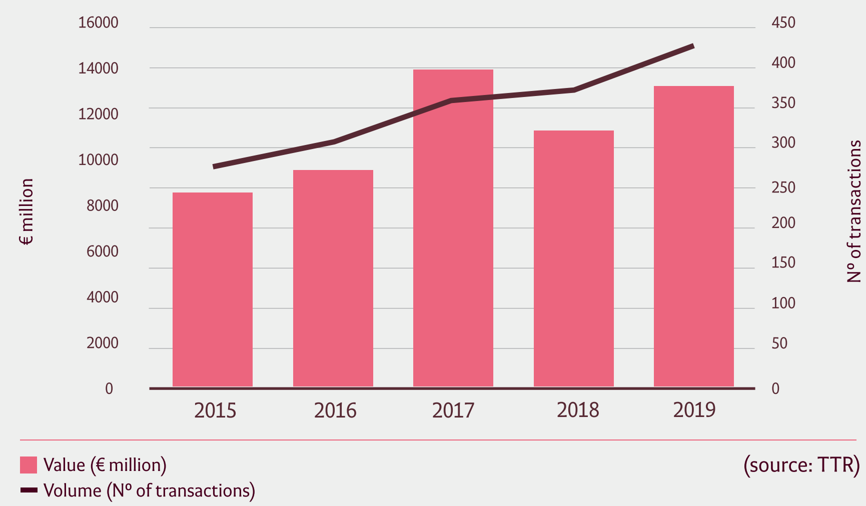


Snapshot Portugal

Market outlook

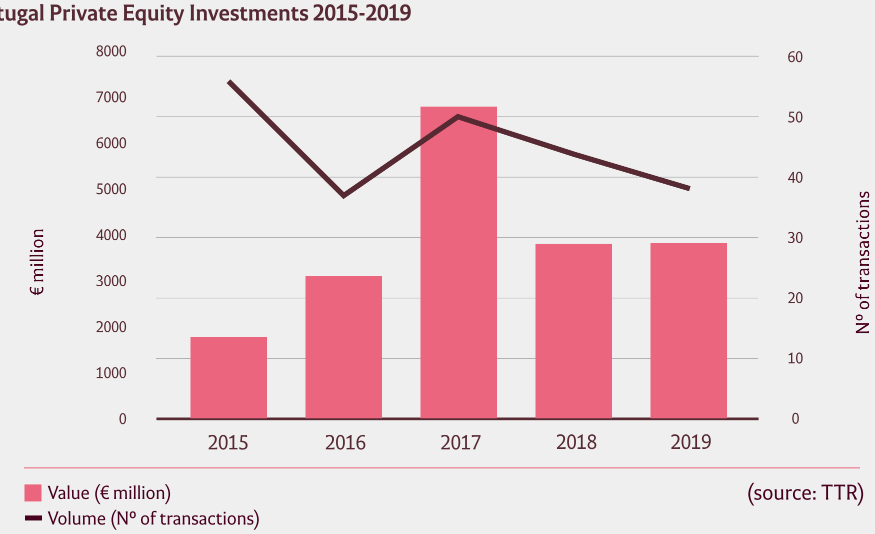
In 2019, the volume of mergers, acquisitions, private equity and venture capital deals in the Portuguese market totaled 427 deals and €13.4 billion, up 15% in volume and 17.85% in value compared with the same period in 2018, according to the data TTR has registered for Portugal.

Total Transaction Volume and Aggregate Value 2015-2019



Regarding private equity (PE), there were 38 investments, with a total value of €3.9 billion, meaning a 13.64% decrease in the number of transactions and a 0.03% decrease in the value of the transactions with disclosed value. Seventy one percent of the PE deals in Portugal were crossborder.

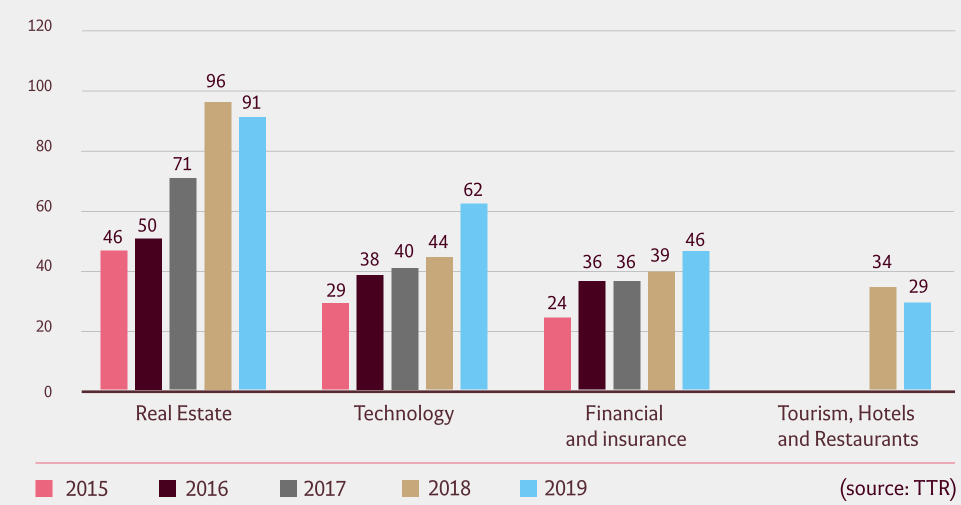
Portugal Private Equity Investments 2015-2019



According to TTR, the leading subsectors in PE deals in 2019 were real estate, technology and financial institutions, as well as tourism, hotels and restaurants

Data on M&A, PE and venture capital shows that crossborder inbound acquisitions focused on the following sectors, in order of preference: real estate (91 deals), technology (62 deals), financial and insurance (46 deals), and tourism, hotels and restaurants (29 deals). Domestic acquisitions (155 deals) are second only to inbound acquisitions (184 deals), which clearly outperform outbound acquisitions (55 deals).

Subsectors With Most Deals 2015-2019



Only 11 of the PE transactions (29%) disclosed their value, totaling €3.9 billion, representing a 16.6% increase

Spanish investors are the most active bidders in terms of crossborder activity in Portugal, with 49 deals, but with only €732.34 million disclosed value, followed by the United States (34 deals with an overall €3.6 billion disclosed value), the United Kingdom (31 deals with an overall €1 billion disclosed value) and France (16 deals with an overall €3.5 billion disclosed value).

In addition to the local PE firms, UK and US firms seem to be the most important players

Based on the size of the transactions, larger transactions (over €500 million) amount to 54.72% of all transactions during 2019, while 27.52% of all transactions ranged between €100 million and €500 million (from 60.9% in 2018).

Local distinctions

While the deal process does not vary substantially across Iberia, there are certain legal distinctions in Portuguese law that must be considered when structuring and implementing a PE transaction.

Shareholding funding

Public limited liability companies (Sociedades Anónimas or "SAs") require a minimum share capital of €50,000, and quota companies ("Lda") do not require a minimum share capital.

The shareholders' contributions can be allocated fully to the share capital or allocated partially as share premium (ágio), both accounted for as equity. Subject to certain exceptions, the share premium (ágio) is subject to the legal reserve regime and can only be used to (i) cover part of the losses shown in the balance sheet that cannot be covered by other reserves; (ii) cover losses from previous years, which cannot be covered by the financial year's profits or by other reserves; and (iii) increase the share capital, up to the mandatory amount of the legal reserve.

Shareholder loans (suprimentos) are subordinated debt and require that the credit has a continued basis, which is considered to exist when the maturity term exceeds one year.

Shareholder funding is often made by supplementary capital contributions (regulated for quota companies, but used also in SAs), which are cash contributions accounted as equity not bearing interest, the reimbursement of which would require that (i) the company's equity does not fall below the sum of the share capital and legal reserve, and (ii) the shareholder has already paid in full its quotas/shares. The credits derived from the supplementary capital contributions are transferred with the corresponding quota/shares and are generally priced at their nominal value.

Shareholders' liability

Quota companies can be held by two or more shareholders. If a quota company is held by a single shareholder, the sole shareholder may be exposed to liability for the company's debts in the case of insolvency, if there was patrimonial confusion between the shareholder and the company and subject to the specific legal regime for sole shareholder companies, including certain disclosure obligations.

Public limited companies must be established by five or more shareholders, unless they are established by a single shareholder, which must be a corporation. There are specific liability rules for the companies in a group relationship exposing the dominant company to the losses of the subordinated company that should only apply to companies with registered offices in Portugal.

Financial assistance

Portugal prohibits financial assistance provided expressly for SAs. The application of this prohibition to quota companies is controversial.

In cases where financial assistance is provided, directors are subject to civil and criminal liability (with a fine up to 120 days).

Although there is no specific legal regime on mergers subsequent to a leverage acquisition, forward and reverse mergers are used in Portugal, among other alternative transaction structures, subject to certain restrictions, namely valid economic reasons to justify the merger.

Personal guarantees and corporate benefit

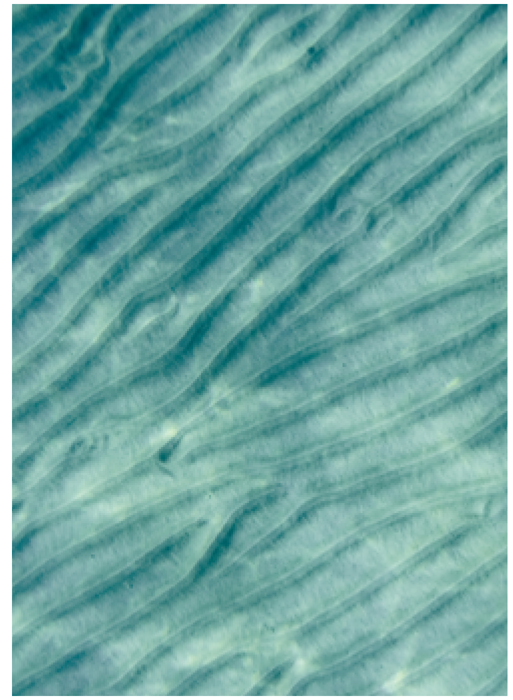
In Portugal, a company must justify that it is acting for corporate benefit when granting a guarantee or security to a third party, unless there is a group or controlling relationship with the company benefiting from the guarantee or security.

Disclosure obligations

According to the Portuguese Companies Code, a company with a shareholding of 10% or more in another company (the "Target") must disclose to the Target any acquisitions and disposals of equity, provided its shareholding remains above the threshold.

Build-up strategy and minority shareholdings

When a company with registered offices in Portugal directly or indirectly reaches a shareholding of 90% or more in another Portuguese company (Target), it must notify the Target within 30 days, and it is entitled to start a "squeeze-out mechanism" to acquire the Target's remaining equity. To trigger this mechanism, the majority shareholder must present a bid over the minority shareholdings within six months following the 30-day notice, for compensation in cash or in kind (purchaser's shares or bonds), the value of which must be confirmed by an independent chartered accountant. If the controlling shareholder does not initiate the squeeze-out mechanism, the minority shareholders may request the purchase offer and exercise a put option right, for compensation to be agreed on with the majority shareholder or, failing that, to be determined by a court.



Legal highlights

Recent changes in Portuguese law may affect the PE market as follows:

Regulatory

Decree-Law 144/2019, of September 24, implemented changes by:

- approving a transfer of the supervision powers of investment fund management companies and credit securitization fund management companies from the Bank of Portugal to the Portuguese Securities Market Commission (CMVM), which may expedite management companies' regulatory approval process in Portugal; and
- amending the Legal Framework for Venture Capital, Social Entrepreneurship and Specialized Investment (approved by Law 18/2015, as amended) regulating loan funds to complement the financing instruments available to Portuguese companies.

Loan funds

In September 2019, a new category of funds, the loan funds, was introduced into Portuguese law[1].

These are alternative investment funds that aim to finance the economy directly, by granting credit to companies, and indirectly, through acquiring credits, including non-performing loans held by banks. These funds are not allowed to carry out certain transactions such as short sales of securities, or securities financing transactions, including securities lending and derivatives, except for risk coverage. Also, these funds are not allowed to lend money to natural persons or financial institutions.

[1] CMVM has approved Regulation 5/2020, which regulates the activity of the loan funds.

Market trends

New local funds and GPs

There was an increase in local players as 2 new private equity companies and 33 new private equity funds were registered in Portugal in 2019.

Concentration of AUM

According to the 2018 Annual Private Equity Report issued by the CMVM, nine funds with assets under management exceeding €100 million form approximately 58.9% of the national total.

Minority versus majority investments

According to the 2018 Annual Private Equity Report issued by the CMVM, 77% of shareholdings owned by PE firms, whether in companies or in other funds, correspond to a minority stake.

International PEs

there was a significant presence of international private equity firms (particularly Spanish private equity firms) in bids for Portuguese Targets.

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