FACES OF M&A 2012

MARKET COMMENTARY FROM LEADING ADVISERS

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DUE DILIGENCE AND VALUE

THERE HAS BEEN A FUNDAMENTAL change in the way that dealmakers get deals done in the post-global financial crisis world. Investors, LPs and shareholders are becoming more and more cautious about their investment strategies. As a result, private equity firms are aligning their strategies and business models to add value and drive operating performance in their portfolio companies in ways that were unnecessary when financial engineering was enough to deliver promised returns to their limited partners. Strategic buyers have also learned to be very careful in their growth strategies and have adopted much more disciplined approaches to help ensure a deal will drive incremental value to their shareholders. In response to this new scrutiny, wise buyers are becoming more and more insistent on a thorough due diligence process that includes a long look at the future state of the target business.

More and more we are hearing our clients tell us that merely reaching the old bar isn't enough for them and their stakeholders. Our advice to gain value on the back end of the transaction is to invest more energy on the front. To be sure, this has always been a best practice, but one that is fortunately becoming more and more common as a matter of course. Due diligence is transforming from being a check box on a done deal to being a vital upstream component of the decision making process itself.

At a minimum, you need to run a due diligence process that supports a critical examination of the sustainability

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of revenue streams and the ability of the current cost structure to support the growth plans for the business. But why stop there? Why not take full advantage of this window of opportunity to look into the future. A well-constructed financial due diligence program can actually take the target business apart and put it back together in the image of your business strategy to thoroughly discover the magnitude of the risk in the transaction thus allowing you to outline comprehensive integration plans and address post-acquisition operating issues on paper before you determine the structure of the deal and your go-forward strategy. Properly executed, due diligence can reveal a diamond in the rough or a pig in a poke – either way you benefit from having the information you need to see what is and what could be, before you write the check.

"Due diligence is transforming from being a check box on a done deal to being a vital upstream component of the decision making process itself."

FUTURE OF DUE DILIGENCE

TODAY, BUSINESSES CAN ILL AFFORD to make mistakes with their investments and select the wrong target for merger or acquisition. It's given practice that companies perform due diligence before a deal is agreed, but in the future how will companies go about assessing each other to further reduce the risk of not realising synergies and potential profitability?

If we take the example of Daimler-Benz's merger with Chrysler, on paper this may have been a perfect partnership, but the clashes in the organisation hit from management to manufacturing. The culture of the two organisations wasn't suited and this was part of a critical clash that ultimately led to a costly mistake.

Synergising culture, management, systems and infrastructure need to be battled or resolved in the effort to make two organisations into one. This can't be done through analysing documentation alone. Integrated communications processes that are platform or browser agnostic are needed for successful due diligence of the future.

The more integration you have in terms of communication throughout the discovery phase and beyond, the more likely potential clashes can be uncovered, planned for, or averted. This means keeping the document review, obviously, but integrating it with audio and video platforms, which the world is increasingly used to using for information-sharing real-time, any time – FaceTime, Skype will become the norm in transactions. This is especially significant as organisations that join together are more likely to be cross-border and multinational.

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Many ill-fated M&As have been exacerbated by the fact people can't connect with each other, work from the same platforms, or stick to a schedule that will mean synergies and goals are achieved. Integrated communication is also about knowing what others are doing (and working with them in their native tongue), no matter where in the world. We are focusing on the development of workflow and language capabilities for communication in our v7 virtual data room. Workflow enables communication and lets others know what's happening in a process, and in the language they're most comfortable with, which keeps projects on track.

Transparency in communication, use of workflow, native language, document review and 'face to face' interaction are how people will work together in organisations that stick to schedules and achieve successful M&As.

If we look into our crystal ball and ask 'what's the future of due diligence?' I'd have to say it will enable integrated communication, so all aspects of a business can be reviewed and synergised from the culture to the finances, and back again.

"The more integration you have in terms of communication throughout the discovery phase and beyond, the more likely potential clashes can be uncovered, planned for, or averted."

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EXIT PROVISIONS

COMPANIES LOOKING FOR FASTER GROWTH and higher returns and, therefore, considering emerging or nontraditional markets for investment, such as in Latin America, must address the associated higher risk and uncertainties arising from an unpredictable legal environment and limited observance of, or differences from, US-style corporate governance.

Alternatives to traditional M&A investment structures that take the form of strategic alliances, such as joint ventures, distributorships, supply agreements, contract manufacturing and licensing arrangements or combinations thereof, can be used creatively to help mitigate risk by limiting exposure to a counterparty's liability and the legal risks a particular market may pose, and protect pre-existing assets while allowing for customised economics. These structures are also useful as a component of traditional M&A transactions when the parties need to maintain an ongoing economic relationship for several years post-transaction. These structures also allow an investor to secure the long-term participation and benefit of a partners' influence and economic position in the market rather than losing that involvement at the time it is most needed.

Of equal importance to choosing the optimal structure for investment is anticipating and planning an exit strategy at the outset by establishing objective valuation mechanisms, enforceable termination rights, transparent financial reporting, allocation of rights to jointly developed

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assets and enforceable non-competes, among others. It is understandable that parties often resist engaging in discussions that acknowledge the potential failure of the alliance, since the initial focus with any form of strategic alliance is on establishing the business relationship, as well as the belief that the circumstances involving an exit are impossible to predict. Careful consideration of the triggers for termination or exit, however, as well as the consequences of such an action, are a worthwhile and necessary part of the planning and negotiation process. This is especially true when operating in less established markets where valuation disconnects are prevalent between a local partner's estimation of growth prospects and that of a foreign investor. Well-drafted exit provisions should allow the parties to terminate the arrangement and preserve as much value as possible. Valuation provisions should be designed so as to inflict the least harm on the value of the parties' remaining business interests.

Strategic alliances often provide the most flexible and profitable vehicle for investment in emerging markets, especially when exit mechanics are given adequate attention and take into account local law restrictions on foreign ownership of assets. By using the various legal and economic components available to the parties in structuring an alliance, each party can achieve its central objectives while anticipating and protecting against legal, market and other risks.

The challenge lies in striking a delicate balance between earning the trust of your business partners and protecting your own interests.

"Careful consideration of the triggers for termination or exit, however, as well as the consequences of such an action, are a worthwhile and necessary part of the planning and negotiation process."

HUNTON & WILLIAMS

M&A INTEGRATION

MANY COMPANIES VIEW THE M&A process in three sequential steps: (i) evaluate and approve the deal; (ii) negotiate and close the deal; and (iii) integrate global operations.

While this sequence of steps seems logical to most, companies can improve the speed of the integration process and thereby improve the chances of a successful integration by taking some important planning steps before the deal closes.

In a global deal, the business will benefit from quickly combining operations in each country. The integration focus should be on combining the sales operations, achieving manufacturing efficiencies and looking for new marketing opportunities presented as a result of the new combined company. The last thing the business wants to deal with is two separate financial reporting systems, cross-charging for services rendered between the operations and duplicate administrative functions. Thus one of the first challenges the tax and legal team face is to combine legal entities in a tax efficient manner. While implementation cannot take place until the deal closes, early planning can save months of waiting post-close to effect the necessary legal steps.

Take another look at your due diligence request list. Are you only concerned about the material issues that could affect the deal valuation and business risk? This is a missed opportunity to request information that could give you a head start with post-transaction integration. Understanding

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- the target's global legal structure will give you an advantage in bringing the two companies together.

Many global deals will require merger control filings and government approval as a condition to closing the deal. There are extensive documentation requirements and waiting periods involved. Similarly, many countries will require the same filings to be made even for a group reorganisation where there are no competition issues presented. While the details of the group reorganisation may not be fully known at the time, the mere discussion of the group's future reorganisation will facilitate any future filing. If there is enough detail available, a combined filing can often be made. This saves not only time but money as well.

In short, reworking the M&A process to plan for speed in the integration process will save time, money and help bring the planned synergies to the bottom line – fast.

"Reworking the M&A process to plan for speed in the integration process will save time, money and help bring the planned synergies to the bottom line."

ENERGY SECTOR M&A

THE HUNT CONTINUES FOR SIGNIFICANT, well established international investment opportunities by the financially strong national energy companies and majors with an appetite for expansion. Targets are both conventional and unconventional oil and gas plays.

Strategic game plans appear evident as acquiring companies target liquids production in the range of US$14.00 to US$16.00 per Boe for 2P reserves while Brent crude at just over $100/Bbl maintains an approximate $15.00 premium to WTI. Projects that are primarily natural gas based seem to be of interest to those companies that have either the ability to hold on for a long term financial return and/or the capability to turn gas into liquids for international trade. The environmental pressure to replace coal with gas has also begun to take effect in companies buying into areas that will require long development times. On a gas equivalent basis these projects generally trade around the US$2.50 per Mcfe basis depending on the location of the assets.

Conventional and unconventional resource type plays have also attracted investment dollars and merger activity among companies with technical expertise to apply. Areas such as the shale plays of northern Europe and South America and the heavy oil sands of Canada have attracted companies that have had to balance opportunity with both environmental concerns and host country economic uncertainties.

The current world economic situation has not appeared to diminish the level of activity in the M&A arena, as the

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companies driving M&A continue in their effort to expand their asset base. North America has seen international players enter the acreage buying frenzy with cash payments, drilling carries and direct acquisition of significant acreage holdings. The international group with a strong financial position has apparently been sold on the idea of getting in quickly before they miss out on the next big emerging play. Some of the companies have waited until the proved nature of the play has been established, but it will remain to be seen if the geographic area they have entered into will have the same economic results of the model that may have been presented.

M&A activity in the upstream energy arena continues to be a situation of many of the large players getting larger, and becoming better positioned to control their future through exposure to a more diverse portfolio of assets. The trend doesn't appear to be waning in its intensity as undercapitalised and stressed targets exist on the international stage.

"The current world economic situation has not appeared to diminish the level of activity in the M&A arena, as the companies driving M&A continue in their effort to expand their asset base."

US ENERGY MARKET

PRIOR TO 2008 MANY ENERGY industry experts were predicting that peak oil and gas would result in continued US production declines, sustained high oil and natural gas prices and a growing US dependence on imports to satisfy US energy requirements. During that period, the transformative effects of horizontal drilling and hydraulic fracturing on US production and proved reserves were not yet known. In fact, the decline in US oil production (then over 40 years in duration) was not expected to end. LNG regasification facilities were being constructed as the US prepared to become a net importer of natural gas as a result of declining US natural gas production.

The game changer for the US energy market has been the enormous success of combining horizontal drilling and hydraulic fracturing to unlock the reserve potential of various US shale formations. This success reversed the decline in US oil production and substantially increased the production of natural gas. In fact, the success of producers in applying these techniques in oil shale and conventional complex formations has resulted in several experts predicting that the US could halve its imports of Middle East oil by 2020 and eliminate such imports altogether by 2035. In addition, US natural gas production has been growing at twice the rate of demand in recent years, increasing the likelihood that the US may become a net exporter of LNG.

Unlocking the reserve potential of US shales has led to substantial investment in the US energy industry over the

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last four years. Substantial investment has been made by the US oilfield services industry in response to the demand for equipment to drill, equip, and place in production the wells being drilled. Substantial investment has also been made and remains to be made to build the midstream and downstream infrastructure essential for the production to access markets. For example, a recent paper published by INGAA Foundation estimated that more than US$200bn would be invested in US midstream infrastructure investments through 2035, of which over US$56bn would be invested in the 2012-16 period. Those projections omit the investments required to expand the oilfield services industry, to expand and refurbish the downstream refining and processing capacity, and to build LNG liquefaction facilities. As a result, the US energy industry appears poised for both continued investment of substantial capital and substantial M&A activity for the foreseeable future.

The above optimistic outlook is, however, tempered by the risks of a potential prolonged decline in oil and natural gas prices and political and regulatory changes. The tremendous increase in sustainable US production of natural gas has caused a substantial decline in US gas prices that is not expected to recover in the near term. Indeed, natural gas prices are now so low that US producers have elected to shut-in gas production, substantially scale back their drilling activities or sell or release prospective acreage. Despite increased demand for natural gas as power producers elect to replace coal with low priced gas, political and regulatory interventions generate substantial uncertainty about the continued pace of US shale development. If low oil and gas prices prevail or moratoriums on hydraulic fracturing are imposed, the levels of investment and M&A activity in the US oil and gas industry could be significantly below that which are otherwise expected from the existing favourable conditions..

"The US energy industry appears poised for both continued investment of substantial capital and substantial M&A activity for the foreseeable future."

ANDREWS
ATTORNEYS KURTH LLP

US UTILITIES CONSOLIDATION

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THE 2010-11 YEARS SIGNALLED A dramatic return to M&A activity within the United States. Seven transactions were announced and closed in excess of $1bn in acquired company market capitalisation, with several substantially above $5bn in acquiree market capitalisation. And several smaller transactions were also announced as the industry's long awaited restart to the next stage of consolidation finally arrived.

The reasons for the sudden flurry of transactions were not unlike those that have driven utility combinations in prior years – with a little twist this time. Certainly the typical reasons for consolidation like executive succession, portfolio balance and valuation differentiation were part of the logic. But this time around another factor seems to have been a more direct catalyst than observed in recent years – the pursuit of real scale. Several of the acquiring companies relied on two pressing drivers for establishing the rationale for the transaction: the need for a larger, stronger and more flexible balance sheet to fund capital investment and the need to break through cost improvement ceilings by leveraging greater economies of scale and scope. Both of these considerations lead utility managements to conclude that the benefits of scale were well worth the challenges of executing large transactions.

With these transactions completed it is interesting to now look at the relative scale of the US utility industry. Not long ago, the league table of the world's largest utilities

was dominated by European and Japanese companies with no US entity within the top 15 utilities based on market capitalisation. But things have changed in just a few years. Now, US utilities comprise 6 of the top 15 companies and two of the top five. This shift in global scale has been the result of a continuing focus by US utilities on growth and the aforementioned transactions, as well as a series of financial travails that have been experienced in many European countries and lingering impacts from Fukushima to Japanese companies.

This significant presence among the largest global utilities is not likely to diminish any time soon. In fact, US company scale and presence is likely to continue to grow as companies are once again becoming acquisitive. Moreover, approximately 50 percent of the US power sector has a market capitalisation of less than $5bn. As companies search for opportunities to both grow and improve financial performance, building a stronger balance sheet and capturing the benefits of scale will be naturally facilitated by further consolidation, particularly when the industry track record for deal execution creates renewed market receptiveness for industry consolidation.

"As companies search for opportunities to both grow and improve financial performance, building a stronger balance sheet and capturing the benefits of scale will be naturally facilitated by further consolidation."

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US MIDDLE MARKET

US MIDDLE MARKET

IF YOU ARE LOOKING FOR middle-market deals, then go to the Midwest. Since 2010, the Midwest has accounted for more mid-market private equity transactions than any other region of the US.

While billion-dollar deals like the sale of Motorola Mobility to Google garner most of the headlines, mid-market acquisitions are bolstering M&A activity. By some estimates, transactions under $500m accounted for more than 80 percent of the deal flow of private equity funds, and corporate acquisitions between $50m and $250m accounted for more than half of the closed transactions in Q1 and Q2 2012. While total M&A transaction value has steadily declined, an increasing percentage of that value has been concentrated in the mid-market.

Various factors are driving this activity. Retiring baby-boomers and aging portfolio companies alike are looking for exits, and there is a staggering amount of capital available for acquisitions (by some estimates, $430bn in PE dry powder and nearly $2 trillion on corporate balance sheets). In particular, PE funds and corporate acquirers are able to integrate these mid-market companies into their portfolios more quickly and with relatively lower risk than large-cap acquisitions.

But a word to the wise – transactions in this space have unique challenges. Tough financing markets have forced buyers away from financial engineering and towards acquisitions with true value and growth potential. This often

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requires wider and deeper diligence, which can lead to deal fatigue among less experienced sellers. Smaller companies must be prepared for more comprehensive diligence processes, and buyers must manage expectations to ensure that the process does not become bogged down and over-burden the seller's resources.

Another challenge is that valuations for smaller companies have not recovered as well as their larger competitors. Values for lower mid-market companies are averaging 5x-7x earnings, versus 6x-9x multiples for deals over $250m. Consequently, parties continue to use earn-outs and seller financing to close valuation gaps.

Here, it is critical that both parties understand the terms of these arrangements, particularly regarding subordination. While PE buyers in particular think of seller debt like equity, sellers who only are familiar with traditional financing do not. This disconnect can lead to miscommunications and even mistrust if the parties' expectations are not discussed early in the process.

Like any transaction, developing good relationships is important. But for mid-market deals in particular, managing expectations throughout the process is critical to deal certainty.

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Mid-market value. Large firm expertise.

REGULATIONS IN ARGENTINA

ARGENTINA IS SEEING AN INCREASING government tendency towards intervention and regulation of economic activities. Almost all aspects of economic activity are currently being affected. Measures include restrictions on transfers of funds abroad, restrictions both on the import and export of goods, limitations on the acquisition of real estate by foreigners, and increasing regulation and scrutiny of companies that carry out certain activities such as broadcasting and oil & gas. These are only some examples.

Regulation and government intervention *per se* should not necessarily have a negative impact. However, when these create uncertainty, economic activity is invariably affected. The higher the uncertainty, the higher the negative effect. This applies especially to transactions that require a huge investment and a long ROI period.

Uncertainty is the main challenge Argentina faces at the moment. Profitable business opportunities exist, but the analysis of the risk involved must increasingly include an evaluation of political and macroeconomic aspects of the proposed transaction.

Due diligence in Argentina should not only include the typical range of issues, but also a much broader scope of questions, such as: Is this company in a strategic sector that may result in delays or non-approval of the antitrust authority? Is this a real estate company that is being purchased by foreigners? Are the prices of this company's products regulated? Are there minimum investment

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requirements for this activity? How do foreign exchange restrictions affect funding of the activity or distribution of dividends? Are there restrictions on the export of the target company's products or on the import of raw materials? Will the regulators limit the exit opportunities of the investment? Again, these are just some examples.

One key point to bear in mind is that it is important to understand not only what the law provides, but more importantly how the law is applied. In some cases unwritten principles override written regulations. Investors not only need to review the legal map, they also need to interpret it with locals who know the landscape and have experienced the journey many times before.

"Profitable business opportunities exist, but the analysis of the risk involved must increasingly include an evaluation of political and macroeconomic aspects of the proposed transaction."

MARVAL
O'FARRELL
& MAIRAL

EU MERGER CONTROL

THE EU MERGER CONTROL REGIME seeks to catch all major transactions in the world that have a material EU element, and to prohibit those that are likely to create a significant impediment to effective competition. Despite the current financial situation, the number of notified transactions has been about 300 per year, and 2012 will be no different.

On 1 February 2012, following a seven-month procedure, the EU prohibited the planned merger between Deutsche Börse and NYSE Euronext (the 'DB-NYSE Case'). The question that can be asked is whether this misalignment between the parties' view of the issues and that of the EU was a one-off caught in the EU's merger control net, or of more general relevance.

The material issues that arose in the DB-NYSE Case were: (i) the definition of the relevant market; (ii) whether efficiencies created could overcome any concerns held; and (iii) the possible commitments to be offered by the parties to ease the EU's concerns.

Winning the market definition debate was a zero-sum game for the parties. The EU targeted its concerns on the market of financial derivatives based on European underlyings, where the parties would have a market share of 90 percent

In relation to efficiencies, the EU clearly stated that efficiencies may only be successfully invoked until a certain level of cumulated market shares. Given the 90 percent market share finding in this case, the EU dismissed entirely the parties' arguments for efficiencies.

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"Despite the current financial situation, the number of notified transactions has been about 300 per year, and 2012 will be no different."

The last chance to save the deal was therefore to find an agreement on commitments the parties could offer. The only one the EU seriously envisaged was a divestment of activities in the field of European interest rate derivatives, which the parties considered as unacceptable. This illustrates that the very understanding of the economic rationale of the deal was apparently not shared by both sides.

The misalignment on these three issues resulted in a prohibition decision, which however is the subject of appeal. It may be that this misalignment arose because of the difficulties applying classic concepts of competition law and policy to the finance market. It may also be that the parties had forgotten the typically conservative attitude the EU takes in its decisions, particularly when market shares can be high on one view of the market. It can be hoped that the changes to the regulation and supervision of the banking and finance sector will allow better understanding for all stakeholders, and thus avoid such misalignment in future. If so, then the EU merger control by-catch of the DB-NYSE case, a $10bn deal with break-down costs exceeding $200m according to some commentators, will be avoidable. ■

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UK VENDORS

A LARGE MAJORITY OF ACQUISITIONS are justified by purchasers because they permit access to new and faster growing markets more rapidly than an organic strategy. It should perhaps come as no surprise therefore that the focus of UK acquirers has moved decisively away from their domestic market to the more tantalising emerging economies of China, South America and Brazil. The UK, seized in the grip of a double dip recession, is apparently no place for cash-rich UK corporates to deploy their capital, at least in the eyes of their investors.

The direct consequence of this profound shift in emphasis among UK corporates has been to make it harder for sellers of UK companies – however successful – to find a new strategic home for their businesses. This challenge has been compounded by the UK's moribund debt market, which is constraining local private equity investors' ability to offer appealing prices to owners of quality assets.

The challenge for UK vendors – and more acutely their financial advisers – is to be able to identify, reach out to and engage effectively with overseas strategic acquirers from all four corners of the globe. Given current UK M&A market conditions, it would be highly complacent, indeed negligent, for an M&A adviser to rely upon UK purchasers to generate the interest that their clients would wish to see in their sale process.

It is also deeply counter-productive for an adviser to spray indiscriminately teasers for a sell-side opportunity across

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hundreds of potential purchasers around the world. The last 10 years has seen corporate acquirers become ever more selective and focused on the types of acquisitions they wish to spend time on. As they have become more discerning, their approach to acquisition opportunities has become binary – the quick 'no' in greater evidence than the emphatic 'yes please'. Knowing which buyers to go to for any given asset has never been more important to avoid compromising an asset's intrinsic worth and to draw wary buyers into a constructive dialogue. Few acquirers have the appetite today to subject themselves to the bruising auction processes that investment banks have traditionally favoured for anything but the most attractive targets.

Current market conditions are pushing clients towards M&A advisers with a proven track record of cross-border deals, a robust and 'joined up' international infrastructure and deep insight into industry sectors that means that they not only know which buyers should occupy the short-list but can point to an enduring dialogue with key decision-makers at those purchasers.

"Knowing which buyers to go to for any given asset has never been more important to avoid compromising an asset's intrinsic worth and to draw wary buyers into a constructive dialogue."

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INTEGRITY RISKS

ONE OF THE BIGGEST RISKS to realising increased value in an acquisition is the increased likelihood of fraud, corruption and other related activity. This is particular true in emerging markets where high growth opportunities may exists but in weaker legal and regulatory regimes.

Difficulties are further compounded with the reality that the prosecution of economic crimes is becoming more global, Legislation like the UK Bribery Act apply to all companies with subsidiaries in the UK but further provides that subsidiaries in other countries can also be punished for the misconduct of one specific subsidiary – even if not accused of directly taking part in the wrongdoing.

Accepting the above, 'compliance' risks are a particularly sensitive topic in M&A deals. Whilst warranties given in the M&A contract may require the previous owner to be liable for any compliance breaches occurring during their ownership, once that warranty period lapses the liabilities fall to the new owner. The resulting consequences may see the new owner facing regulatory investigations, fines and penalties, and ultimately brand and reputational harm which can destroy the goodwill of the company and erode value.

A robust compliance structure is a key consideration for mitigating potential risks. To protect themselves, companies should examine their potential partner carefully before engaging in a takeover or joint venture, especially an international transaction.

A key constituent of the necessary due diligence should

be 'compliance and integrity' risks. Key indicators of risk, amongst others, include: (i) geography – higher risk jurisdictions lack transparency, requisite standards of corporate governance and strong enforcement of legal and regulatory requirements; and (ii) industry structure and practice – examples would include industries vulnerable to money laundering and economic sanctions violations, while other exposures may include potential corruption of local and government officials.

By obtaining the right information, and identifying the red flags, companies can mitigate potential risks by correctly structuring the deal around potential liabilities, including provisions around warranties and indemnities and conditions to close.

Furthermore, known compliance and integrity risks can help to determine best purchase price with complimentary adjustment mechanisms.

"A key constituent of the necessary due diligence should be 'compliance and integrity' risks."

M&A IN GERMANY

UNCERTAINTIES IN THE EUROZONE AND volatile conditions in the equity and financial markets have damaged confidence and kept M&A activities depressed. Companies are maintaining a cautious approach to M&A activities. Strategies are focused on organic growth rather than acquisition. Opportunities are seen in emerging, high-growth markets and small and mid-cap enterprises. Cash is king for acquirers and accumulated cash reserves are the preferred method for the funding of M&A deals.

Private equity funds are under pressure to invest. Unlike six months ago though, the private equity market in Germany is starting to climb out of its recession. There is a growing number of deal by deal fundraising and add-on investments. Also, more and more owner-managed mid-cap enterprises finance their growth through long term (five years or more) private equity investments. Preferred target industries are clean-tech, IT, telecommunication and healthcare. Preferred regions for investments in Germany are Bavaria, North Rhine Westphalia and Baden-Württemberg. Despite the positive trend however, debt financing is more difficult to obtain than ever. Return expectations are still too high. Family offices and strategic investors who pursue long term investment strategies with moderate investment expectations have a competitive advantage over private equity funds. There is also a shift from private equity to venture capital and growth capital investments (in particular the global roll-out of e-commerce businesses).

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The cash rich IT sector has been one of the main drivers of the German and the global M&A market since 2011. Increasing numbers of European, US and Asian IT enterprises reach into Germany. Europe, and specifically Germany as the largest IT market in Europe, is of particular importance for Indian IT enterprises.

China has developed a distinct interest in well established German brands and high-tech companies. Whilst in previous years Chinese strategic investors focused on the acquisition of insolvent automotive suppliers, they have now widened their focus in order to leap-frog research, development and subsidisation costs in other industries by acquiring foreign brands, technology and markets.

Eclipsed by Greek tax evaders, inefficient governments and incommensurable crowds of civil servants there are economically healthy Greek companies with limited domestic exposure of revenues, which are ready to transfer their corporate home to Germany and to be listed in more appropriate stock markets than on the illiquid Athens stock exchange. These companies also provide strategic opportunities to foreign investors and industrial players. No other country in Europe offers such an unprecedented pipeline of M&A transactions as Greece does today.

"Cash is king for acquirers and accumulated cash reserves are the preferred method for the funding of M&A deals."

PRIVATE BANKING

WITH THE WORLD ECONOMIC CENTRE of gravity shifting gradually eastward, global and regional private banks increasingly need to readjust their strategies. Europe is still expected to remain an important hub for HNWI in the foreseeable future, but growth in European wealth is likely to slow down.

Current low margins, rising costs of compliance and lower growth prospects have resulted in significantly lower valuations currently in the region of 1 to 2 percent of assets under management compared to 3 to 5 percent at the peak of the cycle before the credit crisis. All ingredients are there to raise M&A and restructuring activity in European private banking but with a focus on higher quality assets.

The general clampdown on tax evaders has also made undeclared clients fundamentally unattractive. If the portion of undeclared money is moderate in the books of a potential takeover target, the cleanup will generally be done by the acquirer. Otherwise, buyers generally prefer to pass the opportunity to avoid importing issues.

Executing a seamless private banking transaction requires the setup of a robust process and a sound understanding of strategic and operational issues. Without being exhaustive, the following is a summary of essential points to consider.

First, deal structuring. Share deals are generally preferred by sellers as these provide a clean exit from the business. If targets are structurally non profitable, asset deals consisting mostly in a transfer to buyers of the HNWI portfolio and a

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large part of front office may be the sole viable alternative to attract potential buyers, but will generally exclude the possibility to transact on a cross-border basis.

Second, the bidder universe. Identifying from the outset a list of potential bidders requires an intimate knowledge of market dynamics, cultural fit between the bidders and the target teams, the appeal of the selected bidder's name to the private banking clients of the target, the strategies pursued by the bidders (i.e., expanding their geographical reach, reinforcing their existing portfolio in specific regions, seeking growth, etc.) and their operational constraints (product and asset management offering, IT systems, back and middle office infrastructure).

Third, the information memorandum. It is a cornerstone of the process and needs to provide a sufficient level of transparency of the business to enable potential bidders to price the portfolio and provide their payments terms. The following are generally essential information to provide: description of business and management team, an analysis of the business model including the types of services provided (discretionary, advisory, financial engineering, etc.), a breakdown of portfolio and margins per wealth band, historical and projective information on revenues, costs, margins and investments, a description of operations, infrastructure, compliance and regulatory matters.

Finally, comparison of the bidder's purchase price and payment terms. Price is generally set as a percentage of AuM or as a total consideration to be paid. Terms include timing of payment upon closing of the transaction or at a later date, use of a ratchet and/or earnout, escrow account, lockbox, etc. These terms need to be carefully assessed when comparing offers.

"All ingredients are there to raise M&A and restructuring activity in European private banking but with a focus on higher quality assets."

MIDDLE EAST M&A

THIS ARTICLE LOOKS AT A sample of major M&A transactions in the principal jurisdictions of the Middle East and looks at likely trends in M&A activity going forward.

We are currently not seeing any particular trend in the Saudi M&A space. Activity remains subdued and many of the deals around have a government angle to them. One deal of note, however, was the purchase by the Coca Cola Company of Aujan Industries, which involved a major acquisition finance for syndicated facilities of up to SAR 1.5bn.

In terms of trends in the UAE, the M&A market is still relatively slow. There are signs, however, of a number of transactions which were originally shelved on account of the global financial crisis coming back with revised commercial terms and in some cases a different seller or purchaser. One transaction that did proceed was Saffar Holdings' sale of its majority shareholding by auction of financial and economic data publisher Zawya Limited to Thomson Reuters.

In Qatar, Ezdan which is a major real estate company listed on the Doha Exchange is acquiring all the assets of unlisted Tadawul Holding via a merger. This very large transaction is expected to close by the end of the year. M&A activity levels in Qatar remain fairly low, however, by comparison with the rest of the Middle East.

In Oman, the major M&A transaction in the last 12 months and indeed over a longer period was the merger of HSBC's Oman branch with local bank Oman International Bank SAOG. This merger involved the transfer of all of the assets and

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liabilities of HSBC's Oman branch to OIB in exchange for the issue of a 51 percent controlling interest in OIB to HSBC. The combined entity resulting from the merger is in the process of being rebranded as HSBC Bank Oman SAOG. The rebranding and much of the integration of the two banking operations is expected to be complete by the end of 2012.

M&A trends in Oman appear to be similar to those elsewhere in the Middle East. Activity levels are subdued but where the parties see an opportunity and are able to agree price, the transactions are going ahead. Volume looks stable and if anything should increase.

The overall picture that emerges is of a recognition of lower valuations reflecting the current economic climate. This is leading to a gradual revival of M&A activity where new opportunities are identified. Given the healthy state of the economies of the Middle East, there is every reason to believe that this trend will continue.

"The overall picture that emerges is of a recognition of lower valuations reflecting the current economic climate. This is leading to a gradual revival of M&A activity where new opportunities are identified."

SNR DENTON

DELISTING OFFERS IN INDIA

FOREIGN INVESTORS IN INDIA WHO have acquired a substantial stake in an Indian listed company with the intention of taking the company private are grappling with the SEBI (Delisting of Equity Shares) Regulations, 2009. The legislation, which replaced the 2003 guidelines, has made it very difficult for promoters or controlling shareholders in India to delist the company and squeeze out the minority.

The reasons for this are as follows: (i) prior approval of the public shareholders of the company, by way of a two-thirds majority, is a prerequisite for launching a voluntary delisting offer; (ii) for the offer to be successful, the post-offer shareholding of the promoter should be 90 percent of the total share capital or aggregate of pre-offer promoter shareholding and 50 percent of the offer size, whichever is higher; and (iii) the delisting offer price is determined by a reverse book building method where the exit price is determined pursuant to the bids placed by the public shareholders. Conditions (i) and (ii), which were newly introduced in 2009, combined with high price expectations of public shareholders (including speculative traders) has resulted in a dismal number of successful delisting offers by foreign investors. The premium to floor price offered by foreign promoter shareholders in some successful delisting offers ranges from 20 to 45 percent.

The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, that regulates mandatory and voluntary tender offers has also added fuel to the fire. It stipulates

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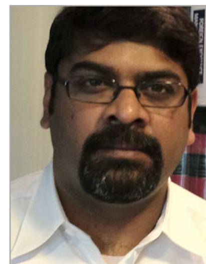
that acquirers who acquire a substantial stake in excess of 75 percent pursuant to a negotiated trigger transaction followed by a mandatory tender offer to public shareholders are prohibited from making a delisting offer for a period of 12 months from the date of completion of the mandatory tender offer. Hence, the acquirer will not be able to take the company private during the statutory cooling-off period. Moreover, a stake in excess of 75 percent is required to be divested by the promoter through one of the six methods prescribed by the Securities and Exchange Board of India prior to making a delisting offer, so that the excess stake is transferred to diversified people who fall into the category of public shareholders.

A combination of the speculative markets' expectations and the unfavourable regulatory regime has made delisting a huge challenge for foreign promoter shareholders in India.

"A combination of the speculative markets' expectations and the unfavourable regulatory regime has made delisting a huge challenge for foreign promoter shareholders in India."

amarchand mangaldas

DOWNSTREAM INVESTMENTS



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PRIOR TO ACQUIRING A STAKE in an Indian company, it is critical to identify the most efficient vehicle for making the investment. If the investment vehicle is offshore, the key determining factor is the tax efficiency of the jurisdiction where the vehicle is situated (the applicable Double Taxation Avoidance Agreement). However, if the investor (being a non-resident) decides to invest via an Indian entity, the downstream investment rules become the key determining factor in identifying the investment vehicle.

'Downstream investment' is defined as indirect foreign investment by one Indian company into another Indian company. A downstream investment envisages two steps: (i) investment into an Indian company ('investor entity'); and (ii) investment by that company into another company ('investee entity'). If the investor entity is solely engaged in the activity of investing in the capital of other Indian companies ('investing company'), then prior government and Foreign Investment Promotion Board (FIPB) approval are required for the initial investment. Such investment would be subject to sectoral conditions on entry route, conditionalities and caps, regardless of the amount, extent, ownership or control of the foreign investment.

On the other hand, if the downstream investment is being made by a company otherwise engaged in operation, such investments would be subject to sectoral conditions on entry route. Further the investor entity is required to: (i) notify Secretariat for Industrial Assistance, the Department

of Industrial Policy and Promotion, and the FIPB within 30 days of the investment, even if the capital instruments have not been allotted along with the modality of investment; (ii) support the downstream investment, if it is by way of induction of the foreign equity in the company by a resolution of the board of directors along with a shareholder's agreement; and (iii) ensure that the issue, transfer, pricing or valuation of shares will be in accordance with the applicable pricing guidelines.

Once it is determined whether the investor entity is an investing company or operating company, it is important to determine the impact on the investee company. If the investor entity is 'owned and controlled' by the resident Indian citizen or Indian companies which are owned and controlled by resident Indian citizens, then the investment would not be considered a downstream investment. However, if the investing entity is owned or controlled by non resident entities, the entire investment would be considered downstream investment and subject to sectoral conditions on entry route, conditionalities and caps, regardless of the amount, extent, ownership or control of the foreign investment, unless the investee entity is a wholly owned subsidiary of the investor entity.

Therefore, it is crucial to understand and identify the correct investment through which foreign investments can be made in India. It is also vital and significant to understand the guidelines for the investments and approvals required so that investments are not delayed while obtaining necessary sanctions from the relevant authority.

"It is also vital and significant to understand the guidelines for the investments and approvals required so that investments are not delayed while obtaining necessary sanctions from the relevant authority."

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BANKING M&A

M&A DEALS IN THE INDONESIAN banking sector are likely to increase significantly over the next few years following the 13 July issuance of new bank ownership rules by Indonesia's central bank (Bank Indonesia Regulation No. 14/8/PBI/2012). The new regulation, which has been a long time coming, limits the maximum stake in an Indonesian bank that can be held by a single shareholder or corporate group. Under the new rules, unless Bank Indonesia approves a higher stake, the maximum Indonesian bank shareholding becomes 40 percent for financial institutions (including banks), 30 percent for non-financial institutions, and 20 percent for individuals.

An existing shareholder of an Indonesian bank may retain a higher level of ownership, provided it ensures that the bank stays financially sound and practices good corporate governance since Bank Indonesia's review period of December 2013. The existing shareholder needs to divest its shareholding to the limit under the rules if the bank fails to satisfy the financial health and good governance requirements for the review period of December 2013. The divestment must be conducted no later than 1 January 2019. The divestment is also applicable to the existing shareholder if: (i) the bank fails to satisfy the solvency and good governance requirements for any period of three consecutive years after the review period of 2013; and (ii) it sells part of its stake.

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In light of the above, opportunities to acquire and merge local banks are likely to arise if domestic shareholders face difficulty maintaining the bank's solvency and good corporate governance.

"M&A deals in the Indonesian banking sector are likely to increase significantly over the next few years following the 13 July issuance of new bank ownership rules by Indonesia's central bank."

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