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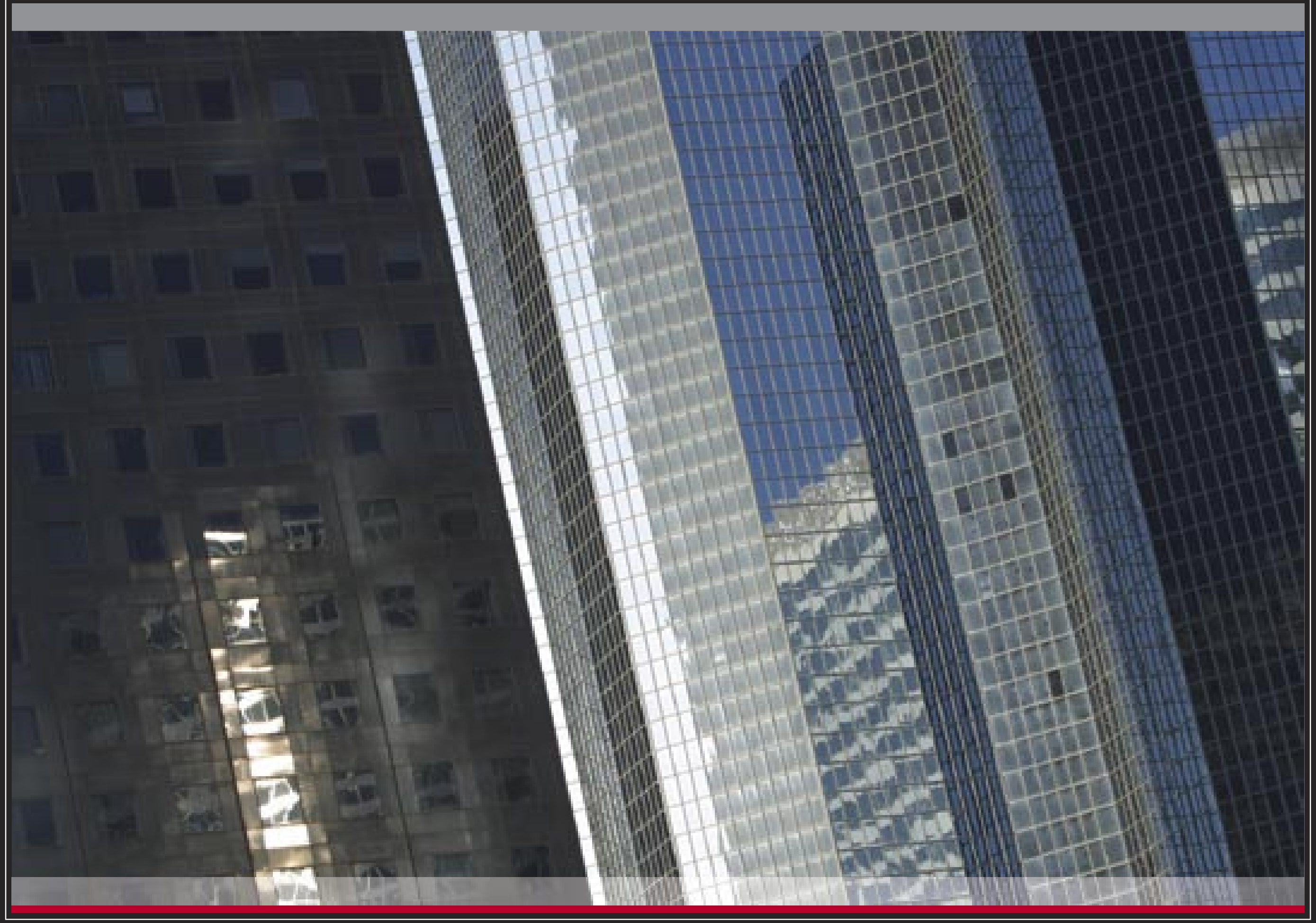
SPECIAL REPORT

GLOBAL MIDDLE MARKET

The middle market stays strong



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INDUSTRY OVERVIEW

The middle market stays strong

BY CLAIRE SPENCER

Despite a slight decline in disclosed transactions at its close, 2006 represented the fourth consecutive year of increased deal volume in the global middle market. It should come as no surprise that M&A activity is expected to remain constant throughout 2007, and probably in 2008. Traditional deal drivers, such as the availability of cheap debt, record-breaking fundraising and strong corporate balance sheets, show no signs of abating. Indeed, this speculation has been corroborated, in the US at least, by the Q1 results for 2007. Dealogic figures demonstrate that, despite an 11 percent decline in overall deal volume since the fourth quarter of 2006, merger activity increased by 21 percent when compared to Q1 2006. In particular, January 2007 saw the announcement of 961 transactions, a 6.5 percent increase on January 2006, and 19 more than the trailing month average of 942. Nonetheless, the value of transactions, notably in the US and Europe, rose significantly more then the actual number of transactions.

Predictably, private equity involvement has been a vital enzyme to this growth process. Over the last two years, private equity funds have raised almost $360bn, and the capital has to go somewhere. In fact, 19.6 percent of transactions in the US middle market were backed by private equity, according to Robert W. Baird & Co. The increasing number of mega funds, and the headline-grabbing forays of private equity into multi-billion dollar transactions, has unfairly overshadowed the surge of activity in the middle market, which some professionals describe as the lifeblood of M&A. Moreover, this activity is not confined to a single industry. Technology was the most active sector in the US middle market in 2006, with 17 percent of the total number of deals, while the financial services industry has a built up a pipeline of divestitures and mergers. Healthcare, manufacturing, oil & gas, metals & mining, retail, real estate, telecoms and media also featured prominently.

In this highly competitive market, flooded with liquidity, the persistence of high valuations and transaction multiples was inevitable. There is still some doubt as to whether they have peaked, or will continue to increase. Baird research found that valuation multiples remained at the upper end of historical levels, with the median LTM EBITDA multiple for the middle-market at 9.7x in 2006, down slightly from 10.4x in 2005. Professionals tend to agree that a weakening of the market due to restricted debt access is not yet in sight. This is particularly true as the diversity of investor classes has spread the credit risk across numerous participants. As John W. Kellogg, a partner at McKenna Long & Aldridge LLP, points out, the evidence so far suggests that the large amounts of capital available to execute transactions, and the limited number of high quality businesses, make this is a seller's market. "This is reflected not only on price, but on the legal structure as well," he says. "We have seen deals where sellers are able to negotiate positions that would have been unheard of five years ago. You can see this in the trend from no-shop to go-shop clauses and in indemnification. We've completed transactions in which the seller's obligations are limited, even in the event of fraud on the part of the seller."

Much of the current deal appetite can be attributed to financial buyers, who are energetically making acquisitions in the mid-market. But this does not discount the impact of strategic buyers. "Financial buyers are certainly not the dominant force; the strategic imperative can always drive a trade buyer to pay the highest price," says Jeremy Furniss, a partner at Livingstone Partners LLP. "There are also many companies – often more mature manufacturing businesses – that do not possess the high growth characteristics required by PE investors to achieve their returns." KPMG's January 2007 European Mid-Market M&A Outlook found that corporates are more bullish about mid-market M&A than private equity, with 67 percent believing the level of mid-market M&A activity will increase over the next six months, compared to 58 percent among private equity respondents. Interestingly, the survey also found that 58 percent of corporates do not consider private equity to be a serious competitor when looking to acquire mid-market assets.

Structuring mid-market deals

If the deal is private equity backed, a major consideration will be incentivising management through appropriate compensation arrangements. This can be even more crucial to the long-term success of a mid-market deal compared to a larger transaction. The aim is to develop a sense of loyalty and commitment among the managers, which can be achieved by offering equity stakes that allow managers to participate in the rewards of a future liquidity event – a goal they may pursue for several years. Ratchets attached to company performance may be used to provide further incentive, to promote the virtues of driving revenues beyond expectations.

But whether it is a strategic or financial buyer that is assessing an M&A opportunity, the due diligence process will often form a core part of the investment decision and determining whether a deal should proceed to completion. In the opinion of Kevin Hovorka, Executive-in-Charge of Private Equity Groups at Crowe Chizek and Company LLC, middle market buyers unfortunately tend to rely too heavily on feedback from vendors, employees, and key customers when gathering information on the target. Often, there is more to a company than meets the eye. "Potential buyers should be wary of targets that prepare themselves for sale by failing to maintain equipment, neglecting to invest in R&D, and reducing advertising expenses. These actions will inflate profits in the short term, but will have a negative effect in the long term," he says. Acquirers should also try to uncover pertinent information about financial and operating systems, which can be a challenge in mid-market scenarios. "For small, closely-held companies' complete financial records, risk management policies, and GAAP basis financial statements may be difficult to come by. In these deals, the buyer needs to spend more time on basic financial due diligence. As always, the fundamentals of financial statements, HR, market and contract diligence are key," suggests Mr Kellogg.

The presence of widespread and flexible liquidity sources is the main reason experts believe middle market M&A will probably remain strong for the next 18-24 months.

Transaction risks are almost universal, but when making a purchase in an emerging market, problems are amplified and multiplied. In Russia, for example, there are various obstacles that must be overcome during the due diligence process, according to Yury Troshchenko, a partner in Financial Advisory Services at KPMG. "Financials are often impacted by aspects of tax minimisation, incomplete data, understatement of revenues and overstatement of expenses, non-reflection of labour costs in favour of payment in black cash, payment of invoices for fictitious goods and services to generate black cash, and extensive and complex trading structures involving a number of companies. Financial projections are often absent or poorly prepared; the best solution is often to build your own models," he says. This could mean starting from scratch when compiling data. As such, investors should be prepared to invest extra time to construct models and cross-checking facts. Considering how inaccurate the figures might be, buyers will want to do as much as possible to be absolutely convinced about the merits of an emerging market endeavour.

Cross-border deals account for a growing number of middle market transactions. A survey released by mergermarket in its April 2007 report on cross-border M&A activity found that expectations were strong for increased transactions, with 76 percent of respondents anticipating a rise, up from 70 percent six months earlier. According to Mr Troshchenko, cross-border M&A accounts for over one-third of activity in the Russian deal market, where in 2006, approximately 200 inbound and about 150 outbound transactions took place. "This is a significant increase compared to previous years and indicates the growing appetite of foreign strategic investors for Russian assets and increasing ambitions of Russian companies in relation to expansion opportunities," he says. "However, international buyers also face certain complexities when acquiring assets in Russia. These issues are mostly connected with transparency issues, differences in corporate governance and the necessity to deal with local government." If a company is prepared to take on the occasionally hit-and-miss climate in promising emerging markets such as Russia, and are willing to be flexible where it matters, there are compelling opportunities to reap huge benefits. Globalisation will not subside, and many observers argue that cross-border deals are a necessary part of building truly international businesses.

Continued M&A activity

Today's lending market shows an eagerness to provide financial support for M&A activities and a high tolerance for leverage. Banks and other lenders are more than happy to provide leverage in these deals, and this has been particularly noticeable in the area of subordinated debt. During 2006, the use of dividend-related and second lien loans increased by 13 and 74 percent respectively. The growth of these debt structures has led to heightened complexity and creativity in the lending arena, which while facilitating the increase in deals has also laid the groundwork for future volatility. Observers point to historical patterns that signal future changes in the business cycle. "Clearly, lending activity is more brisk today than it was five years ago, and we expect this level of activity to continue for another two years. But when you have a run that long, it indicates that we may be encountering future restructuring and turnaround situations," says Mr Hovorka. Many investors are already gearing up to service the distressed debt market when defaults eventually hit and radical restructurings become the order of the day.

For now, the presence of widespread and flexible liquidity sources is the main reason experts believe middle market M&A will probably remain strong for the next 18-24 months. "It would be wrong to call the end of the market just yet," says Mr Furniss. "Liquidity will continue to fuel mid-market M&A activity. There may be some high profile problems, but these will most likely arise among the mega buyouts, where levels of leverage have been significantly greater than mid-market deals." Admittedly, there are macro risks to consider, on the scale of terrorism, natural disasters, and political uncertainty relating to global conflicts – all of which have the potential to cause harm beyond anticipation. In terms of immediate investing forecasts, however, such risks remain firmly on the periphery of an otherwise upbeat and optimistic market. ■

EUROPEAN M&A FOCUS

US mid-market investors take the transatlantic trail

BY DAVID SULASKI

Record levels of liquidity have driven an intensifying level of competition among the UK's leading private equity (PE) investors. The return of strategic buyers to the M&A market over the last two years has further fuelled the tension among bidders for a relatively static volume of attractive acquisition opportunities.

The last development that either community of acquirers will welcome is the arrival in Europe of a growing band of US mid-market PE investors, focused on broadening their portfolios by investing in the UK and across Western and Eastern Europe. While the UK has long-hosted the European headquarters of mega-PE groups including The Carlyle Group, KKR and Hicks Muse, the arrival of mid-market players in growing numbers is indicative of a structural shift in the transatlantic PE market.

The US is home to roughly 1200 mid-market private equity firms, many of them on a national basis, all of them competing for finite high quality assets. The willingness of these funds to stretch further afield is a function of a number of key developments: (i) as prices remain high in the US, mid-market PEs are keen to seek out more reasonably priced investment opportunities; (ii) as portfolio companies embrace a global market through overseas acquisitions, so too their PE investors are following; (iii) a general relaxation of fund investment criteria to include up to 20 percent fund allocation to non-US investments; and (iv) as the mid-market M&A advisory community globalises, so many more overseas opportunities are being presented to mid-market sponsors.

Many of these new entrants have chosen the UK as their first port of call, attracted for all the traditional cultural reasons, together with London's continuing emergence as the world's leading international financial centre, with the structured and acquisition finance infrastructure that goes with it. Early mid-market arrivals included Sun Capital, Summit Partners, and European Capital, part of US public PE vehicle American Capital.

Recent research by deal intelligence publisher mergermarket indicates that US PE houses have been closing up to 40 mid-market deals in Europe each year with an aggregate deal value of €3.8bn. The UK is presently accounting for approximately one-third of this activity.

This pervasive trend is amply illustrated by three recent UK deals involving US PE houses. The $580m acquisition of European plastic pipe manufacturer Polypipe by Castle Harlan of New York demonstrated the resolve and resourcefulness of a mid-market US house making its first significant investment in the UK, through successfully competing in an auction for Polypipe by its former parent, industrial group IMI plc. In December 2006, Boston-based Audax Group made its first UK investment through the acquisition of Nicholl Food Packaging, Europe's largest manufacturer of aluminium trays for the food sector in a $150m deal that saw it pitched against two other US houses – and just one UK-based sponsor. Most recently, Sun Capital backed portfolio business LOUD Technologies in the acquisition of Martin Audio, a leading international supplier of professional speaker systems to the concert and event markets.

All three are indicative of the wave of interest among US-based houses in establishing a European bridgehead-most recently HIG Capital, which is adding a London team to compliment its existing Paris and Hamburg offices. A number of the houses have novel and compelling differentiators: European Capital taps its parent's access to the US public markets to reduce its cost of capital, while both European Capital and HIG are willing to deliver a total funding package for a deal, and undertake much of the due diligence in-house, thereby delivering greater certainty to vendors.

Sun Capital has established a powerful franchise for investing in troubled companies, using its access to hands-on operating partners to achieve remarkable turnarounds such as Hunnebeck, a European market leader in the hire of formwork and scaffolding acquired relatively cheaply from ThyssenKrupp and sold two years later for €140m.

While the UK PE community has been slow to target continental Europe as a source of opportunity (with a few notable exceptions, such as Barclays Private Equity, Baird Capital and Bridgepoint), a number of active US PEs have completely circumvented the UK and headed straight for the mainland. Aggressive mid-market players such as Riverside have already established their credentials across central Europe. In this respect, the London PE houses face a serious threat that their more ambitious US brethren will establish a significant lead in their own backyard. At the same time, a hungry community of local PE houses has been quick to emerge across Europe, notably in France, Germany and The Netherlands, which has been quick to present real competition for overseas investors. ■

David Sulaski is the co-founder of the Chicago team of Livingstone Partners.

AUTHOR BIOGRAPHY

Bull market accelerates in Spanish M&A

BY NEIL COLLEN

The Spanish M&A market has long been dismissed as a relatively small, 'emerging' market in an economy whose low cost advantages have succumbed to the even more competitive attractions of central and eastern Europe and China. However, the blunt stereotype of the Spanish business world involving long siestas, multiple sets of accounts and a (not unreasonable) focus on lifestyle over long hours, has been left far behind in recent years.

Three significant deals perhaps define the 'new' Spanish M&A environment – and its close relationship with the UK in recent years. In November 2004, major Spanish financial institution Santander mounted a successful take-over of Abbey National for €12.8bn, creating a merged group which at the time made it the world's seventh largest bank ranked by profitability. Abbey was the seventh largest bank in the UK and the second largest provider of mortgages and savings accounts. The Abbey deal was just the latest in a succession of cross-border acquisitions in Germany, Poland, Portu- ▸▸

gal and across Latin America which have taken Santander from Spain's No.1 bank into a major global force in the financial services sector.

Within the UK construction and facilities services sector, two Spanish groups have actively led the charge to build major international businesses. In June 2006, major construction group Ferrovial announced that it had beaten off a rival bid to acquire BAA, the operator of the UK's largest airports, in a €15bn deal. This followed the takeover some years previously of UK roads and infrastructure contractor, Amey. Even before the BAA bid, Ferrovial was generating 46 percent of its operating profits from outside Spain, and had already dipped a toe in the airports market with significant shareholdings in Sydney and Belfast airports.

Fast on the heels of the BAA takeover, in July 2006 rival Spanish construction services group FCC announced the acquisition of Waste Recycling Group for €1.5bn from private equity group Terra Firma. The acquisition makes FCC a major player in the growing UK waste management market, as well as reinforcing its position as one of Europe's leading operators, combining Spain's No.1 operator and the recently-acquired ASA in Austria.

The scale and ambition behind these significant deals signals Spain's arrival as a force to be reckoned with among the major European M&A markets and a significant exporter of acquisition capital. This is a marked turnaround from only five years ago, when Spain was widely regarded either as a destination for international acquirers keen to establish a presence in a growing Mediterranean economy with a relatively low cost base, or an acquirer of exclusively Latin American assets.

It would be wrong to point at these very large deals and argue that they are exceptional rather than indicative of a growing confidence and appetite for M&A activity among the Spanish business community. This ambition is absolutely mirrored in the Spanish mid-market, where a sophisticated and international cadre of management has emerged. While the majority of Spanish business is still concentrated among family-owned and privately held companies, these groups nonetheless are seeking to buy and build, exploiting deep pockets and access to a growing domestic private equity community.

Equally, the stigma of 'selling out' that has traditionally been attached to Spanish business owners that have chosen to exit rather than pass on their company to the next generation is steadily dissipating. While this may not occur with the same surprising speed with which it waned in other European countries – the Germany Mittelstand, being the most vivid example – there is now a widespread acceptance among Spanish owners that a company sale should take its place in the natural business order.

Two recent examples of this trend in the mid-market can be seen from the sales of Iberlim, a Spanish distributor of cleaning supplies, to UK-listed group Bunzl plc, and of fire protection manufacturer Projiso to Belgian multinational Etex SA. In each case, the owner managers of these traditional mid-market recognised the additional benefits that these international groups could bring to bear, in addition to an attractive valuation.

The Spanish M&A market promises to be an exciting and active environment in which to close deals in the mid-market, as well as a burgeoning source of strategic acquirers for international assets. Despite the market's growing sophistication, however, for those groups seeking to close deals in Spain there is no substitute to having an advisory team with a local infrastructure and deep roots into what remains a very close-knit and private business community. ■

Neil Collen founded the Spanish team of Livingstone Partners.

AUTHOR BIOGRAPHY

Nordic mid-market M&A

BY CLAIRE SPENCER

2006 was a busy year for both public and private M&A in the Nordic region, and activity is going from strength to strength in 2007. Deal values and volumes even exceeded the record year of 2000. Financial buyers have established a notable presence and made a meaningful contribution to these figures. But, as Petter Wirell, a partner at Cederquist, notes, financial buyers are only playing a part. "Private equity funds are no longer alone in the arena. Industrial companies are active as sellers in taking advantage of high liquidity, and as buyers in taking advantage of the opportunity to grow their businesses with existing and borrowed capital," he says. Increased buyer diversity has had a positive effect on the financial services sector, which was the most active in the Nordic mid-market. Other sectors of interest included biotechnology, pharmaceuticals and manufacturing.

Private equity firms have been drawn to the region by the steady supply of attractive opportunities. Adding to the appeal is the reduced regulation that governs Nordic companies, compared to certain other regions, and the possible privatisation of certain traditional businesses, such as TeliaSonera in Sweden, which may open the door to financial buyers. But the increase in leveraged buyouts and growth capital investments has made private equity a controversial topic among trade unions and politicians in the UK and US. So how does its reputation fare in the Nordic countries? According to Biörn Riese, chairman of the board and head of the M&A practice at Mannheimer Swartling, in Sweden private equity does not stir the same levels of apprehension seen elsewhere. "The global discussions regarding the PE business has been mirrored in Sweden, but with a less negative approach," he says. "Governmental representatives have expressed their positive attitude towards the industry, on the basis that it is important for the business climate and the economy, and have also invited the industry to further discuss how the investment climate can be improved." It is largely thanks to private equity activity that there is so much liquidity in the Nordic mid-market at present. This has helped to drive M&A activity as funds look to capture controlling stakes in companies to improve their operational efficiency and management performance.

By its nature, the Nordic area is geared to welcome foreign investors. It is generally investor friendly and there are few exotic features when it comes to dealmaking. Generally, foreign investors are happy to lay down roots in the Nordic countries, as investment procedures are aligned with accepted international traits. Today, many deals are conducted in English, which has been a fairly recent development. "Historically, even rather large deals were conducted with fairly short and limited documentation, with the parties relying, to a considerable extent, on the provisions of statutory law, case law and general legal principles. But deals are increasingly being conducted in an Anglo-Saxon style, involving lengthier and more detailed documentation, thereby reducing the differences in how deals are conducted," Mr Wirrell explains. Of course, cultural differences will always arise, but professionals say these can be overcome by awareness, acceptance and compromise on both sides.

Yet the M&A market is not without risks for prospective buyers. For one, like many other places, valuations are currently soaring. "Some studies concerning investments indicate that the most successful investments do not usually take place when the valuation of target companies is at their peak. Therefore, it is evident that the risks of private equity companies in the Nordic market will be linked to the development of valuations and the market condition in the Nordic market in general, which is closely linked to developments in Europe and the US," says Petri Morelius, a partner at Luostarinen Mettälä Räikkönen.

Moreover, the relentless competition for quality assets gives sellers a clear advantage in negotiations, and they are frequently able to shift transaction risks onto the buyer. There are fewer representations and warranties included in purchase agreements, and indemnities provided by sellers have declined. "The buyer must be able to handle, and assume, this risk allocation, in order to be a successful candidate. A buyer must make a more detailed analysis of what the real risks of the relevant business are, understand them, and if necessary, set a price tag on them," points out Mr Riese. This is made more difficult by controlled auction processes, which are almost unavoidable in the M&A market, and an expectation that successful bidders are expected to close the deal in a matter of days after acceptance. Such haste can impinge on the need for care and caution in analysing the target and identifying potential complications.

Nevertheless, deal advisers recommend that buyers should strive to maintain a considered evaluation process. They should investigate the target's products, its scope for growth, the existing management team and the company's position within its market. Due diligence is vital in answering the surrounding questions. With sellers keen to jettison all the transaction risks, due diligence findings are a buyer's best hope of clawing back certain provisions. Then it comes down to drafting the legal agreement.

"A well thought out and carefully drafted agreement ensures that disputes are minimised at the closing and post-closing stages. Obviously, the seller and the purchaser have opposing interests on matters such as the extent of seller's liability, warranties, and so on, but both parties share an interest in ensuring that the agreement contains a clear enough road map that avoids the need to seek interpretations of the parties' intent from the courtroom or arbitration," asserts Mr Morelius.

According to local professionals, the legal and regulatory environment in the Nordic region complements the M&A market. Investors are comforted by clear legislation, stable and transparent judicial systems and improved standards of corporate governance. Employee and pension laws seldom create obstacles to deal closure. Tax policies are also applauded, especially by private equity firms. Sweden, for example, has an advantageous tax regime with the potential to makes dividends and capital gains tax-deductible. In Finland, new laws have been put in place since the beginning of 2006 to pique private equity interest in the region. These laws were designed to allow any profits gained from a Finnish limited partnership to be taxed in the same way as a direct investment into a Finnish company, which represents a considerable improvement on returns.

On the whole, the macroeconomic climate in the Nordic region is quite predictable. Politicians are keeping their promises to lower taxes, exchange rates remain sturdy, interest rates are at an all-time low and economic growth is ahead of the eurozone average. All of this suggests that M&A levels are set to remain high. Even in the event that interest rates do rise, the effects are likely to be felt on a sector-by-sector basis rather than across the board, at least in the initial stages. For the time being, the Nordic region is prominent on the global stage and will continue to take advantage of the wide availability of equity and cheap debt to finance mid-market acquisitions. In addition, synergies between neighbouring countries lead to plenty of cross-border deal flow as foreign companies attempt to establish multiple footprints in the region. But persistent deal activity means valuations will remain high, and buyers must hone their skills to identify the right targets, beat out competitors and ensure they do not shackle themselves with unnecessary risks brought on by the speed of the process and the unrivalled negotiating strength of sellers. ■

For the time being, the Nordic region is prominent on the global stage and will continue to take advantage of the wide availability of equity and cheap debt to finance mid-market acquisitions.

Acquisition finance under the new Finnish Companies Act

BY KIMMO METTÄLÄ

Mid-market M&A transactions in Finland often involve private equity firms as buyers. Such buyers fund a portion of the purchase price by debt from external sources. This article looks at the limitations that apply in using the target business and its assets as security in such leveraged buyout transactions in light of the new Finnish Companies Act that entered into force in September 2006.

Importance of collateral in acquisition financing. Typically, lenders providing acquisition finance extend their loans on a non-recourse basis to the private equity sponsors. Therefore, it is crucial for the lenders to obtain a security package that consists of share security, guarantees and pledges of movable and immovable assets and, ideally, cash flows of the target business. When the acquisition target is a multinational group, involving one or more Finnish subsidiaries, from a Finnish law point of view the issue is whether the subsidiaries can provide 'upstream' guarantees and security to secure the borrowings by a foreign entity that is acquiring the foreign parent company. Similar issue arises in a purely Finnish acquisition, when the sponsors set up an acquisition vehicle that will be funded by equity ▸▸

and bank debt and will then acquire the Finnish target.

What limitations are there to take collateral? The Companies Act contains limitations on the 'distribution of funds' by a Finnish company. Basically, a company is allowed to dividend the distributable equity to its shareholders. As to other distributions, transactions that reduce the company's assets or increase its debts without business grounds are considered illegal distribution of funds. One purpose of this limitation is to protect the company's unsecured creditors. Since the granting of a guarantee or security does not immediately reduce the company's assets, is it considered distribution of funds? No specific answer is given by the new Act, but legal literature indicates that it might be. Thus, the lenders' security package may be limited by the restrictions on distribution of funds. Illegal distribution occurs also if, at the time the distribution was approved, it was known that the company is insolvent or that the distribution will lead to insolvency.

The party that received the illegal distribution must return the funds to the company if it knew or should have known that the company was insolvent or that the distribution leads to insolvency. If granting a guarantee or security can indeed be viewed as distribution of funds, the possibility that the guarantee or security arrangement must be reversed can of course be disastrous for the lenders. To protect against such consequence, the lenders usually require evidence to confirm that the governing bodies of the guarantor and provider of collateral have found that business grounds exist for the arrangement, and that the financial standing of the guarantor as well as those group companies against which it will have a right of recourse have been duly considered and approved.

Prohibition against financial assistance. The new Companies Act prohibits use of the assets of the acquisition target as security for debts obtained for the purpose of acquiring the shares of the target or its parent company. The prohibition, usually called the prohibition against financial assistance, also covers loans and guarantees by the target for such purpose. This limitation applies equally to private and public limited companies. The prohibition usually does not prevent the granting of share security in the Finnish target. However, it extends to the giving of a guarantee or asset security by the target to secure certain acquisition loans.

What if there is a separate Finnish acquisition vehicle (Newco) that acquires the Finnish target company, can the target be legally merged into Newco after the merger? This way, operational assets of the target can be transferred to the balance sheet of Newco and, if Newco has given floating charge security to the lenders, this security will after the merger cover also the movable assets of Newco. Such a merger is a common procedure in Finnish acquisition finance practice, and as such is not illegal. However, there is some doubt as to whether the borrower as a condition of the loan agreement may be required to implement such merger. Since the protection of creditors is arranged by separate provisions in the law, an argument may be made that the financial assistance limitation is not violated even if such merger is contemplated already in the loan agreement, but no case law exists to confirm this view.

The prohibition against financial assistance does not apply to possible loans to finance the working capital needs of the target, loans to refinance existing debt, or loans to finance the acquisition of other subsidiaries of the parent company. Therefore, in practice the target in an LBO-transaction almost always gives security over its assets to the lenders to secure debt for these purposes.

Early experiences of the new Companies Act. From a legal practitioner's point of view, the new Finnish Companies Act has eliminated some problematic provisions in the previous Companies Act, and the Act now provides a reasonable legal framework for acquisition financing which is in line with similar principles in other EU countries. ■

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AUTHOR BIOGRAPHY

EMERGING MARKET TRANSACTIONS

M&A heating up in Russia

BY WILFRIED POTOTSCHNIG

Over the past few years Russia has constantly remained among the fastest growing economies globally and one of the most attractive markets for investment. The overall favourable macroeconomic environment is stimulating various processes typical for civilised economies. Corporate M&A activity provides a clear indication that business has progressed to the next stage of its development, with the major industries experiencing consolidation and integration. As the economy becomes increasingly attractive for foreigners, many international companies are looking to enter the market via acquisition or joint venture options. The market's current status is stimulating M&A activity, as ambitious players seek growth opportunities and expand into the regions in order to survive the growing competition. At the same time, the high demand for acquisition targets is providing attractive exit opportunities.

In value terms, the Russian M&A market is demonstrating one of the leading growth rates globally, reaching $63.3bn in 2006 and meaning that Russia accounts for 2 percent of the global M&A market in value terms and 6.2 percent of European M&A. We do not, however, believe that this represents a peak for Russia's share and are confident that it will increase further, taking into account the dynamic pace of growth. Although 2006 was marked by 15 deals over $1bn in seven industries, we have also observed growing M&A activity in the middle market and the total amount of disclosed deals increased from about 500 in 2005 to over 800.

The growth of the M&A market is driven by impressive overall economic performance and balanced development across industries. The market capitalisation of listed Russian companies has reached $1 trillion, meaning that Russia is now ranked among the top 10 strongest world economies according to this criterion. The steady growth in consumer demand, stimulated by increasing household income (real salaries increased by 13.3 percent over Q1-3 2006 year-on-year), along with intensive development of consumer loans are among the important drivers of the economy. Accordingly, consumer-related industries were among the fastest growing in 2006 (i.e., consumer goods & retail, telecoms and consumer finance).

Such dynamics of economic development along with relative political stability make the Russian market more attractive for foreign investment. Recent statistics for foreign direct investment (FDI) in the economy show that it more than doubled in 2006, reaching $35bn (compared to $15.2bn in 2005), while according to recent government announcements, total ▸▸

foreign capital inflow into the Russian economy in 2006 (which does not include loans provided to Russian companies by foreign banks) totalled $41bn. Another important trend is the change in the structure of FDI, which is now more diversified due to substantial capital inflows into industries other than oil & gas and metals & mining. In previous periods the oil & gas sector accumulated 80-90 percent of FDI; in 2006 the share of this sector decreased to 60-70 percent. Foreign investors are increasingly investing in companies in the financial services, consumer goods & retail and other industries.

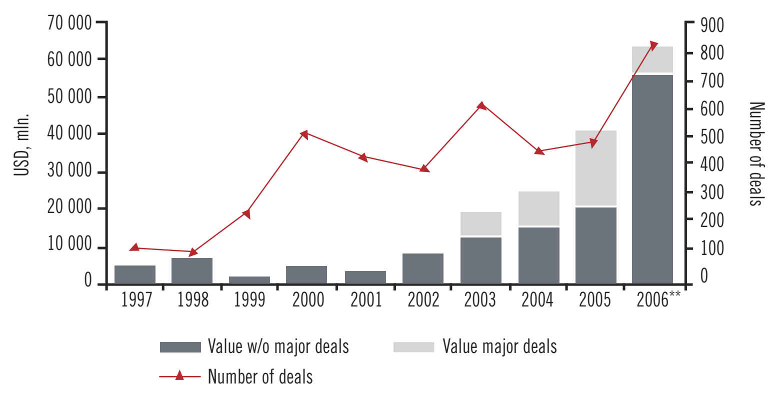
Russia is currently in the process of switching from a policy of stabilisation to development, diversification and stimulation of the economy. The government has begun implementing intensive programs to stimulate production, export, domestic demand, foreign and domestic investments, the social sector of the economy, and small and medium enterprises. While the Russian M&A market is rapidly developing, the government is devoting considerable attention to appropriate regulation of M&A processes. As part of this initiative the government is considering introducing significant changes in regulations on corporate relations by the beginning of 2008. This process has already started and resulted in certain changes in the Federal Law on Joint Stock Companies (January 2006) with the main purpose of introducing a new procedure for acquiring open joint stock companies and related instructions.

M&A activity in Russia in 2006 featured a reorientation of the main focus from extractive sectors only to processing and consumer-related sectors. However, the majority of deals still originated from the same set of industries that have led for several consecutive years, namely oil & gas, metals & mining, consumer goods & retail, telecoms and financial services. Nevertheless, we have observed a more balanced allocation of M&A value and number of deals among the major industries. In 2006 such industries as media, industrial markets, energy, transportation, real estate, construction, hospitality and chemicals also proved to be a field for M&A activity due to their attractiveness for strategic and financial investors, both domestic and international. This tendency demonstrates the increasing diversification of the economy and, accordingly, its more balanced condition.

The top 10 deals combined accounted for 42 percent of the total M&A market value, compared to 70 percent in 2005. This indicates a growing share of middle market transactions. About 300 deals (almost two-thirds of all deals with disclosed value) were reported in the value range of $10m-500m with a total value of approximately $24.2bn. The middle market remains the main source of targets for M&A processes in Russia as well as the main focus for cross-border M&A activity both outbound and inbound.

Cross-border M&A activity remains an essential part of the M&A market, accounting for over one-third of the market value (about $25bn), and demonstrates positive dynamics in relation to both inbound and outbound transactions. In 2006 we have observed a change in the structure of cross-border M&A transactions in favour of inbound deals in value terms (60 percent inbound versus 40 percent outbound) as compared to 2005 (34 percent inbound versus 66 percent outbound). We observed approximately 200 inbound deals and 150 outbound transactions in 2006. Western Europe is the most active region, with a share of approximately 40 percent of both inbound and outbound deal value. Nevertheless, the increasing share of other regions (e.g., North America and CIS countries) indicates a more balanced geographic distribution of cross-border M&A activity.

Figure 1: M&A market in Russia (1997-2006)



Source: Thomson Financial and KPMG analysis

The significant increase in inbound M&A activity indicates the growing appetite of foreign strategic investors for Russian assets, particularly in oil & gas, financial services, consumer goods & retail, and metals & mining. Meanwhile outbound activity is mostly fuelled by major players looking for opportunities for expansion abroad in order to enter new markets, to improve the quality of products and to gain access to new resources and know-how. These purposes are primarily accomplished through acquisitions of mid-market players in foreign markets. We expect an increase in outbound acquisitions in 2007, as numerous Russian businesses plan to become global companies, to penetrate foreign markets and to set up joint ventures with their foreign partners.

The continuous improvement in the qualitative features of the Russian M&A market is another positive trend observed in 2006. This was reflected in the increasing amount of reported deals, especially those under $100m, and better disclosure rate, which is now about 57 percent. Compared with the 2005 disclosure rate of approximately 30 percent, this represents an improvement in the transparency of the Russian M&A market. This progress is caused by further proliferation of western business practices, increasing motivation for transparency (e.g., preparation for IPO), more frequent involvement of advisers and private equity houses, and improvement of the regulatory environment.

Domestic expansion is currently one of the most relevant strategies for M&A in Russia. In 2006 we saw a significant number of such deals, where major players were expanding their businesses in the various regions of the country. The reasons for this strategy include intensifying competition (consumer goods & retail); limited growth opportunities in the Central regions (telecoms); the need for expansion of branch networks (financial services); the significant growth potential in the regions (telecoms, consumer finance), among others. This strategy has already been broadly implemented in all major sectors and is likely to be followed by other industries.

Meanwhile, the intensive development of the M&A market provides firm ground and substantial motivation for the development of small and medium-sized enterprises (SMEs). In particular, financial investors in SMEs consider trade sales as one of the most attractive exit options. Strategic investors consider M&A ▸▸

as a mean for further development of investment projects in all industries. At the same time IPOs are becoming a more widely used tool for raising finance and may potentially be implemented by mid-market players in the future as an alternative option to the sale of their business, which is likely to be reflected in a growing average transaction value in the long run.

The substantial increase in the number of small and medium-size deals represents another important change, and is driven by the intensive development of consumer-related sectors as a result of growing incomes. The latter have also led to increasing disposable capital and thus stimulated the rapid development of investment infrastructure (private equity, mutual funds, asset management institutions) powered by growing demand for investment opportunities, although the scale of such investments is still quite limited.

The positive growth dynamics of the Russian M&A market in 2006 illustrate the quantitative and qualitative changes taking place in Russia. Russia's planned ascension to the WTO will open the borders for further development of the consumer, financial services, metals & mining and other sectors of the economy, and lead to a warming up of the investment climate and to more M&A transactions, especially cross-border. The rapid growth of the M&A market, in line with the most aggressive forecasts, represents an important trend that is likely to continue in the near future, but may gradually slow over the next several years. We anticipate continuing growth in M&A value in view of the intensive development in all major industries, increasing investment attractiveness and aggressive expansion plans of blue chips. In particular, we expect a further value increase in cross-border M&A activity. However, although the market is demonstrating impressive progress there is still substantial scope for improvement, especially with regard to such aspects as financing of transactions, transparency of the market and business in general, valuation and due diligence issues. Taking into consideration the increasing competition for targets and the active involvement of international parties and advisers in M&A in Russia, we expect further improvement in the market which is likely to be reflected in the growing number of deals and accordingly higher market value. ■

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AUTHOR BIOGRAPHY

Demystifying China dealmaking

BY PATRICK HURLEY

Mystery about M&A deals and private equity investing in China abounds for good reason. The market is unlike the Western market in nearly every way. Even so, there is no reason to either shy away or be too ready to change your ways just because of market inefficiencies and culture nuances.

There is a broad and deep knowledge gap in China about the type of M&A and equity sponsor investing commonplace in North America and Europe. That chasm will remain for several years, but there are encouraging developments for those set on staking a claim in the world's fastest growing major economy.

As middle market dealmakers try to extend their relationship base to China, one launching pad is Tianjin because of its mandate to serve as the platform for growth companies across China to access Western private equity, strategic corporate and domestic institutional investment.

Tianjin is slated for a London – AIM (Alternative Investment Market) type public market for institutional financing for high growth Chinese companies. Tianjin has been granted the flexibility to introduce a variety of corporate financial products not currently available to issuers or investors.

Most of the active players in China keep their experience close to their chest because they either want to shroud their moves in secrecy for competitive advantage or they view the benefits of sharing their knowledge as not worth the potential downside.

There are dozens of arms-length deals that make headlines and details exist in filings you can access. The success of 3i-backed advertisement placer Focus Media and it's acquisition of Target Media is one. Another is the rise of Gome and its recent acquisition of China Paradise Electrical followed most recently by the news that it's CEO has teamed up with Bear Stearns to form Eagle Investment for a retail sector consolidation.

The other extreme is the Chinese government's ongoing reduction in state-owned companies (SOE) which are often put together with no data to be found. That is changing as SOEs are being sold to Western private equity groups. Outright acquisitions in basic industries include the Goldman/CDH purchase of meat processor Henan Shineway and Jordan Industries' acquisition of coal equipment makers Jixi and Jiamusi Coal Mining Machinery Groups.

Set aside the government as seller or control owner of enterprises looking to raise capital. Those deals are fraught with complexity because you never really know what the decision making process is or when you will be done. Carlyle has an ongoing root canal with its effort to complete a deal with Xugong Group which fell victim to political fallout sparked by an ornery local competitor.

In-between is the constant stream of big Western early movers into China now buying out joint venture partners. Recent examples include 3Com purchasing Huawei's 49 percent stake after less than two years and the purchase by FedEx of Datian's half interest in their long time joint venture.

There is a broad and deep knowledge gap in China about the type of M&A and equity sponsor investing commonplace in North America and Europe.

Minority position investing is often a creeping acquisition mechanism as with Wal-Mart's deal for initially 35 percent of the Trust-Mart chain of Bounteous. Minority stakes investments by private equity players include Warburg Pincus buying 35 percent of Huiyuan Beverage and Morgan Stanley buying 20 percent of CTCI Construction.

Eight million privately owned Chinese enterprises produce 40 percent of the country's gross domestic product. A meaningful subset of only one quarter of 1 percent of those companies is 20,000 companies that are as entrepreneurial as any North American or European ▸▸

private companies.

Many of the Chinese growth companies have Western customers operating in China as well as in Western markets. They appreciate the Western quality standards and process methods as essential for long term success in their business. They know the faster way to infuse Western systems and management expertise than to take a Western partner.

Eventually going public is the dream that Chinese entrepreneurs have just like in the US in the 1980s and 1990s. Those business owners are tracking successes of the likes of Home Inns, New Oriental Education, Mindray Medical and JA Solar. IPOs are very important for the private equity crowd because of the limitations on resale exit paths.

These private business owners are more like Western entrepreneurs than many investors realise. Owner/manager bosses are alike the world over. They are tough minded and strong willed. There is little need to beat around the bush and cow-tow to the lore of cultural differences. They want to do business with sharp and capable partners who can speed their path to greatness.

The door to China is open and both private equity and corporate investors are welcome. Despite static in the headlines about regulatory hurdles and other risks associated with entering somewhat uncharted waters ahead of the crowd, the opportunities are significant and the rewards are real. ■

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DUE DILIGENCE PROCESSES

The evolution of due diligence

BY CLAIRE SPENCER

It has become common knowledge that a significant percentage of M&A deals fail to achieve their objectives. In the hope of avoiding the pitfalls of their predecessors, companies today are taking a fresh approach to due diligence. There was a time when a cursory glance over the account books was enough to satisfy diligence criteria – but this is no longer the case. The process has intensified and become far more sophisticated. Its scope is often all-encompassing, taking in multiple aspects of business operations, from human resources and management profiling to market research and environmental issues.

Due diligence is quickly permeating the risk profile of corporate deals. The aim is simple: to reduce risk by developing a complete understanding of the target company. To highlight the progressive importance of due diligence, this aim has even filtered down from mega deals into mid-market transactions. Indeed, some of the most meticulous due diligence processes are adopted in mid-market deals, where issues that could be glossed over or absorbed in a larger deal could prove fatal to a smaller entity. Due diligence practices are also spreading internationally. Whereas US processes were historically the most rigorous, the European M&A scene has picked up the trend and improved its own investigations in recent years.

Areas that were previously overlooked or downplayed have become firm fixtures on the agenda. One example is environmental due diligence, the importance of which has escalated due to changing environmental laws and a general concern for the world's climate, according to Heather McKay, a director at RPS Group. "Stringent environmental regulations can result in potentially significant costs associated with maintaining compliance and more severe penalties when compliance is not achieved, both of which can affect the value of a business and represent a risk to the investment," she says. "Greater general concern for the environment means that investors are increasingly interested in the environmental performance of their investments, both on a personal level and in order to maintain good standards of corporate governance of the investing company." In the mid-market, the cost of compliance can be disproportionately high, particularly in the wake of recent regulatory overhauls on environmental matters. As a result, clients are increasingly demonstrating a tendency to start the environmental due diligence process earlier than was previously the case.

Another area that has witnessed dramatic developments is commercial property transactions. Investigation processes have become more focused due to increased deal activity, the threat of litigation against deal advisers and the fact that technology has made information easily accessible. "In the past, due diligence for property transactions was considered a necessary evil, mainly to satisfy lenders. It was unusual for a property vendor to prepare thoroughly in advance of marketing a property asset. But for a variety of reasons, some legislative, others to do with improvements in technology and market conditions, much more serious attention has been turned to due diligence," says James Keys, Director of Investment Agency at Nelson Bakewell.

Overall, the breadth of due diligence has widened and more specialists have been introduced into the process. Nick Hood, Senior London Partner at Begbies Traynor, points out that advisers have been added to the transaction process almost in response to the emergence of new risks. "As investors and financiers have begun to analyse risk, the human angle has become more important, bringing in management profiling and HR specialists. As markets have globalised, research specialists have replaced generalist commercial consultancies. High profile environmental disasters and the increasing influence of the green lobby have opened another field for investigation. Many more stones need turning and the bugs underneath need more precise examination," he says.

Particular disciplines of due diligence have also evolved. A decade ago, environmental due diligence was largely a box-ticking exercise, but now involves collecting information through a combination of desk-based research, environmental data, management questionnaires and site visits. "The focus and scope of environmental due diligence has changed dramatically in recent years," suggests Ms McKay. "Historically the focus was primarily on land contamination and the associated impact on property value. EDD now not only includes compliance of the target's activities with current and foreseeable legal requirements, but can also include the safety of products and raw materials, technical assessment of processes and equipment, and emission trading." She adds that there is no 'one size fits all' guide to EDD, and that it must be carried out in a manner determined by the unique requirements of the target business and the sites involved.

Commercial property due diligence provides another example of the explosion of detail and manpower within a single discipline. "More and more people are now involved in the property transactional process based on the risks associated with making the wrong property investment decision," says Mr Keys. "To demonstrate the extent of diligence undertaken, the professionals that could be involved in the process include lawyers, property and corporate valuers, building surveyors, structural ▸▸

surveyors, deleterious materials technicians, and environmental surveyors, among others."

Considering the vast army of advisers that might be engaged on any given deal, the most proficient acquirers will be selective, tailoring their use of specialists to their acquisition strategy and previous experience. Sharon Mattingly, a principal at Hewitt Associates, notes that the requirements for human resources and cultural due diligence, for instance, will be heavily influenced by the buyer's post-deal intentions. "In deals where the benefits are largely derived from financial restructuring, people issues may not be a significant concern. However, if aggressive integration is required in order to drive out the business benefits, such integration is dependant upon harnessing the efforts and energies of key people from both sides, and organisations may well engage a specialist people adviser to develop a specific approach to engaging critical talent," she says.

There are also considerable differences in the way due diligence will be carried out on behalf of a strategic buyer versus a financial buyer. These differences stem from the buyer's goals and the nature of their investment models. "As a general rule, private equity funds are more focused in their due diligence on issues that impact cash flow, while strategic buyers are more focused on how the target can be integrated successfully into their larger operations. While each approach will review the same documents and pay attention to similar issues, a well structured diligence effort will focus on what it is that the buyer is seeking to achieve with the acquisition and tailor the diligence review to meet those objectives," says Mark Thompson, a partner at King & Spalding LLP.

With the vast array of investigative strands that could form part of the due diligence process, management of the entire process must be carefully planned to minimise cost and resource wastage. Some professionals insist this aspect is paramount. "Not surprisingly, managing the due diligence process is one of the single most important aspects of a transaction," notes Mr Thompson. "It is crucial that not only is the relevant information gathered by the due diligence team, but that information needs to be filtered and provided to the decision makers in time for them to make informed decisions." He adds that, particularly on multi-jurisdictional transactions, it is important to have an organised diligence team operating with a pre-defined set of protocols that enable information to be gathered and disseminated efficiently. Each person involved should know their place and role, although they are ultimately answerable to the client and their legal team. It is also prudent to pass all information onto the management team to optimise the post-acquisition value creation strategy. In this way, the benefits of due diligence extend far beyond the deal negotiation stage and can have a huge influence on the long-term results of the investment.

A targeted, well-executed due diligence process is often cited as the foundation of a successful acquisition. Its contribution is more obvious in certain areas than others, such as cultural integration, which frequently contributes to deal failure, according to Ms Mattingly. "The due diligence process will reveal significant amounts of information about the culture of the target organisation, just through the way that information is presented and shared and through the way different people from the target are involved in the process," she says. "An understanding of the culture of the target is only truly useful if there is a similar understanding of the acquirer's culture, and also of the desired culture that will support the achievement of the deal strategy." She adds that while organisations recognise the impact of culture, they still tend to overlook it during the early stages of deal preparation. But even spending a short amount of time focusing on the key fundamentals of culture can make the difference between establishing a favourable culture and allowing a negative culture to develop on its own.

All the evidence points to the continued growth of due diligence, and new areas of exploration. With interest in M&A at an all-time high, and investors watching more closely than ever, executives and buyout firms are under pressure to deliver the anticipated returns promised by their acquisition strategies. Taking stock of all the inherent risks in a transaction will be pivotal to fulfilling this duty. "The more due diligence we do, the more risks we tend to identify, so deals have to be structured to take account of this greater risk awareness," argues Mr Hood. "Transactions tend to be far more driven by disclosures, warranties and indemnities, which assume greater and greater importance. The more we know through the due diligence process, the more we need to protect the parties against it."

Due diligence is a useful tool in creating value, and recent progress is considered a positive move towards greater certainty in M&A. For this to truly manifest itself, companies must prepare to integrate the results of due diligence into their business plans. This forward thinking will guide investigations to meet the needs of individual deals – a far more robust and efficient system than the generic due diligence seen in former merger waves. ■

People issues in mid-market deals

BY SHARON MATTINGLY

Different research studies conducted over several years have pointed to the same thing – people issues can make or break a deal. Unless the value of an acquisition can be largely achieved through financial restructuring, it will be the efforts, energies, talent and commitment of the people involved that will ensure the prize built into the financial model is realised in the anticipated timeframe.

In common with other deals, mid-market deals rely on people for their success. However, there are certain types of people challenges that are particularly relevant to mid-market deals. These include:

Losing the corporate memory: Mid-market businesses are often staffed with teams of people who are deeply experienced in their specific business, and the success of the business is heavily dependant on these individuals. The size and maturity of the organisation can mean that this knowledge has not been embedded in systems or processes, so, if those people are not around, the business suffers badly. Much of the value in a mid-market deal will reside in these individuals, so well-developed retention plans are critical. These may not be long-term plans – indeed the strategy may be to mitigate the risk associated with over-dependency on individuals as quickly as possible. However, if the issue is not addressed, the corporate memory could walk out of the door before the deal is closed –particularly because key individuals may be at operational management rather than executive level, without any personal financial stake in the long-term success of the business.

More limited talent pools: Mid-market businesses are sometimes located regionally, with less access to ready supplies of replacement talent for specialist positions or those requiring industry experience. So, if there is talent loss as a result of a poorly managed acquisition, or one that does not seem attractive to those in the target company, this could leave ▸▸

critical gaps in the short-term.

Way of doing business: The structure, culture and processes of mid-market organisations will reflect their scale, and these will not map well onto the new requirements – particularly if the acquirer is larger, or if the deal brings together two mid-size organisations. For example, there could be a clash of structures, or of culture, where a mid-sized organisation with a deeply embedded relationship network meets a more formal committee-based governance approach. If the issues are not addressed, and dual systems and processes continue, decisions will be slowed down, there will be confusion around roles and responsibilities, and both productivity and morale will suffer, with significant risk to the realisation of deal value.

In addition to the above, there are some specific differences in the most important people issues in mid-market deals, according to the particular type of deal: (i) a large organisation acquiring a mid-market organisation; (ii) two mid-market organisations coming together; and (iii) a small organisation acquiring a mid-market organisation. Each combination has particular characteristics from a people perspective, where certain issues dominate.

When a mid-market company is acquired by a large company, the main organisational issues are retaining and leveraging the strengths of the mid-market organisation within the larger structure, and re-defining governance for the leaders of the mid-market company. The people implications are loss of talent if people see their jobs are reduced in scope – particularly if it relates to loss of power and status experienced by the management team of the target. It is critical to emphasise the benefits that a larger organisation can bring to retain mid-level talent. Short-term retention programmes may be more appropriate for top executives.

If the transaction involves a mid-market company buying another mid-market company, problems may stem from the fact that both organisations have developed ways of doing business that they believe are appropriate. Both may be reluctant to adopt each other's systems. The result may be compromise when the real requirement is for an approach that suits the larger, merged organisation. In these circumstances, the struggle for power at the top can be a substantial distraction to business continuity. There may be significant talent and leadership fallout as individuals struggle for position in the new merged organisation, with serious implications for the retained knowledge of both businesses. Building a new culture and way of working needs early attention so that key individuals are engaged and productivity does not suffer.

In deals involving a small company buying a mid-market entity, value could be destroyed if the acquirer cannot assert leadership and control of the larger partner. This could arise from having an insufficient numbers of mid-level managers to exert the necessary control. Establishing appropriate governance and structure is vital to avoid an unintended reverse take-over. The acquirer may not be skilled in managing the corporate issues associated with the larger organisation, and may need to pay attention to leadership capability. High potential individuals in the acquiring organisation may perceive a loss of career opportunity now they are part of a larger talent pool.

Mid-market deals do have particular characteristics and people challenges. However, as for all deals, by understanding the sources of additional value that the acquisition can release, and aligning the key people issues to those sources of value, organisations can better plan for the likely concerns and obstacles, and avoid delaying or destroying value capture. ■

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AUTHOR BIOGRAPHY

Checking out management in emerging markets – leave your prejudices behind and take nothing for granted

BY NICK HOOD

With major US banks and significant private equity players talking publicly about deals they have done in such places as Azerbaijan and Armenia, the dark art of assessing local management is taking on even greater importance within the usual due diligence package.

Long gone are the days when a sheaf of CVs in the document bundle and a few calls to referees was sufficient research. Now when you are advising clients on transactions in the less-developed world, especially from the buy side, there are some inescapable realities.

You will need to test and then test again the true functioning of the management team. Even assuming that you can piece together a coherent structure chart, never assume that it means what it says. Every box may be filled and they may all be joined up with suitable solid and dotted lines, but delegation and up-down communication will not function like anything you ever studied on an MBA course.

It is common to find large businesses with sophisticated management charts, where in practice one or two executives do all the work, take all the decisions and the rest of the team cannot function without the most specific of instructions, given hour by hour.

The limited number of players in these markets, the lack of opportunities for ambitious managers and the community-based loyalty of middle management all combine to distort the experience profile of local staff. The fact that they have been with the business for 20 years means nothing especially positive by itself. Equally, 15 years in the same job cannot be taken as negative without further investigation. Condemning a management team for too narrow an experience base or assuming that they are less able or intelligent is a frequent mistake.

Think very carefully before placing too much reliance on deeply-embedded ex-patriots from the developed world. They are a mixed blessing. A change of ownership or control, especially into foreign hands, can open a Pandora's Box of frustration against them, which has been simmering amongst local staff, sometimes for decades. Equally, it can uncouple the ex-pat from the ties, which have kept their nose on the grindstone, and may lead to their departure a few months post-sign off or to an unexpected dip in their performance at a crucial time.

With local staff, make sure you understand the unspoken influences on them. Most businesses in emerging markets are family owned and run. Many are also community based. The concept of face is not limited to Asia, it works worldwide and can drive the most unpredictable of actions. Spending time on bottoming out just how far you can drive local management to defy local cultural imperatives is a wise investment.

Most good advisers counsel their clients about having a Plan B, particularly about management. This is fine in the developed world, where replacements from within the jurisdiction can be recruited with relative ease. This will not be possible in many emerging markets. The alternative of parachuting in international or even regional experts is fraught with danger. ▸▸

By way of example, there are many countries in Africa where importing help from the relatively rich resource pool in South Africa is a clear no-win solution, no matter how capable they may be. In other places, there will be insurmountable cultural or religious barriers to your preferred candidate.

So far, so worrying. But it is possible to carry out effective due diligence, so that plans can be laid to overcome these risks or reflect the downside in the price or deal structure.

This means forging good relationships with independent local advisers. These must be people who know their jurisdictions and the players, while having the requisite political and commercial influence. They do exist, but you won't generally find them in a professional directory, or by phoning a friend. You have to invest time in the jurisdiction, getting to understand it and getting known in it.

One recent development has been the use of psychological profiling techniques, specifically to assess how a distant local team might behave in a commercial or financial crisis. A private equity client recently commissioned just such an assignment relating to a planned investment in South Asia.

The outcome was comforting. Despite concerns about the likely reaction of the chief executive, a natural alternative leader was identified, middle management core loyalties were confirmed and a fledgling disaster recovery plan was hatched. Both the investor and the management team gained from the exercise.

Management due diligence must be taken seriously in emerging markets, despite the added degree of difficulty. But the investor and their advisers should avoid any temptation to compare and contrast what they find with the developed world. The findings must be set properly in the context of the jurisdiction concerned and the differences accepted as part of the risk profile. ■

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AUTHOR BIOGRAPHY

MARKET DYNAMICS

Are the storm clouds gathering for a slow-down in 2007?

BY JOHN KELLOGG & SCOTT RAFSHOON

Acquisition activity in the mid-market – deals from \$200m to \$1bn – continues at the pace established in 2006. So far in 2007, 403 mid-market deals have been announced, compared to 347 deals at this point in 2006. The announced value of these transactions stands at \$180bn compared to 2006's total valuation of \$145bn, according to CapitalIQ, Inc. If this trend continues, 2007 will reach over \$500bn in aggregate deal valuation, another banner year.

With the Dow reaching record highs, the number of transactions on pace to eclipse 2006, and mega-deals being announced (or being rumoured) every month, it is worth asking what's driving the mid-market activity. More importantly, are there any factors that point to a 2007 or early 2008 slowdown?

Market drivers

Private equity continues to drive today's buy-out activity for mid-market public companies as well as closely-held private companies. The substantial amount of capital chasing the same targets has generated a seller's market and is pushing multiples into areas where typical strategic buyers are reluctant or even unable to participate. Concern about the cost and complexity of Sarbanes-Oxley compliance is causing mid-market management teams to reconsider the prestige and capital access of being public. Many public, and closely-held, mid-market companies are looking at private equity as an equal, if not preferred, alternative to going public. Companies that would have gone public at this stage of their life just five years ago are remaining in private hands and some companies that have been publicly traded for less than a year are already considering going back private. Managers perceive that the right private equity backer can provide more breathing room and a longer term outlook on management performance than the quarter-by-quarter driven outlook of many public companies and analysts.

In our experience, the large valuation increases result from two driving factors: deal competition and shareholder pressure. The law of supply and demand still applies as there are more dollars chasing fewer 'good' deals. Transactions and industries that would not have attracted much interest a few years ago are now bringing more than one interested suitor. One impact has been the increase in the use of 'go-shop' clauses in acquisition agreements. These provisions actually encourage and allow a window for sellers to seek other bidders after signing a transaction. This is a significant difference from the days when buyers could require a tight 'no-shop' clause on anxious sellers. The result is an effective auction environment for every company. Clearly, this structure is driven by the current seller's market in which we find ourselves. Interestingly, the last time we saw go-shops was toward the end of the 1980's LBO boom.

Sarbanes-Oxley continues to cast its shadow over the mid-market as the perceived costs of compliance – notably 404 internal control issues and heightened, perceived risk and scrutiny – make the public markets less attractive. But this may be more perception than reality. While willing to take a long-term view, private equity firms tend to be less forgiving than public shareholders when it comes to poor performance. Conversely, they may be more generous toward management when rewarding good performance. Management also needs to keep in mind that private equity typically will seek to harvest returns within a 5-7 year time frame. That may mean a return to the public markets, and with that, a view towards current administrative compliance with Sarbanes-Oxley.

Another factor management should consider in deciding whether to sell out to private equity firms is the increased focus by such firms on operations. No longer do the investors rely on financial engineering to create value. The result may well be higher scrutiny of management for poor operating performance, combined with additional investor input and control over operations. Gone are the days when as long as management met financial targets and debt service, it was given free rein over the company.

Deal terms

There is clearly an increase in more seller friendly deal terms, both on the acquisition side as well as the debt side. Although the go-shop clauses discussed above are an extreme example, breakup fees and other seller friendly terms are becoming easier to negotiate. Sellers are successfully negotiating the sort of indemnification that historically only large, public companies selling off pieces of their business could obtain.

On the debt side, there are more borrower friendly terms as well. Toggle notes, for example, that allow the borrower to skip interest payments in exchange for a higher rate on the skipped payment, can be beneficial in highly leveraged transactions. These structures, however, increase the default risk when a distressed ▸▸

borrower with low cash flow skips several payments in anticipation of improving conditions. When the improvement doesn't materialise, the borrower is even more behind and unable to service the increased interest burden.

Death of the IPO?

To coin an old phrase, reports of the death of the IPO are greatly exaggerated. Although IPO activity is up slightly so far in 2007, we have not approached the levels last seen in 2000. This is due in part to the volume of private equity money and concerns about Sarbanes-Oxley compliance. Private equity money comes with an investment horizon of generally 5-7 years. When the private equity fund seeks liquidity, it will need to locate take-out capital, either more private equity or the public markets. By then, Sarbanes-Oxley concerns may have receded as a result of regulatory reform (discussed below) or general adoption of Sarbanes-Oxley requirements within the private sector (a sort of 'best practices' approach). Also, in structuring deals with an eye toward the long-term liquidity exit, if a public exit is to remain an option, investors may require the company to remain compliant with many Sarbanes-Oxley requirements in order to preserve the IPO option.

On the Sarbanes-Oxley front, SEC Chairman Christopher Cox recently announced efforts to reduce the compliance burden on small companies, initially by delaying 404 internal control deadlines. Other reforms may be coming because of the increased cost burdens on smaller issuers. David Hess, in *Finance – Regulators Seek to Ease Small Biz Sarbanes-Oxley Burden*, recently estimated that smaller companies spend \$1 for every \$100 of revenue on Sarbanes-Oxley compliance, compared to \$0.13 per every \$100 of revenue for larger companies.

Trouble spots

The current booming market and significant income levels of private equity managers has attracted a variety of detractors. Late in 2006, the Department of Justice commenced an antitrust investigation of private equity 'club' deals, those in which several firms combine capital to participate in a transaction. The Department asserts that such an arrangement may reduce the level of competition for an acquisition target, resulting in a lower deal price. Taking a page suggested by this investigation, shareholders of several recently announced private equity acquisitions (HCA, Harrah's and Univision Communications) have brought civil suits against private equity firms involved in those transactions, alleging such firms colluded to reduce the prices paid in the transaction.

As demonstrated in the ClearChannel transaction, in addition to antitrust type concerns, shareholders are also questioning the motivation of management whom they believe are pushing the private equity route in order to receive greater compensation, at the expense of shareholder interest.

Congress is also getting into the fray by contemplating a change in the taxation of the carried interest held by private equity fund managers. Currently, the carried interest is taxed at the long-term capital gains rate of 15 percent. Questions are being raised in Congress whether such interest is similar to ordinary income and, as such, should be taxed at the regular income tax rates which currently top out at 35 percent. Although there are numerous complicating factors, such as what types of carried interest should be subject to higher taxation, action in this area seems likely as Congress looks for additional revenue and Democrats appeal to their base. Substantial tax increases on manager income could have a dampening effect on the availability and cost of private equity capital.

We have also seen private equity funds express concerns regarding the level and quality of due diligence on mid-market targets. The competitive nature of the seller's market, combined with compressed timeframes for deal review and execution, and investor demands for capital deployment, is raising concerns about ▸▸

inadequate diligence. Early diligence focused on identified key risk areas will allow buyers to screen deals and pass on questionable deals, avoiding the increased risk of a bad deal resulting from diligence failure.

Slow down factors

Mid-market activity seems poised to continue its strong performance through the end of 2007 and perhaps into 2008. Available private capital, a strong appetite for leverage and a good credit market should keep activity around its current pace.

However, the following factors may contribute to a slow-down in the mid-market: fewer classically good deals available, increasing risk (low debt, high cash flow and trimmable overhead will reduce the number of deals available); regulatory uncertainty, notably on the tax and antitrust side, may slow the inflow of private equity money; interest rate sensitivity – if rates start to climb, the highly leveraged nature of many deals could be jeopardised; due diligence failures, usually identified within 12 months of acquisition; the trend toward larger deals, causing a temporary slowdown in the mid-market, but offspring deals will follow as the private equity owners pare down balance sheets and focus operations on core capabilities (a la the recent Equity Office Properties acquisition and its post-transaction portfolio sell-off); and shareholder demands for better valuations, further increasing multiples and slowing down transactions.

Another development to note is the formation by several private equity firms of restructuring or distressed funds, possibly indicating preparations for a change in the current cycle. In conversations with distressed players, we are seeing renewed interest and preparation for distressed plays, especially as the current seller's market continues. There seems to be a general belief that weaker transactions are getting done at unusually high prices, creating conditions for a strong distressed market in the foreseeable future.

Although these factors may slowly begin to have an impact, sellers should push hard for the best deal and not be afraid of seeking multiple offers. Many times, a controlled auction situation is advantageous for management and creates additional value for shareholders. Sellers and management should also take a long-term view of the current market with a realisation that they will be back in the market within, most likely, 5-7 years. Structuring a deal with that in mind will preserve and create value for both investors and management. ■

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AIM - the international growth market with continuing success

BY DEARBHLA QUIGLEY

AIM was launched in 2005 as the London Stock Exchange's (LSE) junior stock market for smaller growing companies. The market has enjoyed unprecedented growth from its fledgling start with 10 companies so that by the end of March 2007 it had a total of 1637 companies admitted to trading (304 of which were international companies), with a combined market capitalisation of approximately £101bn. Over its 12 year history, 2700 companies have joined AIM and approximately £42.4bn has been raised on the market through both initial and further equity fundraisings. In 2006, a total of £15.6bn was raised, which was almost double the figure for 2005, which in turn was nearly double the amount of the comparable figure for 2004. During the same period, liquidity increased dramatically with the value of shares traded increasing from £18bn in 2004 to £58bn in 2006 while the average number of daily trades increased by 112 percent. Market capitalisation has also increased, with 29 percent of AIM companies now having a market capitalisation in excess of £50m.

The companies admitted to AIM are diverse in nature with 39 different industry sectors represented from 28 countries. Businesses are represented at all stages of their growth cycle from start-up investment funds to trading businesses seeking expansion or a public profile. The most important sectors by both number of companies admitted and market capitalisation are in the general financial, mining and oil and gas and technology sectors.

Interestingly, for a market that was set up with a domestic focus, AIM has flourished into the growth market of choice for international companies. The international influx began in earnest in 2004 when 61 international companies were admitted, a figure that doubled in 2005 and which was maintained in 2006 with 124 of the 462 companies admitted being international companies. The trend for international companies looks set to continue with 10 admitted in the first quarter of 2007 being 22.7 percent of the number of companies admitted. Next to the UK, the jurisdictions with the highest number of companies admitted are Australia, Canada, Ireland and the United States. As one would expect, the vast majority (in excess of 60 percent) of Australian and Canadian companies are in the mining and oil and gas sectors. More generally, resource companies account for 38 percent of international sector distribution by market capitalisation. The technology sector dominates US AIM companies, with 38 percent of its companies operating in this sector.

International companies account for over one-sixth of all AIM companies and are an important part of the AIM business model. Dedicated to raising the profile of AIM globally and developing its international business, the LSE has appointed teams focused on certain geographical areas, who work on the ground, in regions such as Asia, the Americas, Israel and Central and Eastern Europe. The approach has proved successful and in the last two years, AIM has welcomed the first companies joining from India, China and Cyprus. Another milestone was achieved in 2006 when the first Japanese company came to market.

Imitation is the sincerest form of flattery and, encouraged by AIM's success, European competitors in 2005 launched junior stock exchanges to rival AIM with Alternext in France, Belgium and the Netherlands, Entry Standard in Germany and the Irish Enterprise Exchange. However, AIM has a 10 year first mover advantage on these exchanges and they have yet to really challenge its success.

Certainly, AIM has established itself as the world's most successful international growth market, but what are the key drivers that attract companies – both UK domestic and international – to AIM rather than any other stock exchange?

Unlike the Main List of the LSE and various other stock exchanges, AIM does not require a prospective issuer to have a trading history, a minimum market capitalisation nor a minimum number of shares in public hands. In addition, AIM prides itself on its principles-based model for regulation rather than a prescriptive rules-based approach, thereby offering flexibility and decreased costs of listing for growth companies. Listing fees are low with initial and yearly fees being £4535 irrespective of the size of the company. The fundamental tenet of AIM is that all companies seeking an AIM quote must retain a Nominated Adviser (Nomad) whose role is to confirm to the LSE that a company is 'appropriate' to be admitted to trading on AIM. The LSE does not assess the suitability of AIM companies or generally vet their admission documents thereby effectively delegating the policing of the AIM Rules and quality control to the Nomads albeit that the LSE approves a firm's status as Nomad.

AIM has benefited from the burden of local regulation in foreign jurisdictions. The number of US companies on AIM (totalling 39 in March) is attributed mainly to the wrath of Sarbanes-Oxley where prohibitive costs of increased regulatory compliance forced companies and their advisers to consider alternative markets.

However, it is too facile to state that the sole reason for AIM's success is its 'lighter' touch regulation. The main attraction to London is its access to a deep pool of institutional capital. A study by Thomson Financial for the first quarter of 2007 found that IPOs on London's Main List and AIM raised £5.7bn compared to £4.3bn on Nasdaq and the New York Stock Exchange (NYSE) for the same period. However, it is not just fundraisings at IPO which are attractive: AIM has a track record of being able to raise companies substantial amounts on secondary fundraisings with £16.9bn raised by the end of Mrch 2007. An ability to tap institutional investors for additional funds is key for companies seeking to deliver on their growth plans.

London is a leading global financial centre. It has more foreign banks than any other financial centre, accounts for over 30 percent of global turnover in foreign exchange trading, has the world's leading market for internationally traded insurance and has 36 percent of the global turnover for derivatives trading. Geographically, due to time differences, traders in London can deal with both New York and Japan on the same day. In a recent study by McKinsey & Company, although finding that New York was still the financial capital of the world, they warned that if nothing was done from a legal and regulatory perspective within 10 years, New York would be surpassed. Others argue that London is already the financial epicentre of the world.

In addition, as London has a high concentration of talented professionals in the financial markets, AIM companies benefit from quality analyst research on their shares which fosters increased liquidity. Last year, the LSE moved to improve liquidity further, by introducing the FTSE AIM All-Share Supersector Indices, which created additional AIM indices to accurately measure performance and consequently increase transparency on AIM.

Another attraction of AIM is that international companies listed on certain designated stock exchanges (such as Euronext, NYSE and Nasdaq) can take advantage of the fast track route to AIM saving costs and time, if they have been listed for at least 18 months. In these circumstances, no admission document is required, simply a detailed announcement 20 days before admission.

As success generally breeds criticism, it is not surprising that in 2006 in light of AIM's dominance in the global growth market a spat ensued between New York and London. Newspaper reports quoted a US Securities Exchange Commissioner likening AIM to a "casino" on the basis of the perceived number of AIM companies that were 'gone in a year', (a comment that he later said was taken out of context), and the Chief Executive of NYSE as saying that AIM "did not have any standards and anyone could list". LSE responded rapidly, stating that the failure rate was approximately 3 percent – roughly in line with the Main List. It is certainly not the case that a company seeking an AIM quote merely turns up in London, cashes in its chips and obtains a quote. Anyone who has been through the process will testify to a 3-4 month rigorous exercise during which time the company and its directors are subjected to extensive legal and accounting due diligence. The reputations of these professional firms are on the line together with the Nomad's, who, as ultimate gatekeeper, must vouch for the company to the LSE.

Nevertheless, AIM, as a dynamic successful market and in order to protect further its integrity and quality as it grows, recently made changes to its rules. These changes do not alter the enshrined principles-based approach of AIM and according to the LSE are evolutionary rather than revolutionary in nature, as they record what was existing best practice in the market. First, in March 2006, to improve transparency for investors, AIM adopted rules specific for mining and oil and gas companies, key sectors in the market, requiring such resource companies to include a competent person's report in their admission document disclosing prescribed matters relating to the company's resources. Following lengthy consultation, a rulebook for Nomads was introduced in February of this year, incorporating best practice into the rules and stipulating the responsibilities that the LSE expects a Nomad to satisfy to ensure the high quality of companies being admitted. In addition, all AIM companies are now required to maintain a website containing financial and corporate governance information. Despite these changes, it is important to note that AIM is a risk capital market, with no guarantee of success. Although its regulation is robust, investors must take responsibility for their investment decisions - if you want a sure bet, keep your money in your pocket.

It is too facile to state that the sole reason for AIM's success is its 'lighter' touch regulation. The main attraction to London is its access to a deep pool of institutional capital.

The key to a successful public market is that it is efficient, deep, liquid and transparent. AIM has enjoyed tremendous success since its launch and demonstrated that it is such a market. Furthermore, where needed it has jealously safeguarded its successes and implemented initiatives to improve liquidity and transparency. The results for the first quarter of 2007 are disappointing compared to 2006, with 54 companies admitted – less than half the number of companies admitted during the same period last year. However, the amount raised on secondary fundraisings is on a par. It is early days in 2007 and AIM has survived market turbulence before. The figures for April show improvement with 22 companies admitted, more than half the number of companies admitted for the same period last year, while the amount of money raised for initial and further fundraisings at £1.89 billion was generally consistent with the comparative figure for April 2006. The fact that secondary fundraising activity on AIM continues to be successful confirms that there should not be a serious concern about the integrity of the market. A key challenge for the future of AIM is that growth in international investors is required as London itself cannot fund all international growth companies. AIM should also ▸▸

expand its Nomads from overseas beyond the current six located in Ireland and Australia. Such expansion will help attract international investors and improve the integrity of the market as they will bring local market knowledge for the international companies they are admitting. In 2007, AIM can expect to consolidate its position in the international arena and welcome more companies from India, China, Japan and elsewhere. Exciting times indeed for a market that was conceived for domestic small companies but which has graduated to become the pre-eminent exchange for international growth companies seeking a listing. ■

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