FINANCIER
WORLDWIDE corporatefinanceintelligence

FW
E-BOOK

international mergers & acquisitions

creating value in an increasingly complex corporate environment

2008

In assocation with:

dealogic

Customised edition for:

McKenna Long & Aldridge LLP
Attorneys at Law

FW E-BOOK

international mergers & acquisitions

creating value in an increasingly complex corporate environment

2008

The next great acquisition for your library.

The Mergers & Acquisitions Quick Reference Guide from McKenna Long & Aldridge.

Just like the original Corporate Governance Guide, the M&A Quick Reference Guide is free as a service to corporate counsel and senior management. Send an e-mail to order yours today to ensure that you **STAY AHEAD OF THE CURVE** by getting your copy of this indispensable guide.

Topics include Acquiring a Division, Distress Deals, Purchase Price Adjustments, Public Company Concerns/Post-Closing Issues, Non-Disclosure Agreements, Disclosure Letters, Letters of Intent, ERISA Concerns, Escrow Agreements, Representations and Warranties and more.

To receive your FREE copy of the Mergers & Acquisitions Quick Reference Guide and all future updates, simply email us at maguide@mckennalong.com.

McKenna Long & Aldridge LLP
Attorneys at Law

STAY AHEAD OF THE CURVE

www.mckennalong.com

TO RECEIVE YOUR **FREE** COPY, EMAIL US AT MAGUIDE@MCKENNALONG.COM

Click below to read the articles by McKenna Long & Aldridge LLP

Going global: successfully negotiating multi-jurisdiction transactions
BY RICHARD R. WILLIS, CHRIS G. BAUGHER AND ANTHONY M. BALLOON

Drafting and negotiating purchase agreements to anticipate challenges
BY MARC C. D'ANNUNZIO AND WAYNE N. BRADLEY

Taking advantage of the weak US dollar
BY GARY W. MARSH, MICHAEL J. COCHRAN AND ANN-MARIE MCGAUGHEY

Published by
Financier Worldwide
The Exchange
19 Newhall Street
Birmingham
B3 3PJ
United Kingdom

Telephone: +44 (0)845 345 0456
Fax: +44 (0)121 710 5574
Email: ebooks@financierworldwide.com

www.financierworldwide.com

ISBN: 978-0-9558826-0-9

First edition

FW E-BOOK

2008 International Mergers & Acquisitions:
Creating Value in an Increasingly Complex Corporate Environment

Contents

NOTE: These Contents pages are interactive.
Clicking on an article will take you to the relevant page.

CHAPTER FOUR:
PRIVATE EQUITY MARKETS 57

CHAPTER FIVE:
STRUCTURING AND NEGOTIATING THE DEAL 67

CHAPTER SIX:
ACCOUNTING AND FINANCIAL CHALLENGES 118

CHAPTER SEVEN:
DUE DILIGENCE AND INTEGRATION 128

CHAPTER ELEVEN:
REGIONAL VIEW – EUROPE 228

CHAPTER TWELVE:
REGIONAL VIEW – ASIA PACIFIC 311

CHAPTER THIRTEEN:
REGIONAL VIEW – MIDDLE EAST 358

CHAPTER FOURTEEN:
CONTRIBUTOR GLOSSARY 366

About the Publisher

Financier Worldwide is a leading publisher of news and analysis on the global corporate finance market place. Financier Worldwide delivers in-depth commentary, research, and practical analysis that bridges the gap between theory and practice in the complex world of corporate finance.

Through a series of online, print and digital publications, the organisation has become recognised as a leading source of intelligence to the corporate dealmaking community. Financier Worldwide products reach a sophisticated and influential group of professionals responsible for doing the deals that move markets and shape the corporate economy.

Financier Worldwide tracks the latest trends in Mergers & Acquisitions, Private Equity & Venture Capital, Bankruptcy & Corporate Restructuring.

This e-book, entitled "International Mergers & Acquisitions: Creating Value in an Increasingly Complex Corporate Environment", is published in an exciting new interactive digital format. It is the first in a series of e-books to be developed by Financier Worldwide's digital publishing division in 2008.

To learn more about this and other e-books scheduled for distribution, please contact James Lowe on +44 (0) 121 710 5560 or email james.lowe@financierworldwide.com.

Acknowledgement

Data featuring in this e-book was compiled with the help of Dealogic's M&A Analytics team.

Dealogic's M&A Analytics provides a comprehensive view of M&A activity worldwide covering a wide array of transactions such as public offers, open market purchases, stock swaps, buyouts, privatisations, recapitalisations, share buy-backs, acquisitions and includes industry leading financial sponsor coverage. Each transaction provides information on target and acquirer, deal value, advisers, financials, multiples along with a detailed deal commentary. M&A Analytics provides a host of analytical tools to help analyse transactions, regions and industries efficiently.

CHAPTER ONE:

Introduction

2007: a story of two halves

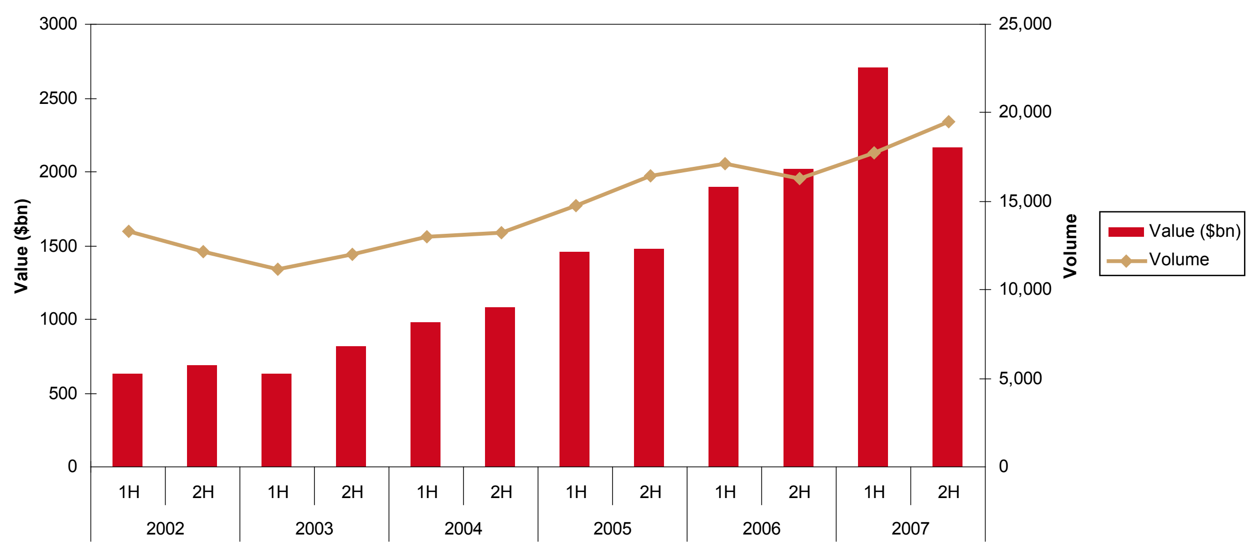
BY SALIM MOHAMMED

In 2007 global mergers & acquisitions reached historic levels with $4.83 trillion in announced deal volume. This surpassed the 2006 record of $3.91 trillion by 23 percent. Due to the credit crunch, which hit in the summer, the year became a story of two halves with volume surpassing $2.7 trillion in the first half but then dropping 21 percent in the second half.

In fact, September 2007 volume of $216bn was the lowest month for global announced M&A volume since November 2005. BHP Billiton's bid for Rio Tinto in November 2007, valued at $152bn, helped push second half volumes above $2 trillion. When looking at the top deals of the year, all but two of the top 10 deals were announced in the first half of the year. The two deals announced in the second half of the year were BHP Billiton's hostile attempt on Rio Tinto and Rio Tinto's own acquisition of Alcan in July.

The second half slowdown was notable for the smaller number of billion dollar deals that crowded the first half of 2007. There were 376 deals over $1bn announced in the second half, down from 466 deals announced in the first half. Deals over $10bn dropped to 17 in the second half from 29 in the first half. In addition, the average deal size totalled $187m in the second half of 2007, down 30 percent from

IH VERSUS 2H, 2002-2007



Source: Dealogic

an average of $260m in the first half of 2007.

As the frenzied pace of first half deal activity gave way to caution, transactions took longer to complete. The average time to complete a deal rose to 91 days in the second half of the year, up from 85 days in the first half.

Significant events of the past year

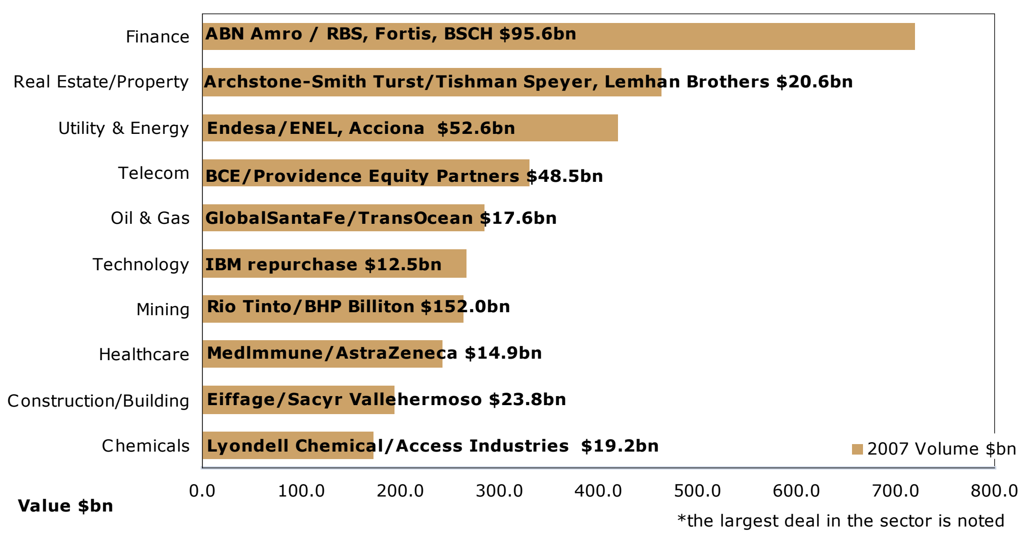
In 2007, finance was the top targeted sector with $720bn, accounting for 15 percent of global M&A. The RBS consortium (RBS, Santander and Fortis) beat out Barclays and completed the acquisition of ABN Amro for $96bn in the fourth quarter of 2007 making it the largest completed deal of the year and the fifth largest on record.

Altria's spin-off of Kraft Foods, valued at $56bn, at the end of the first quarter was the second largest transaction of the year and also the second largest spin-off on record, shy of the record BCE spin-off of part of Nortel in 2000.

Hostile or unsolicited bids heated up in 2007. There were 949 hostile/unsolicited bids in 2007, up from 374 in 2006. Although volume for these bids was up 36 percent in 2007 from 2006 ($929bn in 2007, up from $683bn reported in 2006), volume was still short of the record $1 trillion posted in 1999.

Cross-border M&A represented 41 percent of total announced volume with $1.99 trillion in 2007, up 78 percent from $1.12 trillion in 2006. The US was the most targeted nation by foreign acquirers with $363bn in announced deals in 2007, up 67 percent from $218bn in 2006 while the Netherlands saw the biggest year-on-year increase, rising 642 percent to $188bn, due in large part to the $96bn acquisition of ABN Amro. The UK was the leading acquirer nation with deals worth $307bn in 2007, up from $83bn in 2006 driven by five deals over $10bn.

SECTOR ACTIVITY 2007



Source: Dealogic

Emerging market targeted M&A volume reached $909bn in 2007, up 43 percent from $634bn in 2006 and became the highest annual total on record. Emerging market cross-border inflow increased 43 percent to $371bn in 2007 from $260bn in 2006.

The year ended with sovereign wealth funds (SWFs) making four significant investments into well known financial institutions. Faced with billions of dollars of write downs, Citigroup, UBS, Morgan Stanley and Merrill Lynch all received investments by Asian and Middle Eastern sovereign wealth funds within the course of a month. These four investments totalled over $30bn and were about two-thirds of the total SWF investment of $48.5bn in 2007. The full 2007 figure was a 165 percent increase on $19.2bn invested in 2006 and a five-fold increase from the $8.2bn invested in 2005. In fact, SWF investment made up 1 percent of M&A, up from 0.5 percent in 2006.

For the year, investment banks racked up revenues of $26bn though global M&A advisory. This figure was up 21 percent from $22bn reached in 2006. Of the total, US companies generated a total of $10.8bn, just besting European companies who generated $10.5bn. Advisory revenue generated from Asia Pacific (excluding Japan) companies reached $1.9bn in 2007. Japanese companies generated revenue of $490m.

For the volume league tables, Goldman Sachs led the global and US advisory rankings in 2007 while Morgan Stanley led the European rankings and UBS led the Asia Pacific (excluding Japan) rankings. Goldman Sachs, Morgan Stanley, JP Morgan and Citi all advised on deals worth over $1 trillion in 2007. Previously, only Goldman Sachs tipped the trillion mark in 2006.

Financial sponsors break records, then hits the brakes

The booming buyout market experienced a slowdown in the latter half of the year due to the credit crunch. Even with only about six months of deal making time before the credit market dried up funding, financial sponsor buyout volume hit a new record high of $796bn in 2007, an increase of 9 percent on the previous record $730bn reached in 2006. Putting the two halves in comparison, second half volume reached $221bn, down 62 percent compared to first half volume of $575bn.

With the announcement of the $44bn TXU

TOP 5 ANNOUNCED GLOBAL FINANCIAL SPONSOR M&A BUYOUTS 2007

Announced	Target	Target Nat.	Acquirer/Financial Sponsor	Target Sector	Deal Value ($bn)
29-Jun-07	BCE (93.7%) (Bid No 1)	Canada	Providence Equity Partners; Teachers Private Capital; Madison Dearborn	Telecommunications	48.5
26-Feb-07	TXU	United States	Kohlberg Kravis Roberts; TPG Capital; Goldman Sachs Capital Partners	Utility & Energy	43.8
21-May-07	ALLTEL	United States	TPG Capital; Goldman Sachs Capital Partners	Telecommunications	27.9
2-Apr-07	First Data	United States	Kohlberg Kravis Roberts	Finance	27.7
3-Jul-07	Hilton Hotels	United States	Blackstone	Dining & Lodging	25.8

Source: Dealogic

buyout in February by KKR, TPG Capital and Goldman Sachs Capital Partners, the previous record held by KKR for the RJR buyout was broken after 19 years. However, just four months later, Teachers Private Capital, Providence Equity Partners and Madison Dearborn set another record with the BCE buyout at $48.5bn.

In all, there was a record nine $10bn-plus buyouts announced in 2007 and 158 above $1bn. However, of these, no $10bn-plus buyouts and only 37 $1bn-plus buyouts were announced from August to December.

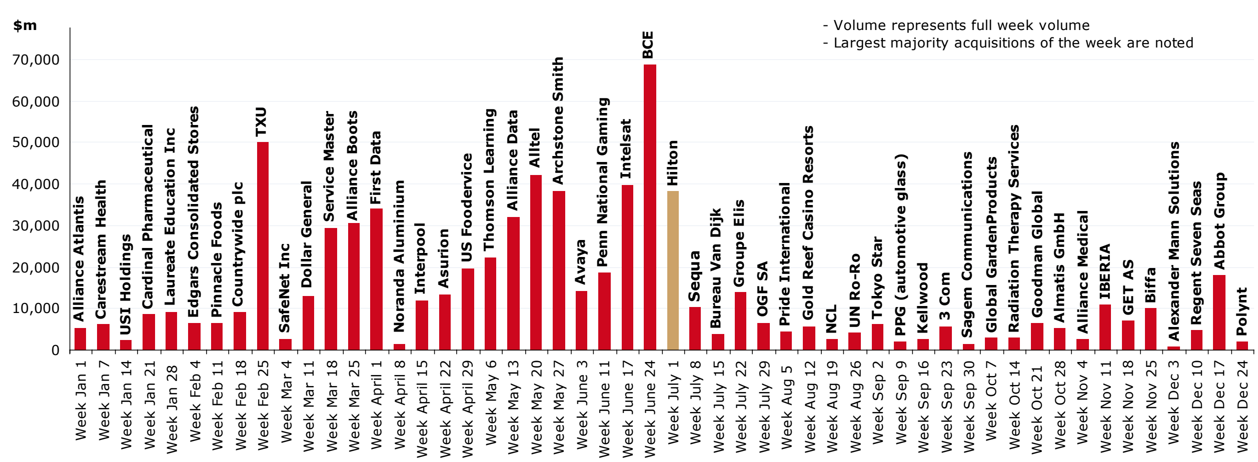
The average deal size for buyouts from August to December was $221m, down 77 percent from its peak of $958m in both May and June. In fact, monthly volume for financial sponsor M&A buyouts peaked in May at $159bn and declined to $27bn in December.

All financial sponsor M&A activity (entry buyouts, portfolio company transactions and exit deals) reached its highest percentage of total M&A in June when it accounted for 38 percent. However this dropped to only 11 percent in November, the lowest level since February 2005.

Emerging market financial sponsor buyout volume reached $47bn in 2007, up 17 percent from $40bn in 2006 and represented 6 percent of global buyout volume. India was the most targeted nation with a total volume of $8bn accounting for 17 percent of all emerging market financial sponsor buyout volume. China was the second most targeted nation with $6bn of volume, down 28 percent on 2006.

Although emerging market financial sponsor buyout volume has fallen steadily since peaking at $7bn in August to $3.5bn in December, the falloff has been less intense as the non-emerging markets. Finance was the top industry targeted by financial sponsors in the emerging markets with $6bn. The largest deal was the $767m bid by Carlyle Group and Citi for a 6.6 percent stake in Housing Development Finance Corp of India.

GLOBAL M&A BUYOUTS (EXCLUDING ADD-ONS) 2007



Source: Dealogic

Regional highlights

The Americas

US targeted M&A volume reached $1.6 trillion in 2007 – a slight increase on the 2006 $1.5 trillion volume. Despite a record second quarter ($581bn), second half volume dropped 42 percent as multi-billion dollar deals disappeared. Financial sponsor buyouts, which accounted for 33 percent of US targeted M&A in the first half ($331bn) fell to just 18 percent of volume in the second half ($107bn).

Volume from deals over $1bn dropped significantly in the second half. However, mid-market volume (deals valued between $100m and $1bn) remained fairly stable – average monthly volume for deals over $1bn dropped 39 percent from the first half to the second half, while mid-market average monthly volume decreased only 2 percent over the same time period.

US targeted cross-border M&A volume reached $363bn in 2007, up 67 percent from $218bn in 2006, fuelled by 16 deals over $5bn compared to eight deals in 2006. The UK was the leading acquirer of US companies with $51bn in 2007, up 49 percent from $34bn in 2006, boosted by the acquisition of MedImmune by AstraZeneca for $14.9bn in April.

Canada targeted M&A volume reached $259bn, up 67 percent from $155bn, fuelled by two significant deals: the BCE buyout for $48.5bn and the Alcan acquisition by Rio Tinto for $43bn. Latin America targeted M&A volume totalled $110bn in 2007, up 15 percent from $96bn in 2006 with 41 percent of volume from deals with an acquirer outside the region compared to 48 percent in 2006.

Europe, Middle East and Africa

Europe targeted announced M&A reached its highest annual volume on record with $2 trillion, driven by robust volume in the first half. Western European volume reached $1.6 trillion in 2007, the highest yearly volume on record. Although second half volume slowed 24 percent compared to first half, it was still the third highest half-year volume on record after the first half of 2007 and the second half of 1999.

Eastern European volume reached $277bn, an increase of 59 percent compared to 2006. Eastern Europe bucked the global trend with the second half recording an increase of 102 percent compared to the first half with volume reaching $186bn, the highest half year on record. Russia was the

TOP 5 ANNOUNCED GLOBAL TRANSACTIONS 2007

Announced	Target	Target Nat.	Acquirer	Acquirer Nat.	Deal Value ($bn)
08-Nov-07	Rio Tinto	United Kingdom	BHP Billiton	Australia	152.0
25-Apr-07	ABN Amro Holding (Bid No 2)	Netherlands	Royal Bank of Scotland Group; Banco Santander Central Hispano; Fortis Group	United Kingdom	95.6
31-Jan-07	Kraft Foods (88.1%)	United States	Existing Shareholders	United States	56.1
02-Apr-07	Endesa (55.03%) (Bid No 3)	Spain	ENEL; Acciona	Italy	52.6
29-Jun-07	BCE (93.7%) (Bid No 1)	Canada	Providence Equity Partners; Teachers Private Capital; Madison Dearborn	Canada	48.5

Source: Dealogic

most targeted nation in Eastern Europe with $176bn in volume, up 75 percent from 2006. The acquisition of 25 percent of Norilsk Nickel by Russian Aluminum (Rusal) for $13.3bn was the largest Russian targeted deal announced in 2007. Russia's deal volume mainly consisted of domestic deals, with 22 percent of its volume coming from cross-border acquirers.

Middle East targeted volume totalled $39bn in 2007, up 36 percent from 2006. Telecommunications was the most targeted industry in 2007 with $19bn doubling from 2006, followed by finance with $9bn, up more than three-fold from $2bn in 2006.

The Middle East became the fourth most active acquiring region for cross-border investment with a volume of $106bn in 2007, three times the $34bn in 2006, fuelled by 25 deals over $1bn. The US was the most targeted nation by Middle East investors with $34bn accounting for 32 percent of total Middle East cross-border investment, fuelled by the $11.6bn acquisition of GE Plastics by SABIC and Kuwait Petroleum's acquisition of Dow Chemical for $9.5bn.

Overall, EMEA targeted announced M&A reached the highest volume on record with $2.1 trillion, up 38 percent from $1.5 trillion in 2006. The first half of 2007 totalled $1.1 trillion, the highest half-year volume on record but this dropped 11 percent to reach $996bn in the second half.

Asia Pacific

M&A volume in Asia Pacific (excluding Japan) was up 37 percent on 2006 reaching $551bn in 2007. First and second half volume were virtually the same. China led the region with $144bn in announced transactions, an increase of 38 percent on $104bn in 2006 and accounted for 26 percent of the region's volume.

China continued to be the top nation attracting foreign investment with $40bn, up 39 percent on 2006. Cross-border deals accounted for 28 percent of total China volume this year. India also attracted substantial foreign investment, tripling volume to $32bn from $10bn in 2006.

Outbound cross-region M&A reached $219bn in the fourth quarter, driven by the $152bn bid for UK based Rio Tinto by Australia-based BHP Billiton. The figure was way above the previous quarterly record of $51bn in the fourth quarter of 2006. Inbound cross region M&A broke the $100bn barrier for the first time with $179bn.

Australia was the most targeted nation with $42bn, representing 23 percent of total inbound activity in the region.

Japan targeted M&A reached $186bn in 2007, on par with 2006 volume of $183bn. Finance was the most active sector in 2007 with $56bn, down 4 percent on 2006. The healthcare sector saw a marked increase, up four times on last year to $10bn. Outbound cross-border volume was down 56 percent on last year while inbound cross-border volume was up almost four times in 2007 compared to 2006.

Salim Mohammed is the director of M&A at Dealogic.

Sovereign wealth funds

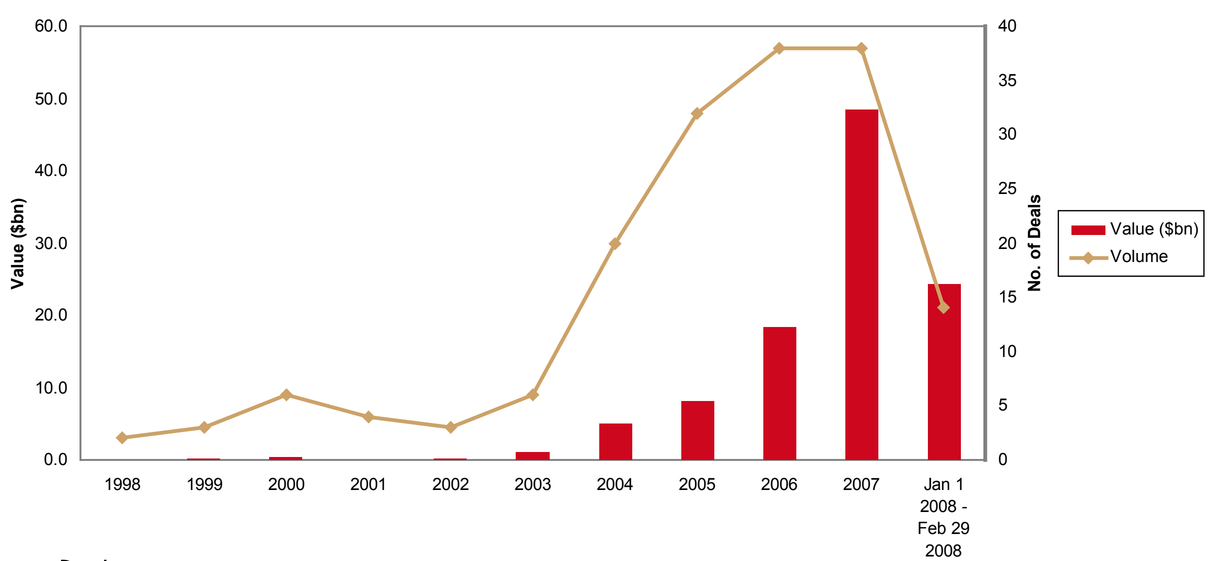
BY SONIA KALSI

On the back of the credit crisis, sovereign wealth funds (SWFs) are emerging as a serious investment source for companies in financial distress. Leading western banks forced to make huge write downs have turned to SWFs, whose buying power is rapidly increasing. According to a recent report, the total write down figure at the end of January this year by the major banks was over $150bn. SWFs, with an estimated fund pool of $3 trillion globally, have helped ease this burden by injecting large sums of capital, totalling $52.7bn, in exchange for minority stakes.

The 'Sovereign Wealth Fund Review', released by Dealogic in March 2008, shows that since 1998 there have been 166 cross-border SWF deals totalling $106bn. Activity since 2005 has accounted for $99.3bn of that total. Deals per annum have more than trebled since 2004, with 30 in 2005 and almost 40 in 2007, compared to the 10 per annum prior to 2004. The first two months of 2008 have already witnessed 14 SWF deals.

Total deal value in 2007 reached $48.5bn, a 165 percent increase from the $19.2bn in 2006 and a 492 percent increase from the $8.2bn in 2005. In the first two months of 2008, total deal value has already hit a remarkable $24.4bn – exceeding all total annual figures since 1998, except 2007. The proportion of SWF investment of all M&A activity was just over 5 percent in the first

SOVEREIGN WEALTH FUND INVESTMENTS 1998–FEBRUARY 2008



Source: Dealogic

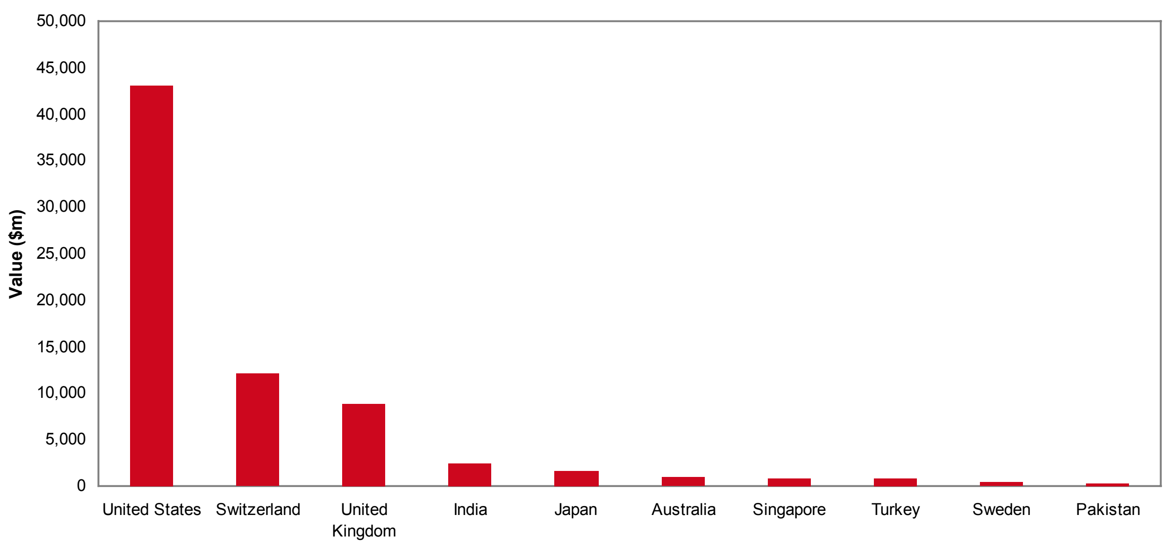
two months of 2008, up from 1 percent in 2007 and 0.5 percent in 2006. The average deal size has also grown. In the first two months of 2008, the average deal size was $1.7bn, 40 percent higher than the $1.2bn average in 2007 and 271 percent higher than the $469m average in 2006.

The buying power of SWFs is proving a godsend for western financial institutions hit hard by the economic downturn. The report shows that the finance sector attracted the most investment from SWFs from 2007 to February 2008, totalling $60.7bn. This, coupled with the falling dollar, has put the US in the lead among countries targeted for investment. From 2007 to February 2008, $43.1bn of SWF investment found its way to the US. Much of this was attributed to investments in large US banks to offset huge write downs. Citigroup recorded a write down of $19.9bn but received $20bn in an SWF investment led by the Government of Singapore Investment Corp and Abu Dhabi Investment Authority. Merrill Lynch's write down of $22.4bn was eased by a $12.8bn investment by SWFs led by Kuwait Investment Authority and Temasek Holdings. The impact of Morgan Stanley's write down of $9.4bn was reduced by a $5bn SWF investment led by China Investment Corp. A whopping $53.5bn (88 percent) of investment has poured into the finance sector since September 2007, following last summer's subprime crash.

Trailing the US as target countries for investment were Switzerland, which accumulated $12.1bn during the period (largely made up of the $11.5bn invested in UBS by the Government of Singapore Investment Corp.) and the UK with $8.8bn. In terms of investment by sector, real estate followed finance at $4.7bn and retail was third at $2.3bn.

According to the report, the $3 trillion held by SWFs is largely accounted for by the UAE Abu Dhabi Investment Authority,

TOP 10 NATIONALITIES FOR SWF INVESTMENT INFLOWS 2007–FEBRUARY 2008



Source: Dealogic

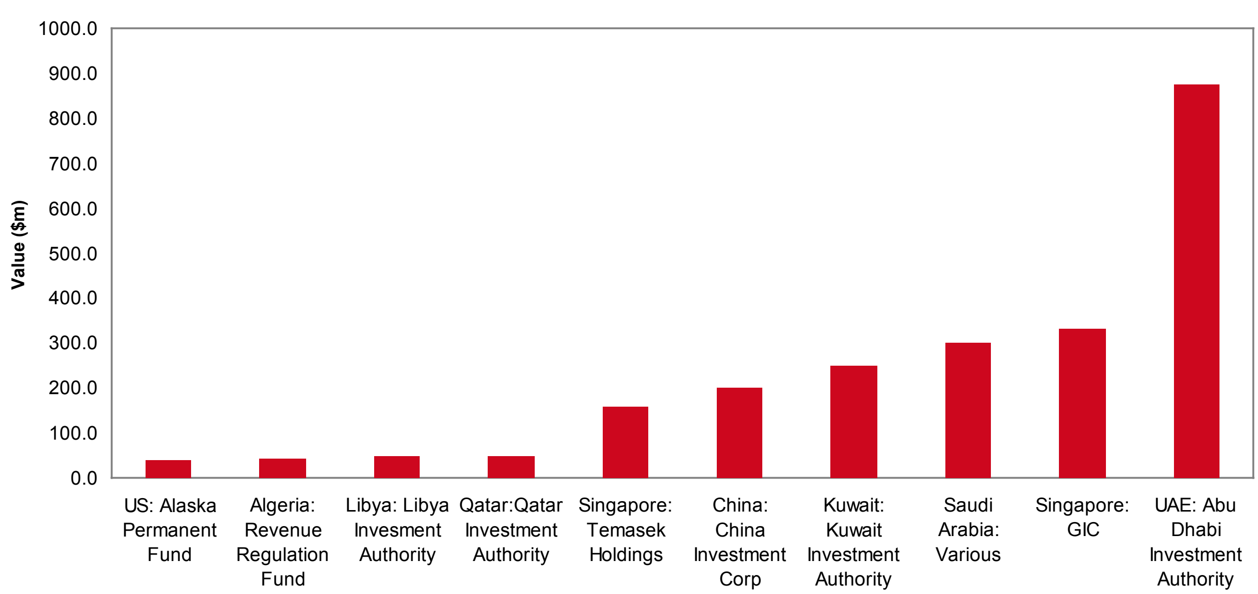
which holds $875bn, Singapore's two funds with a combined $489.2bn, and the China Investment Corp. with $200bn. Between 2007 and February 2008, Singapore was the top regional acquirer, followed by the UAE and China. Dealogic's report deliberately excludes pension plans, such as Norway's Government Pension Fund, due to operational differences when compared with SWFs.

Two SWFs analysed in the report also own and operate private equity firms. Since 2003, the leading investment by the private equity arm of Dubai Holdings, Dubai International Capital, was $1.5bn in the UK's Tussauds Group. For the private equity investment arm of Government of Singapore Investment Corp., GIC Special Investments, the largest investment was $562m in Australian Mayne Group Ltd.

According to data from Merrill Lynch and Morgan Stanley, by 2015 SWFs could surpass $10 trillion in value. Their rapid growth rate has led to political debate in the US and EU, over concerns about their operating models, motivations and long term intentions. As a result, governments have been pushing for increased transparency and accountability. The G7 and the International Monetary Fund have pledged to establish a best practice code of conduct for SWFs but have gained varying degrees of support from individual funds.

The wealth of investment SWFs can offer distressed companies is proving attractive, as they continue to bail out leading financial institutions and others hit by the credit crisis. The first two months of 2008 already showing rapid growth in deal value and volume, so even if markets do ease, SWFs are well on their way to becoming a firm and competitive fixture in cross-border investment.

LARGEST SOVEREIGN WEALTH FUNDS BY ASSETS UNDER MANAGEMENT

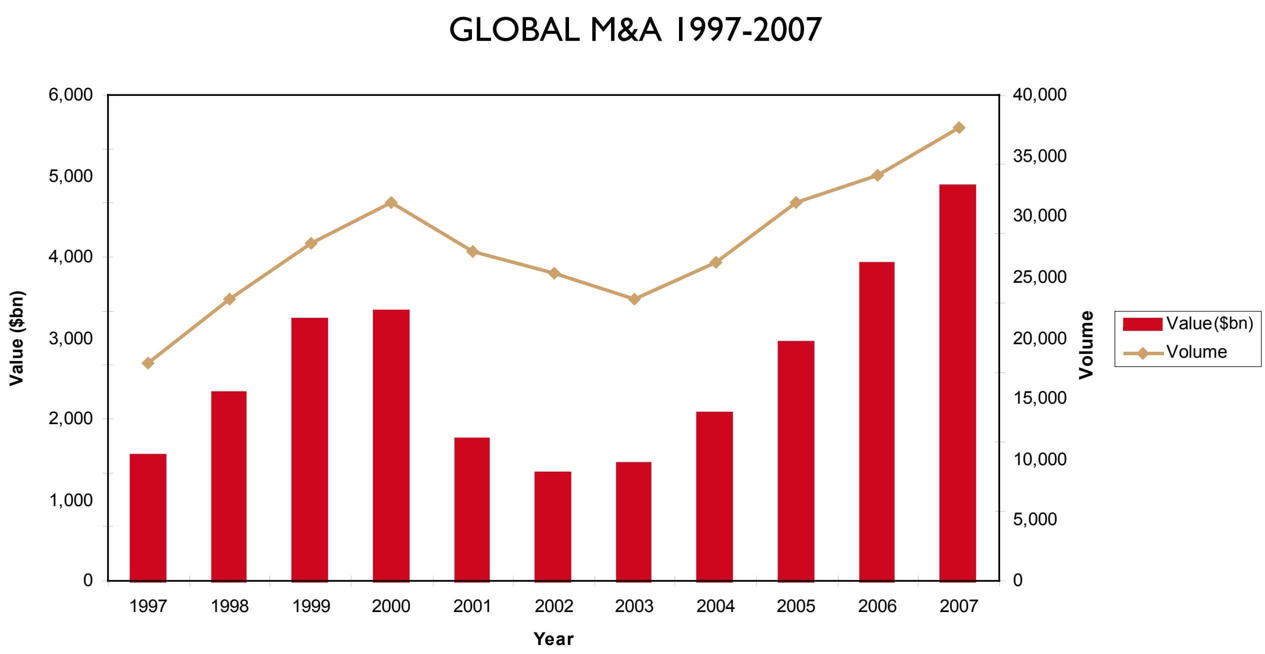


Source: Dealogic

CHAPTER TWO:

Statistical data

M&A trends 1997-2007



Source: Dealogic

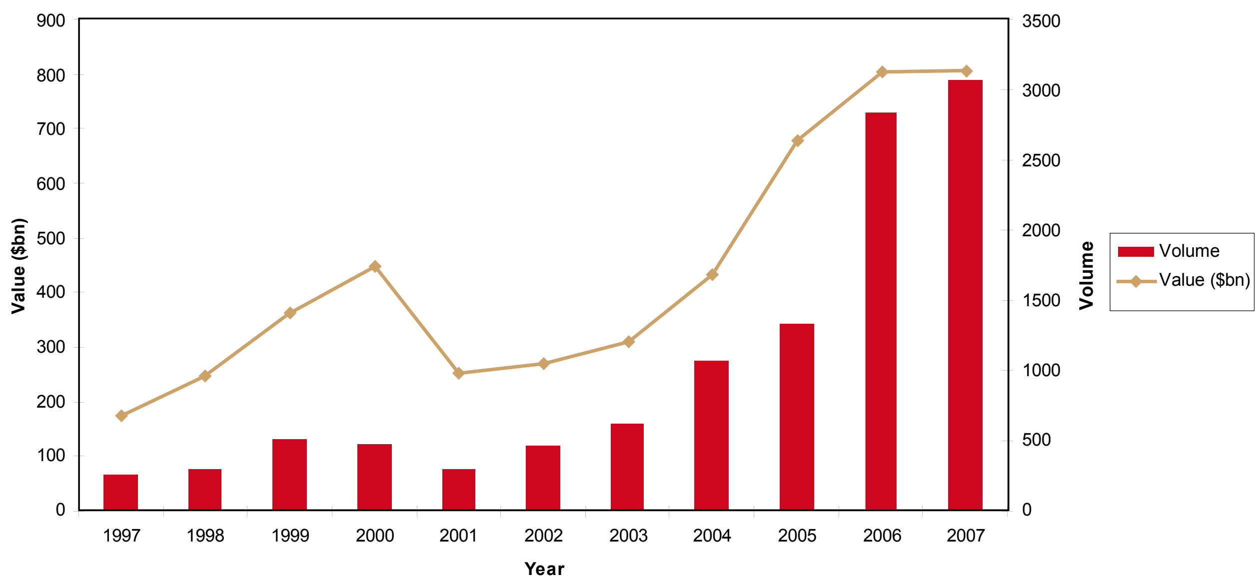
Year	Deal Value ($bn)	Volume
1997	1,548.3	17,910
1998	2,317.5	23,224
1999	3,222.0	27,756
2000	3,335.5	31,196
2001	1,755.0	27,065
2002	1,322.4	25,359
2003	1,452.8	23,164
2004	2,061.2	26,244
2005	2,937.4	31,122
2006	3,916.8	33,429
2007	4,873.0	37,267

(Announced transactions)

The graph provides a clear indication of the global deal boom that began in 2004 and reached new highs in both value and volume in 2007.

Of course, based on credit volatility in the second half of 2007, the line is set to turn south in 2008. But how steep will its decline be?

GLOBAL FINANCIAL SPONSOR M&A 1997-2007



Source: Dealogic

2006 and 2007 were the golden years of private equity. It was the most active period for buyout pros in the industry's history.

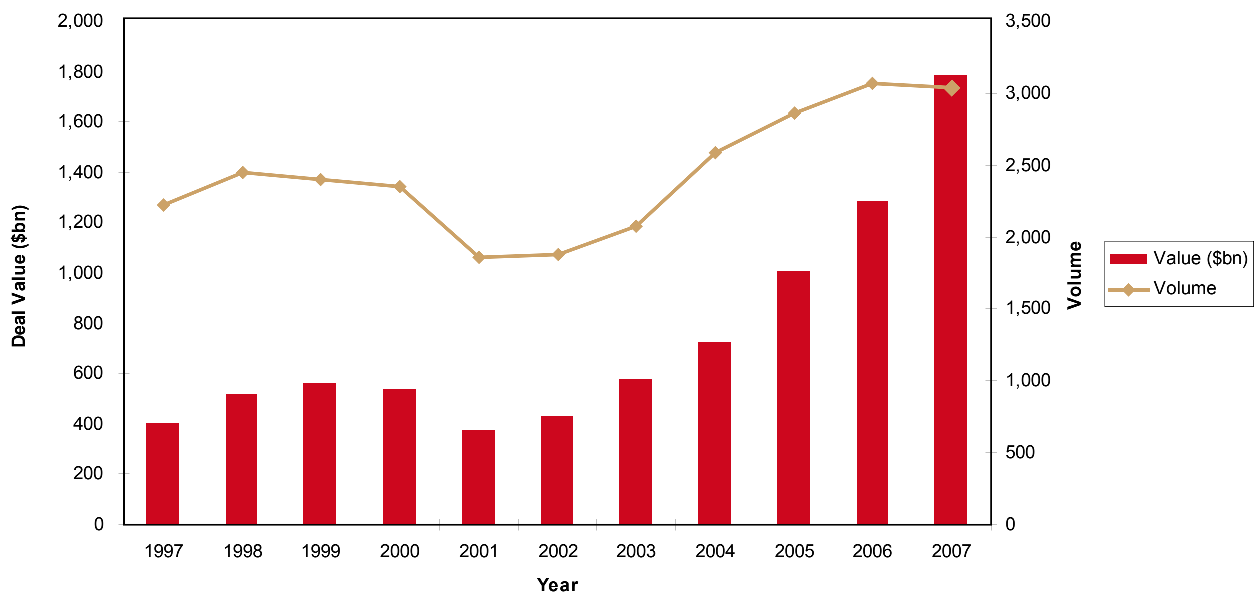
The jump between 1997 and 2007 is astonishing. Volume increased by 363.7 percent while value increased by an astronomical 1,121.2 percent.

Whether this asset class can replicate a similar high point in future years is anyone's guess. Some say the industry took advantage of several factors which created an almost perfect dealmaking environment, and that we are unlikely to see such a culmination again. Others argue that private equity has been through down cycles before – and emerged stronger.

Year	Deal Value ($bn)	Volume
1997	64.8	678
1998	76.1	958
1999	130.9	1416
2000	120.9	1745
2001	76.1	983
2002	117.9	1045
2003	157.8	1206
2004	275.7	1691
2005	344.1	2651
2006	733.5	3137
2007	791.4	3144

(Announced transactions. Figures include acquisitions or divestments by portfolio companies)

GLOBAL LEVERAGED LOANS 1997-2007



Source: Dealogic

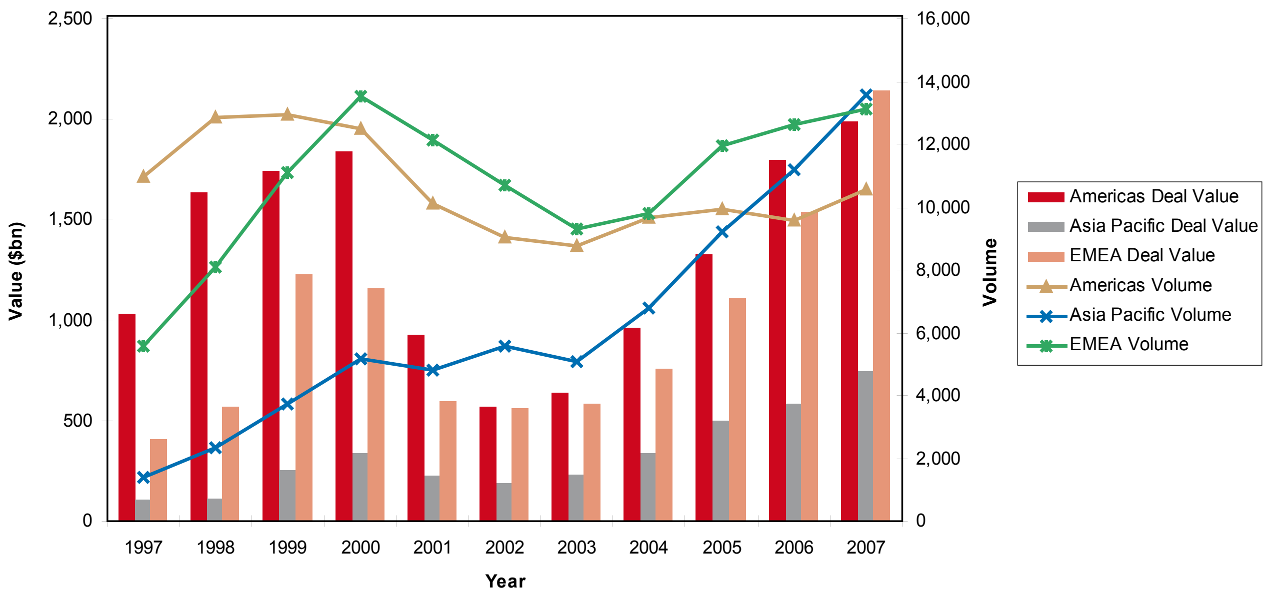
Year	Deal Value ($bn)	Volume
1997	405.3	2,218
1998	515.1	2,444
1999	559.7	2,402
2000	540.8	2,347
2001	378.3	1,859
2002	432.1	1,879
2003	578.5	2,073
2004	726.8	2,586
2005	1,003.3	2,860
2006	1,284.0	3,070
2007	1,786.1	3,035

(Announced transactions)

Today's leveraged finance market is almost unrecognisable compared to a decade ago. New structures, new products and a host of new players drove a huge rise in activity from the low point in 2001 to the onset of the credit squeeze in mid-2007 .

Although the volume of leveraged loans increased by only 36.8 percent between 1997 and 2007, their total value ballooned by 340.6 percent over the same period.

REGIONAL M&A 1997-2007



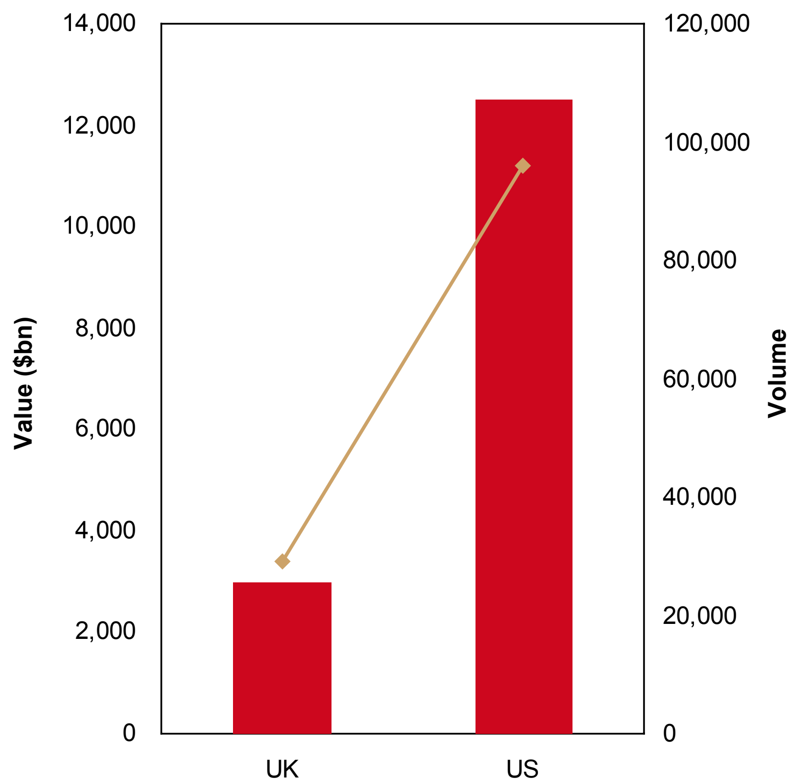
Source: Dealogic

While deal volume remained fairly stable in the Americas, both the EMEA and Asia Pacific regions experienced dynamic growth between 1997 and 2007. In fact, Asia Pacific generated the highest number of transactions in 2007, although the total value of deals was much lower. In the same year, EMEA overtook the US for the first time to become the leading region by deal value.

Year	Americas Deal Value ($bn)	Asia Pacific Deal Value ($bn)	EMEA Deal Value ($bn)	Americas Volume	Asia Pacific Volume	EMEA Volume
1997	1,035.3	106.0	407.0	10,959	1,376	5,575
1998	1,637.3	109.6	570.7	12,832	2,315	8,076
1999	1,741.7	252.0	1,228.3	12,935	3,742	11,079
2000	1,842.4	334.6	1,158.5	12,507	5,149	13,540
2001	927.9	226.9	600.2	10,093	4,824	12,147
2002	571.0	190.4	560.9	9,048	5,593	10,718
2003	642.1	229.9	580.8	8,758	5,081	9,325
2004	964.9	336.2	760.0	9,670	6,793	9,781
2005	1,326.2	498.9	1,112.3	9,945	9,218	11,959
2006	1,794.8	584.2	1,537.8	9,591	11,194	12,644
2007	1,984.7	743.8	2,144.6	10,583	13,571	13,108

(Announced transactions)

UK VERSUS US M&A 1997-2007

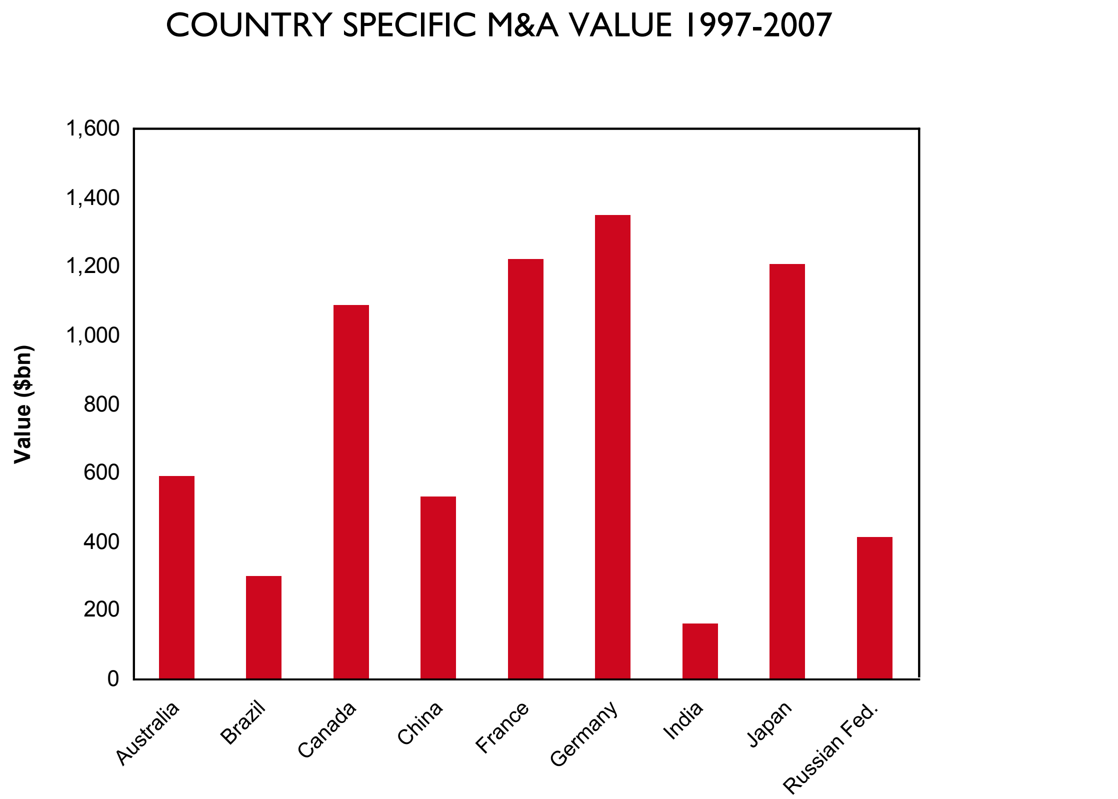


Source: Dealogic

	UK	US
Deal Value ($bn)	2,982.3	12,511.8
Deal Volume	29,229	96,124

(Announced transactions)

Of the two world heavyweights in country-specific M&A, the United States is clearly the dominant force, hosting more than $12.5 trillion worth of deals in almost 100,000 transactions between 1997 and 2007. The UK, despite being second on the global league table by a clear margin, has provided less than a quarter of US transaction value over the same period.



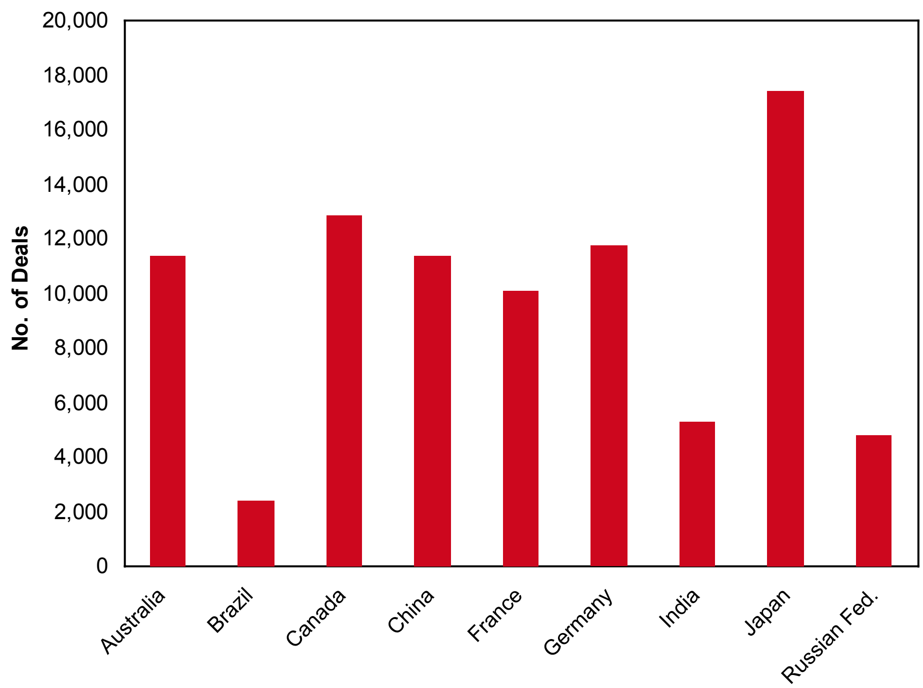
Source: Dealogic

Excluding the US and UK, Germany generated the most M&A value between 1997 and 2007, closely followed by France. Although there is a sizeable drop to the BRIC countries (Brazil, Russia, India and China), these emerging markets have made up ground in the last few years, and the gap between them and established Western markets should close further over the next decade.

	Australia	Brazil	Canada	China	France	Germany	India	Japan	Russian Fed.
Deal Value ($bn)	590.8	299.0	1,086.8	531.0	1,222.6	1,347.2	163.5	1,204.0	415.3

(Announced transactions)

COUNTRY SPECIFIC M&A VOLUME 1997-2007



Source: Dealogic

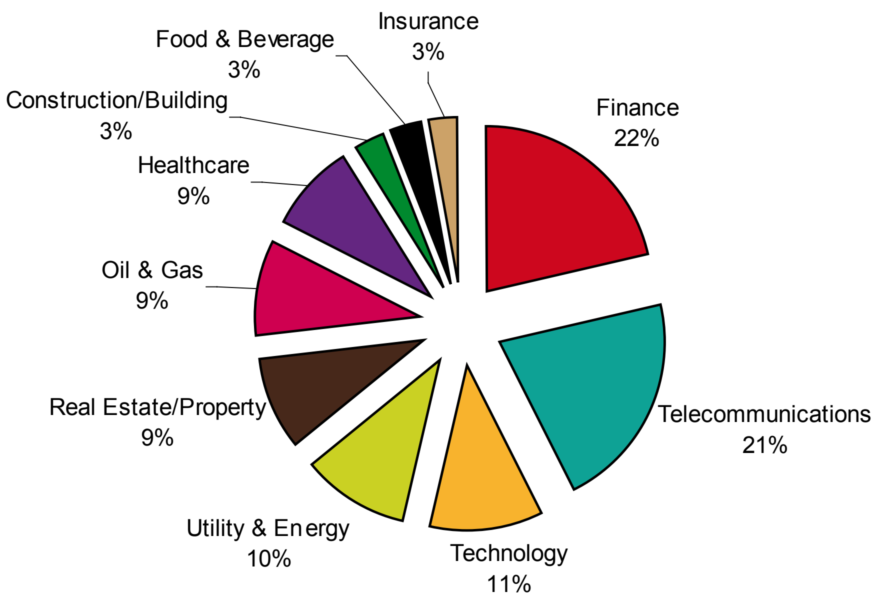
Looking at country-specific volumes reveals that pockets of activity around the world do not necessarily correlate to total deal values.

Here, Japan took the lead by a clear margin, with over 17,000 deals. Australia and Canada saw far more activity than the total deal values suggest. China actually overtook France and came very close to Germany by number of deals.

	Australia	Brazil	Canada	China	France	Germany	India	Japan	Russian Fed.
Deal Volume	11,373	2,412	12,870	11,403	10,116	11,784	5,290	17,414	4,817

(Announced transactions)

TOP 10 ACTIVE SECTORS BY VALUE 1997-2007



Source: Dealogic

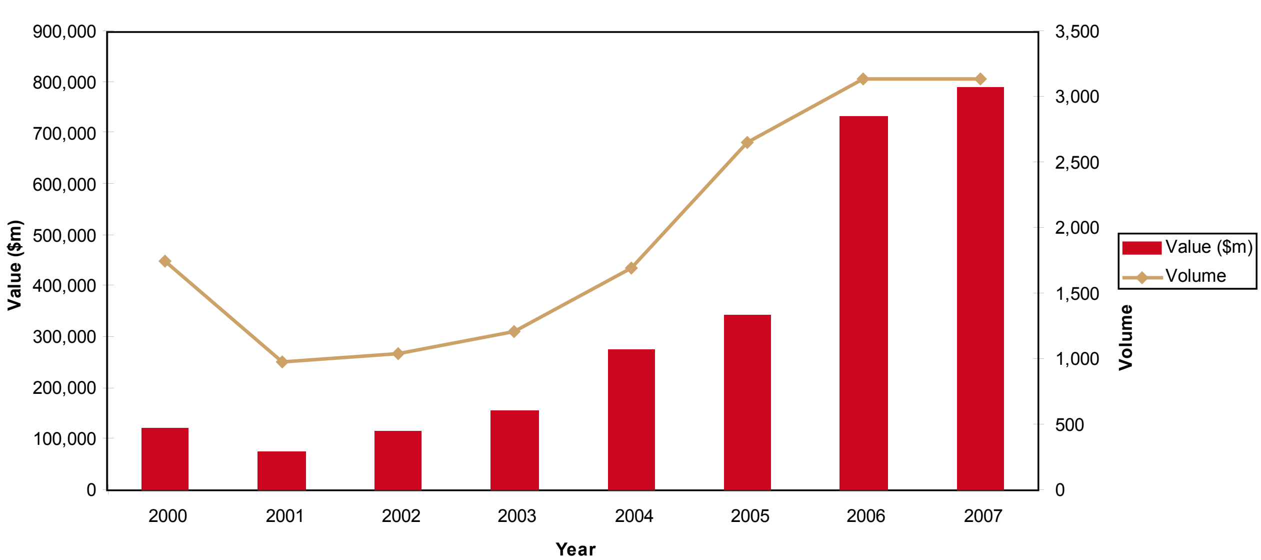
Over the last decade, Finance has provided the highest total amount of deal value, closely followed by Telecommunications, which reached its peak in the 1999-2000 boom.

TOP 20 ANNOUNCED M&A TRANSACTIONS, BY VALUE 1997-2007

Announced	Target	Target Nat.	Acquirer	Acquirer Nat.	Deal Value ($bn)
14-Nov-99	Mannesmann AG (99.6%)	Germany	Vodafone AirTouch plc	United Kingdom	172.2
08-Nov-07	Rio Tinto plc (Bid No 1)	United Kingdom	BHP Billiton Ltd & plc	Australia	154.4
10-Jan-00	Time Warner Inc.	United States	America Online Inc	United States	112.1
04-Nov-99	Warner-Lambert Co	United States	Pfizer Inc	United States	111.8
06-Mar-06	BellSouth Corp	United States	AT&T Inc	United States	101.9
25-Apr-07	ABN Amro Holding NV (Bid No 2)	Netherlands	Royal Bank of Scotland Group plc; Fortis Group; Banco Santander Central Hispano SA - BSCH	United Kingdom	95.6
01-Dec-98	MOBIL CORP.	United States	EXXON CORP.	United States	85.6
17-Jan-00	SmithKline Beecham plc	United Kingdom	Glaxo Wellcome plc	United Kingdom	79.6
11-May-98	AMERITECH CORP	United States	SBC COMMUNICATIONS INC	United States	76.2
28-Jul-98	GTE Corp	United States	Bell Atlantic Corp	United States	74.6
26-Jan-04	Aventis SA	France	Sanofi-Synthelabo SA	France	71.3
11-Aug-98	Amoco Corp	United States	British Petroleum Co plc	United Kingdom	64.3
05-Jul-99	Elf Aquitaine SA (95.56%) (Bid No 1)	France	TotalFina SA	France	63.1
28-Jan-00	Nortel Networks Corp (35%)	Canada	Existing Shareholders	Canada	61.7
05-Jan-99	Airtouch Communications Inc (Bid No 2)	United States	Vodafone Group plc	United Kingdom	61.5
28-Jan-05	Gillette Co	United States	Procter & Gamble Co	United States	60.8
06-Jul-01	AT&T Broadband	United States	Comcast Corp	United States	60.7
15-Jul-02	Pharmacia Corp	United States	Pfizer Inc	United States	59.8
18-Feb-05	UFJ Holdings Inc (Bid No 2)	Japan	Mitsubishi Tokyo Financial Group Inc	Japan	59.1
14-Jan-04	Bank One Corp	United States	JP Morgan Chase & Co	United States	56.9

Source: Dealogic

Financial sponsor trends 2000-2007



Source: Dealogic

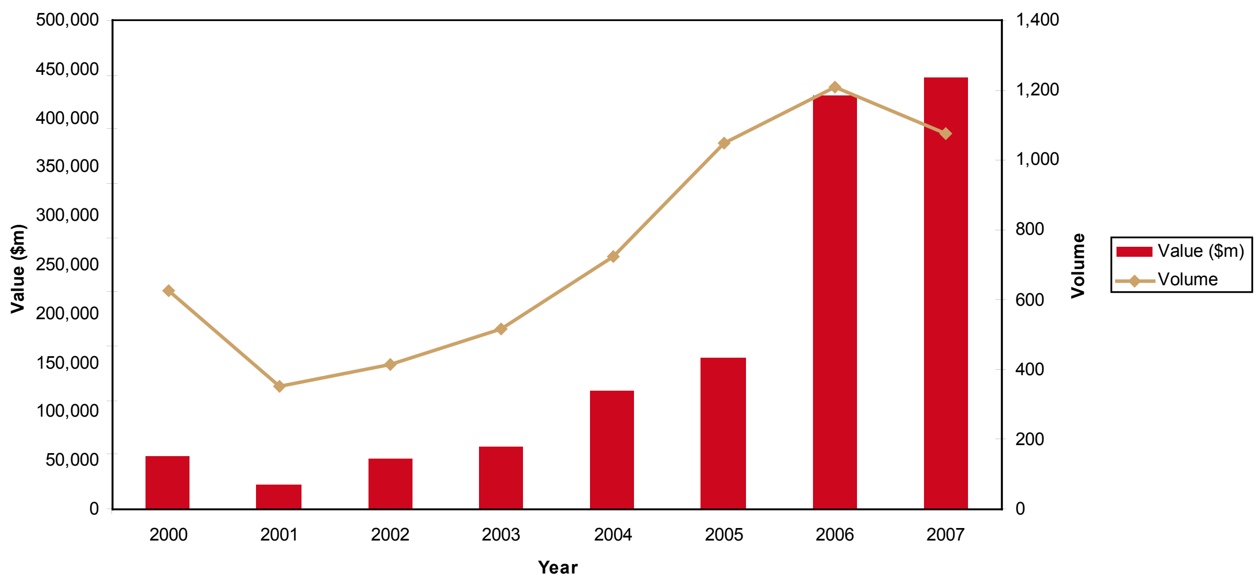
In two years, 2006 and 2007, the total value of announced buyouts worldwide was almost 40 percent higher than the previous six years combined.

In 2000 the average deal size was $69m. By 2007 it had almost quadrupled to $252m.

Year	Value ($m)	Volume
2000	120,916	1,746
2001	76,150	985
2002	117,880	1,048
2003	157,947	1,210
2004	275,724	1,695
2005	344,110	2,655
2006	734,866	3,140
2007	792,551	3,144

(Announced transactions)

US TARGETED FINANCIAL SPONSOR BUYOUTS 2000-2007



Source: Dealogic

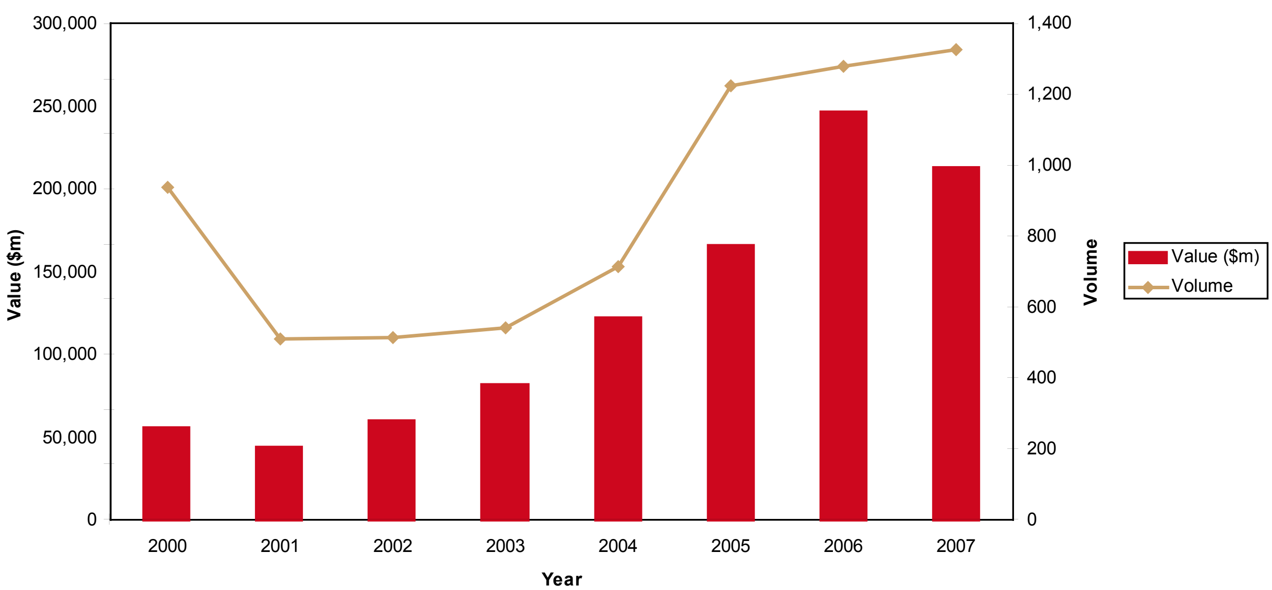
Year	Deal Value ($m)	Volume
2000	54,067	627
2001	25,432	353
2002	51,341	413
2003	64,761	518
2004	121,126	725
2005	155,359	1,049
2006	423,276	1,207
2007	441,161	1,077

(Announced transactions)

As the world's leading economy and the most developed market for buyouts, the US remained the destination of choice for private equity houses.

In 2007, transaction value increased over 2006 despite a drop in the number of transactions.

EUROPEAN TARGETED FINANCIAL SPONSOR BUYOUTS 2000-2007



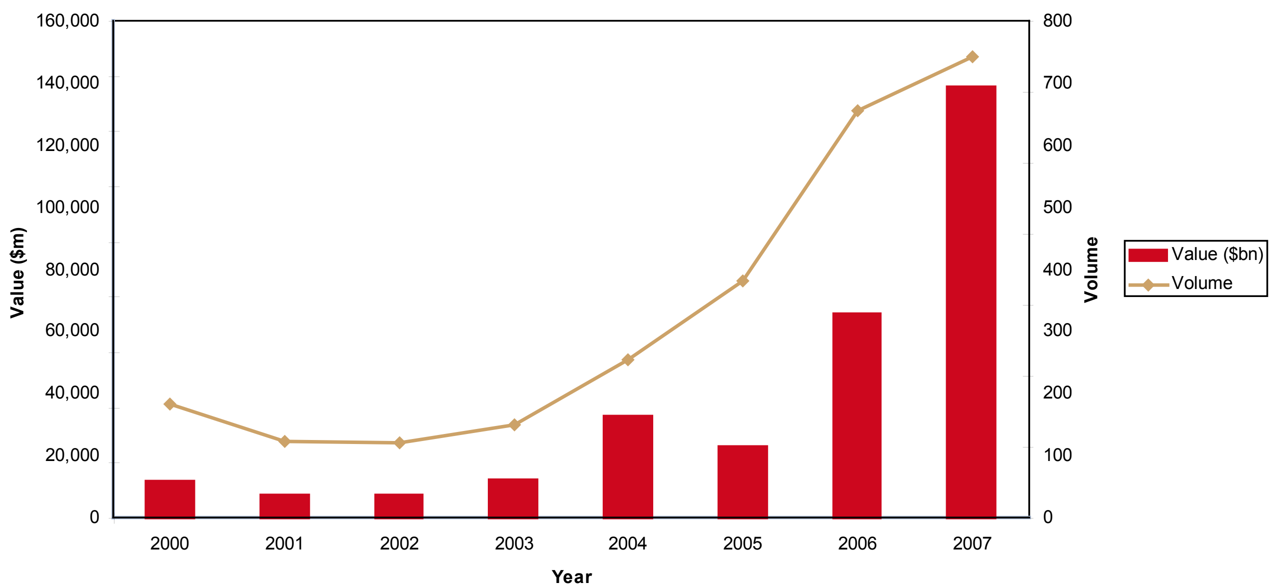
Source: Dealogic

Europe, like the US, hosted a gradual increase in buyouts since the early part of the new millennium. In contrast to the US, however, there were more deals announced in 2007 than 2006 but their total value actually declined from the previous year.

Year	Deal Value ($m)	Volume
2000	55,389	936
2001	43,400	509
2002	59,608	514
2003	81,107	543
2004	122,085	715
2005	165,966	1,224
2006	246,000	1,278
2007	212,777	1,326

(Announced transactions)

REST OF WORLD TARGETED FINANCIAL SPONSOR BUYOUTS 2000-2007



Source: Dealogic

Year	Deal Value ($m)	Volume
2000	11,460	183
2001	7,318	123
2002	6,932	121
2003	12,080	149
2004	32,514	255
2005	22,786	382
2006	65,591	655
2007	138,612	741

(Announced transactions)

Buyout markets have sprung up outside the US and Europe, as leading buyout houses look beyond their traditional borders for new opportunities. The appetite for emerging market deals has accelerated, particularly as these countries actively develop the legal and financial infrastructure to support private equity transactions.

In 2007, the total value of announced deals was only 12 percent lower than combined totals for 2000 to 2006.

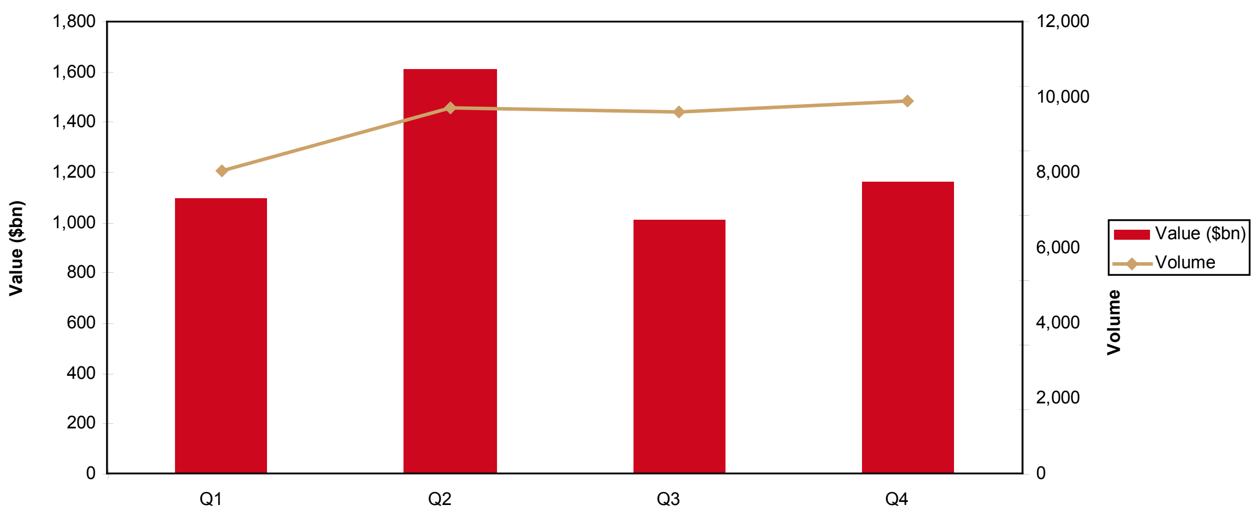
TOP 20 ANNOUNCED FINANCIAL SPONSOR BUYOUTS, BY VALUE 1997-2007

Announced	Target	Target Nat.	Acquirer	Acquirer Nat.	Deal Value ($bn)
29-Jun-07	BCE Inc (93.7%) (Bid No 1)	Canada	Providence Equity Partners Inc; Ontario Teachers' Pension Plan Board; Madison Dearborn Partners LLC	Canada	48.5
26-Feb-07	TXU Corp	United States	Kohlberg Kravis Roberts & Co; Texas Pacific Group; Goldman Sachs Capital Partners	United States	43.8
20-Nov-06	Equity Office Properties Trust (Bid No 1)	United States	Blackstone Real Estate Partners LP	United States	38.9
24-Jul-06	HCA Inc	United States	Bain Capital Inc; Kohlberg Kravis Roberts & Co; Merrill Lynch Global Private Equity	United States	32.7
21-May-07	ALLTEL Corp	United States	TPG Capital LP; GS Capital Partners LP	United States	27.9
02-Apr-07	First Data Corp	United States	Kohlberg Kravis Roberts & Co	United States	27.7
02-Oct-06	Harrah's Entertainment Inc	United States	Apollo Management LP; Texas Pacific Group	United States	27.4
16-Nov-06	Clear Channel Communications Inc (Bid No 2)	United States	Bain Capital Inc; Thomas H Lee Partners	United States	26.4
03-Jul-07	Hilton Hotels Corp	United States	Blackstone Group LP	United States	25.8
29-May-06	Kinder Morgan Inc	United States	GS Capital Partners LP; AIG Global Asset Management Holdings Corp; Riverstone Holdings; Carlyle Group Inc	United States	21.6
29-May-07	Archstone-Smith Trust	United States	Tishman Speyer Properties; Lehman Brothers Private Equity	United States	20.6
30-Mar-07	Alliance Boots plc (85.013%) (Bid No 1)	United Kingdom	Kohlberg Kravis Roberts & Co	United Kingdom	20.5
15-Sep-06	Freescale Semiconductor Inc (Bid No 2)	United States	Blackstone Group LP; Carlyle Group Inc; Texas Pacific Group; Permira Ltd	United States	17.6
23-Jan-06	Albertson's Inc	United States	SuperValu Inc; Schottenstein Stores Corp; Kimco Realty Corp; Cerberus Capital Management LP; Klaff Realty LP; Lubert-Adler Real Estate Funds; CVS Corp	United States	17.4
19-Jun-07	Intelsat Ltd (76%) (Bid No 1)	Bermuda	BC Partners Ltd	Bermuda	16.4
12-Sep-05	Hertz Corp	United States	Clayton Dubilier & Rice Inc; Carlyle Group Inc; Merrill Lynch Global Private Equity	United States	15.0
30-Nov-05	TDC A/S (87.9%)	Denmark	Nordic Telephone Co ApS	Denmark	13.9
27-Jun-06	Univision Communications Inc (Bid No 2)	United States	Madison Dearborn Partners LLC; Thomas H Lee Partners; Texas Pacific Group; Providence Equity Partners Inc; Saban Capital Group Inc	United States	13.6
28-Mar-05	SunGard Data Systems Inc	United States	Investor Group	United States	11.8
18-Dec-06	Biomet Inc	United States	Blackstone Group LP; Kohlberg Kravis Roberts & Co; Texas Pacific Group; Goldman Sachs Capital Partners	United States	11.4

Source: Dealogic

M&A and private equity in 2007

GLOBAL M&A 2007



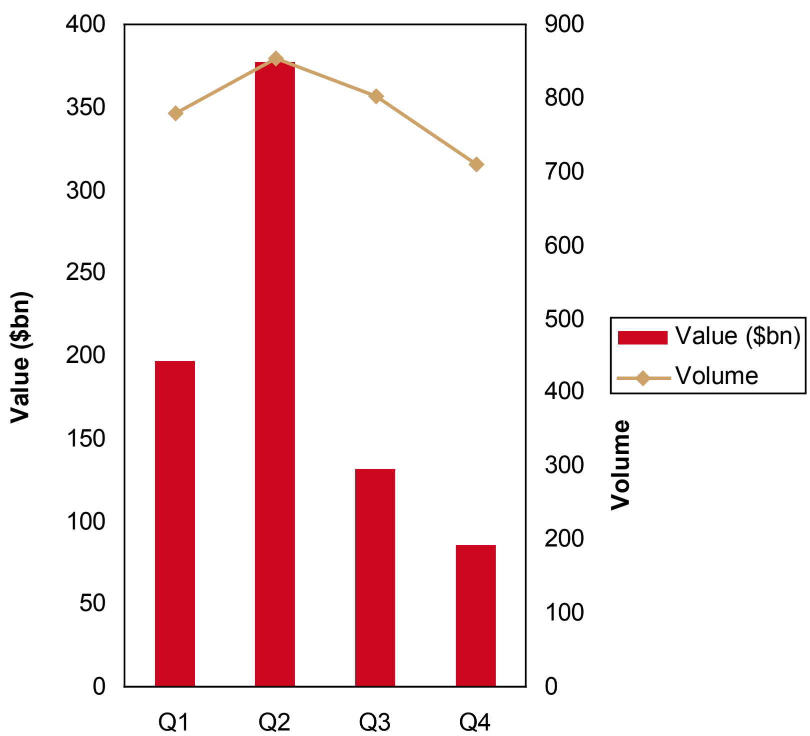
Source: Dealogic

Despite volatility in global financial markets in the second half of 2007, overall M&A was fairly stable throughout the year, particularly in terms of deal volume.

Announced	Value ($bn)	Volume
2007 Q1	1,094.8	8,046
2007 Q2	1,610.0	9,725
2007 Q3	1,006.7	9,595
2007 Q4	1,161.6	9,901

(Announced transactions)

FINANCIAL SPONSOR BUYOUTS 2007



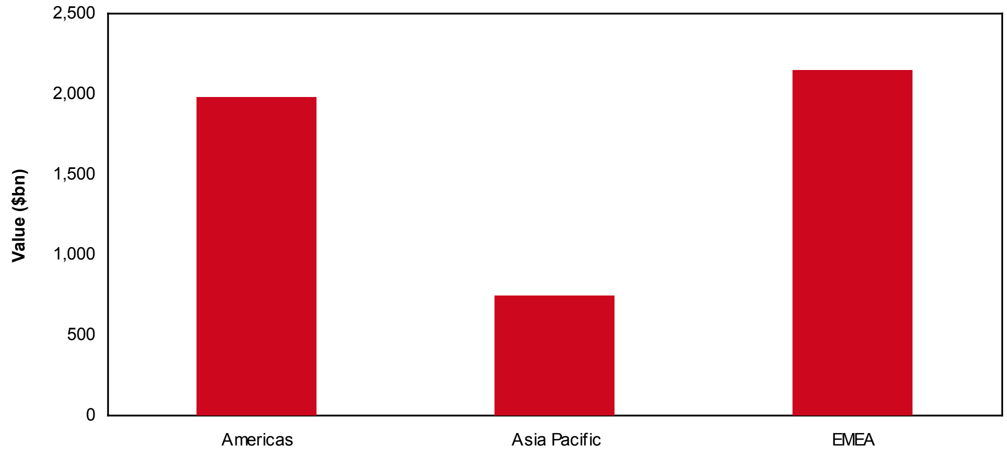
Source: Dealogic

Announced	Value ($bn)	Volume
2007 Q1	197.1	778
2007 Q2	376.6	854
2007 Q3	131.7	803
2007 Q4	86.0	709

(Announced transactions)

The credit crunch sent shockwaves through the global private equity industry in the middle of 2007. As the graph shows, the effect was immediate.

REGIONAL M&A 2007



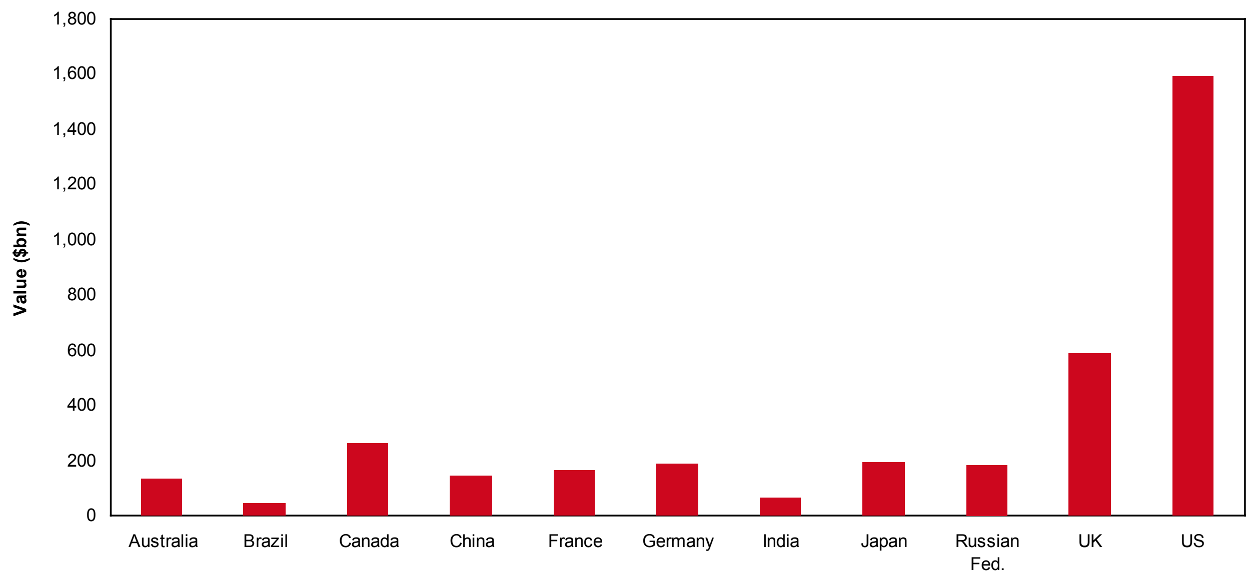
Source: Dealogic

In 2007, EMEA edged out the Americas by deal value. Asia Pacific, although trailing by a fair distance, increased its share of global activity.

Announced	Americas	Asia Pacific	EMEA
2007	1,984.7	743.8	2,144.6

(Announced transactions)

COUNTRY-SPECIFIC M&A 2007

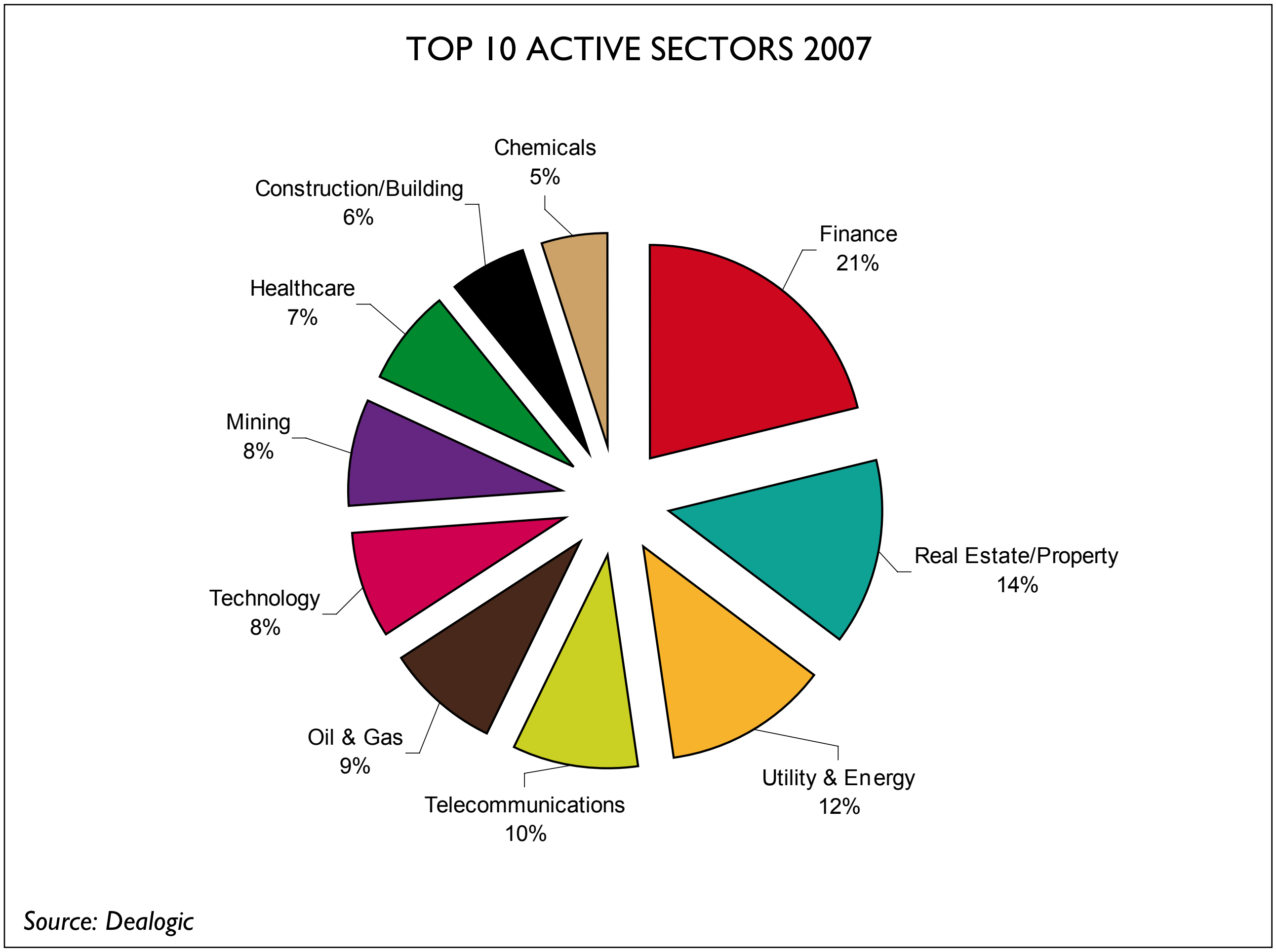


Source: Dealogic

Country	Value ($bn)
Australia	131.7
Brazil	46.0
Canada	259.6
China	144.9
France	164.3
Germany	188.4
India	62.0
Japan	191.0
Russian Fed.	181.6
UK	588.7
US	1,593.2

(Announced transactions)

Unsurprisingly, the US M&A market towered over other countries in 2007. But other standouts were Canada, which claimed third spot by almost $70bn over Japan, and the Russian Federation, which eclipsed France and almost matched Germany. China was not far behind with around $145bn.



In 2007, the majority of deals were announced in the Finance sector. Real Estate/Property and Utility & Energy were also active.

CHAPTER THREE:

Global outlook

Will the next wave of M&A create more value?

BY STEPHANE COHEN-GANOUNA AND NATALIA DANON-BOILEAU

After the M&A activity slowdown of the early 2000s, the market is experiencing a new surge of mergers and acquisitions. It is largely known that in the past, two-thirds of M&A transactions have destroyed value, often resulting in abject failure. In this context, the key question today is: Will the new wave of M&A create more value than the previous one?

Lessons from the past

We have tried to identify the reasons driving value creation and value destruction in M&A deals by analysing 2500 M&A transactions that took place over the past 10 years in Europe. Four lessons jump out of this study and from our experience.

First, there is no statistical correlation between the value creation and the size of the transaction. However, large scale transactions (more than $1bn) tend to destroy value whereas small scale transactions (less than $50m) tend to create value. During 2004-2005 periods, for instance, small scale transactions in our sample have an average positive return after one year of 6 percent, compared to -5 percent for the large scale transactions. Furthermore, the average return weighted by transaction amount is below the average non-weighted return, which means that large scale transactions are obviously tending to destroy more value than small scale ones.

In this respect, it is interesting to mention the existence of some country specificities regarding the average transaction size. Although M&A operations are much more numerous in the UK than in other European countries, France is the place where large scale operations occurred most frequently. Between 2000 and 2005, the average value of transactions was $1.2bn in France compared to $1bn in Germany and $500m in the UK.

Second, an acquirers' previous M&A experience has an influence on value creation. Our study indicates that frequent buyers (involved in one or two acquisitions a year) are more likely to create value. On the other hand, a company which carried out less than one M&A transaction over the past 10 years will risk destroying value.

As a matter of fact, previous experience will allow a company to better evaluate potential synergies with its target. A more realistic approach on future synergies will be translated into appropriate pricing. Previous experience also implies greater capitalisation of knowledge about the integration process (tested integration methods in the pre- and post-acquisition phases) and nurtures a more open, less self-absorbed company culture.

Third, a merger or acquisition can act as a catalyst in uncovering significant savings which were previously concealed. These unforeseen savings could theoretically have been identified regardless of the M&A operation. We have found that only half of the synergies publicised in the past were indeed true synergies, implying that the integration of these companies had actually produced a greater result than simply adding these entities together. The other half consisted of savings that could have been made without the M&A operation.

Finally, value creation depends on how the merger preparation and post-merger integration process is managed. In fact, although the market is positive about value creation after five days in 54 percent of deals, the average rate of value creation decreases to reach only 40 percent one year after the announcement, reflecting, among other issues, integration failure or insufficient realisation of planned synergies.

Best practices and advanced approaches

The key to efficient management of the M&A process is the optimum use of 'traditional' best practices: evaluation of the target's strategic interest and of the potential synergies, retention of key people, preparation of an integration plan, massive use of internal and external communication and, obviously, speed of integration. In fact, it is imperative to keep the ongoing business under control during the integration period, as there may be one, two or even three years between the date of closing and the completion of the merger. While some teams are working on the establishment of the new group, other (different) teams must remain focused on sales and customers: this requires transitory management systems.

Some companies now go beyond those practices, improving their chances to create value. What are these advanced approaches to merger?

Better evaluation of the management and the human capital during the due diligence process. Another point of attention during the due diligence process is an in-depth evaluation of the management team and the human capital of the target. In fact, some groups start copying LBO practices and taking into account – from the due diligence phase – HR assets and cultural differences, as a valuable input to structure the forthcoming merger preparation and integration.

Realistic evaluation of the synergies and their efficient implementation by dedicated line people. In some companies, line people work together with the due diligence team to carry out evaluations of the expected operational synergies, thus producing a better evaluation of the target.

During the integration phase, devoted teams of dedicated line people follow up on the realisation of synergies and ensure their fast and full-scope implementation.

Efficient management of the antitrust notification process. The ongoing consolidation process in many industries leads to an increasing number of large scale cross-border mergers. For these kinds of operations, winning the approval of antitrust regulatory bodies has become a critical issue. The companies' M&A capabilities will also depend on their ability to articulate structured and professional approaches to address antitrust issues; e.g., analyse their need to notify, define their notification strategy, prepare their associated dossier and draw up contingency plans in case the operation fails (such as Schneider/Legrand, GE/Honeywell). Such an approach will help anticipate as much as possible how negotiations with authorities will evolve to better control the approval process and its impact on the operation.

Preserving the value of human capital. The staff's motivation is indeed the most critical component in a merger's success. Maintaining staff's dynamism will ensure continuity in the company's management at a transitional time when the new group can be unstable operationally. Boosting motivation will require appointing the top-management very fast, within a few days, before or after the closing. In this matter, again speed prevails over perfection. Our survey shows that in 60 percent of cases, key managers are actually appointed within 30 days before or after the closing.

Adoption of standardised acquisition and integration processes. Some frequent acquirers have developed an extremely formalised process, a sort of 'acquisition and integration machine'. Based on their previous acquisition experience, these companies have defined and adopted a standardised M&A process helping to address all operation' phases in a coherent and coordinated way. Also, they define tools, methods, checklists and a team to mobilise in case of a forthcoming M&A transaction.

The advanced practices mentioned above are only emerging. Even if the value creation remains highly unpredictable, the generalisation of those new practices should lead to better value creation and better value capturing in future mergers and acquisitions.

Stephane Cohen-Ganouna is a principal and Natalia Danon-Boileau is a senior manager at BearingPoint.

International M&A takes centre stage

BY ERIC BENEDICT, SHEPARD SPINK AND GEORGE VARUGHESE

With the increasing globalisation of business coupled with the protracted weakness of the US dollar, M&A activity is now playing out on a much larger stage, creating new opportunities for international investors and growth-oriented companies in emerging market countries looking to penetrate Western markets. Unlike earlier periods, such as the 1980s, which saw a spike in international transactions, evidence suggests that recent activity is indicative of a more permanent global trend, with M&A targets of the past becoming the acquirers of today and tomorrow.

However, while market forces such as increasing access to global capital and favourable currency valuations are providing transactional tailwinds, inherent challenges remain. For new global business ventures to be successful over the long term, acquiring companies will need to find ways to not only leverage strengths, such as low cost manufacturing, but overcome relative inexperience managing complex global enterprises.

Driving forces

The buyers

While worldwide M&A volume has plunged from the historic highs reached in recent years, deals continue to get done. Even as the US continues to see major declines, overall activity is down just over 6 percent compared to 2005's January-February total, with international activity, particularly in Asian markets, showing more stability, according to Dealogic. Buyers and sellers are still demonstrating an appetite for deals, with foreign buyers, buoyed by financial strengths, becoming more active participants in what they perceive to be a fertile environment for acquiring US assets.

Currency valuation is one driving factor. For the last several years, foreign currencies have been stronger against the US dollar. Leading the pack is the euro, which hit a record high against the dollar in late February, exceeding for the first time $1.50. Many economists predict further weakness ahead for the dollar, as a number of US economic factors, including declining home prices and waning consumer confidence, continue to pressure the greenback. With US assets now roughly 20-30 percent cheaper than they were a decade ago, foreign buyers see an opportunity to bargain hunt. This is especially true of those in oil-rich nations which are flush with liquidity.

For companies in countries not enjoying 'petro capital', another important factor has been the increasing willingness of local banks to provide funding for deals. With the balance sheets of many US and international banks suffering as a result of the subprime mortgage crisis, local banks in emerging markets, which had far less exposure than their US counterparts, are stepping up to provide debt financing for deals. The trend is likely to continue. At the same time, local governments, which in the past often tended to frown on international expansion, are showing greater support for companies looking to acquire foreign assets.

The maturation of foreign companies, both in terms of size, sophistication and experience, has also been a catalyst in driving recent M&A activity. Historically, foreign companies with the necessary market presence and management depth to be serious international acquirers have been few and far between. This has changed dramatically in recent years, particularly in the wake of significant growth in the Asian market. A new universe of capable, cash-rich and strategic-minded buyers, who have successfully developed a critical mass in their domestic markets, have emerged and begun to make their presence known.

Netherlands-based ArcelorMittal, the world's largest steelmaker by output, provides a case in point. In 2006, CEO Lakshmi Mittal – an Indian steel mogul who ranks among Forbes' 10 richest CEOs in the world – further expanded the steel empire he established over several years with the acquisition of European steel giant Arcelor. Since then, ArcelorMittal has continued on an aggressive acquisition spree, announcing 35 acquisitions around the world in 2007 and indicating the pace would continue this year.

The sellers

From a sellers' perspective, international deals have emerged as an important option for US companies navigating a challenging economic environment. With the US credit markets virtually shut off and the overall domestic economy continuing to show signs of weakness, pure US transactions have become much more difficult to execute – as evidenced by recent data. Beyond financing, however, combining with companies outside of the US has become a viable strategic option for many growth-oriented businesses. US companies, which have developed a strong domestic market presence, are seeking to attract foreign buyers with an eye toward leveraging cost advantages in foreign markets, such as raw material access or labour rates. And again, because the pool of foreign buyers has expanded beyond Europe and Japan to now include emerging markets such as Brazil, Russia, China and India, among others, M&A opportunities have increased exponentially.

Looking ahead

Even when the dollar rallies, the US capital markets relax and the economy strengthens, we are likely to continue to see significant interest in US assets among foreign buyers. In the past, companies with the strength and the staying power to engage in significant acquisitions have primarily been based in the US and Europe. Now, companies in markets outside the US – and in nearly every industry – have reached a critical mass and the number of active buyers is likely to continue to increase. In addition, as the geographic boundaries of global capital fade as investors pursue areas of highest return and workforces become more international, national corporate identity will become less and less relevant.

Within this environment, however, significant challenges remain and how international buyers deal with these hurdles will be a key factor in determining the ultimate success of these transactions. At a time when more foreign governments are showing greater support for international M&A, the US could begin to take a more isolationist stance – particularly if the economy weakens further or national security concerns heighten. Already we have seen a number of potential deals scuttled or postponed. National security concerns among lawmakers, for example, postponed 3Com Corp.'s transaction with Chinese technology company Huawei Technologies Co.

A greater test will be how this new group of corporate acquirers overcomes relative inexperience entering new markets and running global enterprises. Simply leveraging strengths such as low-cost manufacturing bases will not be enough to achieve success and staying power. Management will need to be equipped to deal with a range of regulatory issues and prepared to quickly develop global capacity in critical operations, such as information technology systems, supply chain and distribution, as well as enhance their capabilities in areas such as brand management and sales and marketing.

Steering through the US obstacle course – which in many cases requires extensive experience, knowledge and relationships in the marketplace, community and government – will be a challenge for even the most skilled executives if they are mainly accustomed to operating overseas. Utilising valuable resources within the acquired company or bringing in new executives with deep knowledge of the US, forming alliances with US partners, and retaining individuals with the expertise to navigate the range of management and regulatory issues – will all be important factors in executing a long-term business strategy.

Conclusion

International M&A activity has been a relative bright spot in an otherwise doom and gloom deal environment. Rather than a short term phenomenon, the activity – and the driving forces behind it – suggests a more permanent trend of large and middle market US and European companies being acquired by sovereign funds or companies with global ambitions that are located in strong emerging markets.

But as foreign buyers take advantage of market conditions and leverage their strengths and acquire US assets, they must be mindful of the challenges inherent to entering any new market and take steps to position the business for the long term. Many have already discovered that creating meaningful value through M&A transactions, particularly when premiums have been paid, comes down to properly executing the strategy and actually realising the anticipated synergies.

Eric Benedict, Shepard Spink and George Varughese are managing directors at Alvarez & Marsal.

Recent developments and their implications for M&A in 2008

BY TOM HOPKINS AND JASON NORTHCUTT

It was the best of times; it was the worst of times. So might Charles Dickens have described the acquisition financing markets in 2007. Fuelled by private equity sponsored buyouts using readily available credit, the number and value of M&A deals in the US reached record levels in 2006 and the first half of 2007. Private equity sponsors doing mega deals, including The Carlyle Group, Kohlberg, Kravis & Roberts and The Blackstone Group, received unprecedented media attention. Several recent developments, however, make it likely that strategic buyers will return to prominence in 2008 and beyond. Also, partially as a result of the impact of less activity by private equity sponsors, sellers are likely to have less leverage at the bargaining table.

During the recent M&A boom, extensive liquidity in the credit markets created intense competition among lenders. Borrowers found themselves able to obtain acquisition financing cheaply – at more aggressive leverage multiples, at lower spreads, and with fewer and less restrictive covenants than ever before. As a result, private equity sponsors often were able to pay higher valuations and offer more cash than their strategic counterparts. The ability of private equity sponsors to outbid strategic buyers is likely to lessen as a result of several recent events.

First, the much-publicised credit crunch that began in mid-2007 will make it more difficult for private equity sponsors to obtain competitive financing to outbid strategic buyers. The steep increase in defaults in the US subprime market led several lending institutions to fail or file for bankruptcy and has had broad effects throughout global credit markets. In response, lenders have become more cautious by increasing credit spreads, decreasing leverage ratios, and insisting upon more restrictive covenants from their borrowers. Despite Federal Reserve attempts to increase liquidity by cutting the fed funds rate by 225 basis points between September 2007 and January 2008, we expect lenders' risk tolerance to remain relatively low. Private equity buyers will have to readjust their expectations with regard to financing terms and lower their valuations of targets. Strategic buyers, by contrast, often are cash rich or able to rely on existing lines of credit to fund acquisitions.

Second, differences in the ways in which private equity buyers and strategic buyers tend to view and analyse companies may also lead to greater competitiveness by strategics. Private equity sponsors have finite holding periods and only want companies that can deliver an internal rate of return in excess of 25 percent over the investment horizon. Private equity sponsors are further limited by credit pricing and financial models that forecast their anticipated returns and determine their willingness to proceed with a transaction. Strategic buyers, by contrast, often have a longer horizon and intend to integrate them into their existing business lines.

Additionally, strategics often include non-financial factors in their transaction analysis, such as synergies, defensive advantages and other competitive factors.

Non-financial aspects of an acquisition agreement such as time to close, allocation of risks and lack of closing contingencies can also play a significant role in determining the winning bid for a company. Because strategic buyers often have a strong grasp of the fundamentals of the target's industry (and possibly of the target itself), they are often better positioned to assess the scope and magnitude of potential risks posed by the target's business. Private equity firms, however, often have to educate themselves about the target's industry and specific business, which is a time consuming process. Further, since a private equity firm is compensated only if its returns are in excess of a hurdle rate, sponsors often take a more hard-line view of the target's potential risks, which results in transaction agreements that allocate greater economic risks to the sellers.

Most private equity firms do not have the human capital required to operate their portfolio companies day-to-day. Private equity buyers often require management stockholders to 'roll over' a significant portion of their equity rather than cashing out 100 percent of their holdings. They will also likely insist that most or all of the key management sign long-term employment contracts as a condition to closing. Even though the selling stockholders will continue to hold a stake in the target going forward, the private equity firm will control the company and the sellers will find themselves as minority stockholders. For a selling stockholder that is looking to 'cash out' and move on to the next venture or retire, these requirements can be unattractive. Strategic buyers, however, have operational executives and systems in place to run the business and are less sensitive to keeping management in place.

Third, amendments to Rule 144 and Rule 145 by the US Securities and Exchange Commission (SEC) that became effective on 15 February 2008 will also likely benefit strategic buyers. Strategic buyers often issue their securities to sellers as part of the merger consideration. Sellers, understandably, prefer liquidity and want the ability to resell these securities as soon as possible. The changes to these rules reduce or remove restrictions on secondary sales, which should allow strategic buyers to use their stock as transaction currency to increase the valuations of the targets. Below are summaries of some of the primary changes to Rule 144 and 145 which are most likely to benefit strategic buyers.

Rule 144 provides a safe harbour for resales of restricted and control securities. Restricted securities include securities issued in a transaction not involving a public offering, such as where a strategic buyer issues unregistered shares to the stockholders of a target in a private placement. Control securities are securities of an issuer held by an affiliate of the issuer. To qualify for a Rule 144 resale of restricted securities, several conditions must be satisfied. These conditions limit the ability of holders of restricted securities to resell the securities, and therefore reduce their value to the holders. The Rule 144 amendments most significantly affect secondary sales of restricted securities by non-affiliates and make it easier and faster for sellers to get liquidity for their company. As amended, Rule 144 (i) shortens the holding period for restricted securities of reporting companies to six months from one year; (ii) allows *non-affiliates of reporting companies* to freely resell restricted securities after the six month holding period if the issuer satisfies the public information condition; and (iii) allows *non-affiliates of reporting or non-reporting companies* to freely resell restricted securities without complying with any Rule 144 conditions after a one year holding period, rather than two years. Affiliates of reporting companies will still need to comply with the Rule 144 limitations and requirements when selling equity securities of the issuer under Rule 144. The holding period for affiliates of non-reporting companies remains one year, and will still need to comply with the Rule 144 limitations and requirements when selling equity securities of the issuer under Rule 144.

Simultaneously with the amendment to Rule 144, the SEC also substantially eliminated the 'presumptive underwriter doctrine' in Rule 145. Under prior law, an affiliate of a target who received securities in a registered transaction was deemed to be an underwriter. Even though the securities were not restricted securities (because they were sold in a registered transaction), to negate this underwriter status, the resale had to comply with Rule 145 (which mirrored the Rule 144 requirements, without the holding period and Form 144 requirements). Now, except in limited circumstances, affiliates of a target who receive shares registered on Form 4 will be able to freely resell them immediately, unless the holder is also an affiliate of the issuer (in which case the rules governing control securities will continue to apply).

In addition to strategic buyers regaining competitiveness over private equity sponsors, the ongoing credit crunch is likely to reduce the overall number of bidders; therefore, we expect sellers to have less leverage generally against buyers in the negotiation process. We expect fewer auctions, resulting in lower valuations. Where auctions are commenced, we expect an increase in preemptive bids with 'go-shops' – a limited ability of the target to search the market post-signing for other potential buyers. As a result, target boards of directors will have to be increasingly mindful of their fiduciary duties relating to business combinations. Agreement terms will likely become more buyer-friendly, such as more conditions to closing for buyers and lower indemnity baskets and higher indemnity caps and escrows.

In conclusion, we think the continuing credit crunch and the associated deal execution risks involved in selling to private equity sponsors will result in increased competitiveness by strategic buyers. Also, the recent relaxing of rules regarding secondary sales should increase the value to sellers of receiving a buyer's securities, especially if the buyer is a reporting company. Less activity from private equity sponsors is likely to lower the valuations and otherwise lead to more buyer-friendly terms in deal agreements.

Tom Hopkins is a partner and Jason Northcutt is an associate at Sheppard, Mullin, Richter & Hampton LLP.

Emerging markets and M&A activity

BY IAN COLEMAN

There are numerous trends currently affecting the cross-border M&A market. Investors from emerging economies are increasingly interested in developed economies. Activity by private equity funds is growing in emerging economies. National investment strategies are growing. New hot sectors are emerging, particularly financial services and infrastructure. Valuations are rising as a result of emerging market investments.

Acquirers looking to complete M&A transactions in emerging markets face many challenges. Fiscal and legal regimes are often unpredictable. There is a need to identify key tax issues. Buyers must choose the appropriate method of market entry. Cultural differences can be a major hindrance. Finance facilities are limited. There are differing approaches to business valuations and accounting policies. Political risks must be assessed.

Key trends

International investment flows are changing. Whereas in the past the direction of flow was almost universally from the developed to the developing markets, this is no longer the case. Last year, for example, saw the Anglo-Dutch steelmaker Corus acquired for £6.2bn by Tata Steel of India, which outbid a Brazilian rival.

While this changing environment creates opportunities for businesses in developed markets seeking new investment finance, there are associated threats. Companies seeking to complete M&A deals in their home markets face fresh competition from investors in the developing world. As competition grows, so do the prices that must be paid.

Notable among the new investors from the developing markets are sovereign wealth funds, which are likely to have a considerable impact on future investment flows. In 2007, the value of such funds grew by around $1.3 trillion, while new issues of government gilts worldwide totalled just $600bn. Seeking a home for their surplus cash, sovereign wealth funds have begun turning to new, higher risk investments – including listed companies and private equity. This trend seems set to continue. For example, as long as energy prices remain high, sovereign wealth funds from oil-producing states will continue to grow in size. If sovereign wealth fund investments quadruple over the next 10 years, as has been suggested, their influence on cross-border M&A will increase further.

While investors from emerging markets are creating competition for deals in more developed economies, western private equity funds are similarly increasing competition in developing markets. PE funds already account for a large proportion of corporate acquisitions in established markets, and this phenomenon looks likely to be repeated elsewhere as PE houses seek new high growth opportunities.

The impact of PE funds in emerging markets is, of course, affected by the availability of debt finance. Hence the recent credit crunch has had an inhibiting effect, one which is encouraging some PE funds to look to sovereign wealth funds as alternative sources of finance to bank debt. However, if this crunch proves to be merely a cyclical event, over time increasing PE involvement in cross-border M&A will fuel existing inflationary price pressures.

National investment strategies are also likely to shape future M&A trends. For example, the Chinese government announced at the seventeenth Communist Party Congress a new national strategy to make higher value investments. Initially, China's outbound investment was largely focused on securing the country's supply chain – delivering the raw materials, natural resources and energy needed to fuel growth. Now the Chinese are keen to explore opportunities in more knowledge-intensive industries. Such national investment strategies add additional competitive heat to the M&A arena, with acquisition decisions no longer being driven solely by traditional financial metrics.

As a corollary, some countries are showing signs of a growing mood for protectionism – so-called 'resource nationalism' – to prevent domestic businesses and treasured national assets from entering foreign ownership. If such tendencies develop into confirmed national policies, cross-border M&A activity could stagnate or fall.

For the moment, however, deal volumes remain high. Some sectors, such as financial services and infrastructure, are enjoying particularly strong interest among investors from developed markets. Private bankers and insurance companies are increasingly investigating the service opportunities open to them in developing economies. Desire to upgrade infrastructure in emerging markets is also stimulating interest both in corporate investments and in the ownership of assets such as roads and bridges. 3i, for example, has launched an infrastructure fund on the London stock market.

There is, however, a potential inhibitor of M&A in developing markets going forward, and one which could affect all sectors – the increased valuations attached to companies and assets in those markets. In China, for example, high personal savings ratios, the relatively limited equity market and strong interest from overseas investors have pushed up equity prices. Western companies could find it increasingly difficult to find growth opportunities at valuations that are acceptable to their shareholders.

Key challenges

Businesses seeking to complete M&A transactions in emerging markets face numerous challenges. To begin with, emerging markets are inherently fast moving, and this can be true of their fiscal regimes. Until last year, for example, China encouraged foreign investors by offering more favourable tax arrangements than were available to domestic companies. This is generally no longer the case. Investors thus need to consider the potential for tax regimes to be altered, and not necessarily in a favourable way.

They also need to identify the tax policies that have the greatest impact on the relative success of an investment. Investors often focus primarily on the tax incentives available when making an investment, such as the availability of tax relief on debt interest costs. However, the long term investment success of a transaction may be more greatly affected by the investor's ability to realise value from the investment in a tax efficient manner in the future. Given that some tax regimes penalise or inhibit capital or profit withdrawal more than others, this is an important issue for upfront consideration.

If assumptions cannot be made about the continuity of the fiscal regime, the same goes for legal systems. The presumption of contractual certainty is the bedrock of business in the developed world, but can break down in some emerging markets where political motivations sometimes appear to override the rule of commercial law. The longer term in nature an investment is, the more reliant it is on specific legal structures and institutional stability. The need to accommodate legal flexibility, as well as fiscal flexibility, in M&A deals is therefore an important issue for investors.

Another challenge is the most appropriate method of market entry – whether through forming a joint venture with a local party or going for sole control. Established practice has generally been to form a joint venture with a local partner. The inward investor benefits from the local partner's cultural understanding and contacts, but may subsequently seek to buy out the partner if the venture proves successful. That model now appears to be losing favour, perhaps due to its associated problems. It can, for example, be hard to agree on shared objectives for the venture. If the venture is successful, the inward investor can have difficulty extracting full value – many agreements give the local partner pre-emption rights in the event of a sale. As a result, there are early signs of a trend – both in developing and developed economies – towards sole control investments and organic growth models, where local regulations allow.

Whatever the market entry model, cultural differences between domestic and developing economies need to be understood. The moral and ethical frameworks that exist in a number of emerging market countries are not the same as those in developed economies. In certain territories a monetary reward for 'assistance' might be expected, whereas elsewhere this might be deemed a bribe. These are serious legal issues, with potentially far-reaching implications. For example, directors can fall foul of the US Foreign Corrupt Practices Act as a result of actions that take place miles away from the US. Our survey of global chief executives found that cultural issues are considered the biggest impediment to cross-border M&A, particularly during the post-deal integration period. It is essential that cultural norms and expected business practices are made explicit prior to any transaction being completed. This extends to an understanding of the governance, control and reporting structures that will be established – the structural manifestations of corporate culture.

The options for financing and for successfully hedging M&A investments in developing economies can also be constraining. Although bilateral or syndicated bank finance may be available, corporate bond markets are generally less developed than in more advanced economies which may inhibit emerging market acquirers. This will change gradually – in India efforts are being made to create a financial centre in Mumbai, but this will take time.

Differing approaches to valuation methodologies can also arise. In some markets the standard basis for agreeing a price is depreciated cost, rather than discounted cash flow. Even where the latter is accepted, estimating risk and establishing the appropriate discount rate may not be straightforward. Variations in accounting policies can also create difficulties in interpreting reported figures. These and other technical issues all need to be overcome.

One other possible challenge for investee companies looking at opportunities in developing markets concerns their ability to assess political risk appropriately. High turnover rates among senior executives in developed economies are arguably resulting in rapid corporate memory loss. Awareness of problems that have previously arisen due to politically unstable regimes is being lost from the corporate consciousness. Companies may, therefore, be underestimating the political risks associated with emerging market transactions. This is a particular problem for cross-border investments involving major physical assets, which are relatively difficult to withdraw from without significant losses being incurred.

Even so, across all sectors, M&A activity with developing economies remains a high priority for companies from more established markets. Despite the many challenges involved, the need to find growth opportunities will continue to stimulate transactions.

Ian Coleman is head of emerging markets at PricewaterhouseCoopers LLP.

Developments in merger control in the EU and worldwide

BY DAVID HARRISON AND RACHEL CUFF

Review of a potential transaction by one or more competition authorities can seriously affect the structure and timing of a deal, whether it be an acquisition, merger or joint venture. Many jurisdictions prohibit implementation of a deal before merger clearance is obtained, and time-periods for review of the transaction can be considerable. The impact of merger control worldwide is increasing as more jurisdictions introduce new, or revise existing, regimes. Such legislation is frequently produced in order to facilitate self-assessment of a transaction by the parties, and thereby to avoid prohibition by competition authorities of notified deals. However, the fact that outright prohibition of transactions remains relatively rare in many jurisdictions should not deflect attention from the emphasis that competition authorities such as the European Commission place on ensuring that their merger rules are respected, and their willingness to use their enforcement powers against merging parties (and even other countries) that attempt to circumvent those rules.

Development of merger legislation worldwide

In recent months, two industrial superpowers, India and China, have passed new merger legislation, bringing their regimes further into harmony with more mature systems such as those of the European Union and the United States. China adopted its first competition law in August 2007, introducing a merger control regime. The law has been a decade in the making, and will come into force in August 2008. Certain important elements, such as thresholds for merger control to apply, still remain to be finalised, but pre-merger notification will be required. Of particular concern is the requirement that acquisitions of Chinese companies by foreign companies go through national security checks, although details of this obligation are not yet clear. In addition, observers are keen to see how the new law will be applied to Chinese state-owned companies, and how the overarching requirement for behaviour to be appropriate for a socialist economy will be interpreted.

India's new regime introduces mandatory merger notification where specified assets or turnover thresholds are met. However, the law incorporates a 'domestic nexus' element, with notification to the Competition Commission of India (CCI) only required where both parties have assets or turnover in India. Under the new Indian law, the 'suspensory period' following notification of the merger, during which the transaction cannot be implemented, is theoretically 210 days. The relevant period under the previous regime was 90 days, and this change has caused significant concern. However, the implementing regulation for the new regime (currently only in draft form) introduces an interim period of 30 days for the Indian authorities to take an initial view, upon the expiration of which approval of the transaction can be presumed. As the CCI is not yet fully constituted, the regime is not currently being enforced.

Jurisdictions with well-established systems of pre-merger clearance have also been developing and clarifying their rules. Such reforms are often driven by an aim of facilitating self-assessment by companies and their legal advise`rs, in order to minimise the amount of pressure put on the limited resources of competition authorities.

The European Commission has been continuing to review and develop its merger legislation. In April 2007, the Commission published a draft Notice on remedies acceptable under the EC Merger Regulation, with the aim of updating its current 2001 guidelines. The guidance relates to modifications that may be proposed by parties to a transaction in order to 'remedy' competition concerns identified by the Commission in its merger control review. The draft Notice has been subject to a public consultation, and is expected to be adopted in the first half of 2008.

In 2007, the Commission also adopted guidelines on non-horizontal mergers, to complement its guidelines on horizontal mergers, which were introduced in 2004. The non-horizontal guidelines relate to both vertical mergers (between parties operating at different levels of the supply chain) and conglomerate mergers (between parties active in closely related markets). The Commission also combined four important pre-existing notices (relating to the calculation of turnover, as well as to the concepts of 'concentration', 'full-function joint ventures' and 'undertaking concerned') into a Consolidated Jurisdiction Notice.

The Office of Fair Trading (OFT) in the UK issued revised guidance in November 2007 regarding situations in which it will view the markets affected by a merger as not of 'sufficient importance' to justify a referral to the UK's Competition Commission. The *de minimis* market size threshold was raised from £400,000 to £10m. The OFT has applied the revised thresholds in a number of cases since their introduction, but has also clarified that, as a matter of policy, it will not apply the *de minimis* thresholds in cases where any harm to competition could, in principle, clearly be remedied by clear-cut undertakings in lieu of a referral to the Competition Commission.

Yet other countries are in the process of reviewing and amending their merger rules. The Federal Supreme Court of Germany has confirmed the geographic extent of Germany's *de minimis* provision, confirming that the relevant geographic market for this provision refers to the German market, and not to a wider geographic market. Clarification of the *de minimis* exception in both the UK and Germany should better enable companies operating within relatively small markets to avoid becoming subject to the merger control regimes of these countries.

Norway has made proposals aimed at improving the efficiency of its merger review system, and is considering prohibiting implementation before clearance of any transaction that has to be notified. Currently pre-clearance implementation is only prohibited when a complete notification has been requested by the Norwegian competition authority or made voluntarily.

The Czech competition authority is in the process of creating best practice guidelines on pre-notification contacts between merging parties and the competition authority, and Australia is, at the time of writing, consulting on draft revised merger guidelines. As merger notification is currently voluntary under the Australian system, such guidelines are of particular importance in enabling companies and their legal advisers to ascertain whether voluntary clearance should be requested.

Merger control activity by competition authorities

While competition authorities work to improve their merger control legislation, they continue to review notified mergers and sanction companies that do not adhere to the rules.

The European Commission received a record number of merger notifications in 2007, with the figure exceeding 400 for the first time. With over 60 notifications received in the first two months of 2008, the level of notifications appears to be remaining reasonably constant.

The Commission's approach in relation to merger control continues to be relatively non-interventionist. Of some 3700 notifications received since 1990, the Commission has prohibited only 20 proposed mergers, and only two since 2002, although a significant number have been cleared conditionally, after a first phase or a second phase investigation, on the basis of commitments by the notifying parties. However, 2007 saw the Commission's first prohibition decision since 2004 and the first of Competition Commissioner Kroes's tenure, in relation to the proposed Ryanair/Aer Lingus deal. The Commission concluded that the merger of the two leading airlines operating from Ireland would reduce choice for consumers and 'most likely [lead] to higher prices for more than 14 million EU passengers' using the 35 routes on which the merger would create a monopoly or dominant position. Ryanair, whose chief executive accused the Commission's decision of being "bizarre, illogical, manifestly inaccurate and untenable", has appealed the decision to the European Court of First Instance (CFI).

The level of caution with which the Commission approaches a decision to prohibit a merger will only have been increased by the decision of the CFI in July 2007 to award partial damages to Schneider Electric for loss stemming from the Commission's 2001 prohibition of its merger with Legrand. The CFI annulled the Commission's prohibition decision in 2002, considering that the Commission's analysis was riddled with "errors and omissions". The Commission has appealed the CFI's judgement awarding damages.

The Commission has, however, made it clear that it expects its rules relating to merger control to be respected, and in particular those relating to pre-clearance implementation of a deal, or 'gun-jumping'. In December 2007, the Commission conducted surprise inspections at the premises of merging parties, INEOS and Norsk Hydro, looking for evidence that the companies had exchanged commercially sensitive information to such an extent that they could be considered to have already implemented the deal. This is the first time that the Commission has conducted raids in response to concerns about gun-jumping and, although it has now closed its investigation and approved the merger, the inspection serves as a reminder that the Commission has significant investigative powers in this area, as well as the ability to impose considerable financial penalties. Failure to comply with an authorised Commission inspection in the context of a merger investigation could lead to fines of up to 1 percent of a company's turnover, while fines of up to 10 percent of turnover could result from implementation of a merger before approval is granted by the Commission.

Nor can the presumption be made that the merger regimes of smaller countries will not raise concerns and can therefore be disregarded. Jersey's Competition Regulatory Authority, for example, has imposed its first fine on a company for failure to notify a merger until after the acquisition had been completed. The fine of £10,000 was imposed on the Italian travel restaurant company Autogrill regarding its acquisition of Alpha Airport Groups, clearly demonstrating that some smaller competition authorities will not hesitate to apply their powers to large international companies operating within their jurisdiction.

The Commission has also shown its teeth in its response to displays of economic patriotism by countries such as Spain and Poland regarding mergers with a 'Community dimension' and falling within the Commission's sole competency under the EC Merger Regulation. For example, further to the Commission's approval of the acquisition of the Spanish energy company Endesa by German-based E.ON, the Spanish National Energy Commission imposed conditions on the acquisition. Further to a number of formal requests and decisions, the Commission referred Spain to the European Court of Justice, which ruled in March 2008 that Spain had failed to fulfil its obligations under the EC Treaty.

The cost of flouting merger control rules can be high, leading to significant fines or even a requirement to undo a completed transaction. With more countries developing sophisticated merger regimes, companies need to ensure that, when assessing the benefits of a potential transaction, they are aware of the merger control obligations and risks in the jurisdictions relevant to the deal.

David Harrison is a partner and Rachel Cuff is an associate at Berwin Leighton Paisner LLP.

CHAPTER FOUR:

Private equity markets

The case for value creation focused LBOs

BY OLIVIER SIBENALER AND MATHIEU BAUDOUIN

As it sparked off spiralling debt cost, the subprime crisis has undoubtedly shaken the private equity industry, more particularly acting as a brake on buyout funds' activity. Large operations involving players of the likes of KKR were indeed abruptly cancelled. Those collateral effects, influential as they may be, should not hide that since the mid-90s the industry has gone through a more fundamental, less visible reshaping process. Although many reasons may be invoked to support the assertion, four key factors actually prevail. They have brought about a restructuring environment in which funds are confronted with new challenges. The latter, combined with a soaring secondary LBO market, induce stronger demands in terms of value creation for private equity backed companies. What is at stake today is the funds' ability to develop competitive advantages that produce high IRRs based upon genuine industrial and commercial strategies.

The buyout industry is under growing pressure, both from the inside and the outside. The prevailing endogenous factor is today's intensifying internal competition, fuelled by the commoditisation of LBO techniques. Exogenous factors include limited partners' (LPs) increasing expertise, the extension of market intermediation and newly healthy corporations with an appetite for M&A.

Approximately 25 years after its early beginnings, the buyout industry has proved attractive for newcomers, as its mechanisms – once mastered by a happy few financial engineers – became available to the rank-and-file. All it took to get involved in LBOs was money. With low debt costs and abundant liquidities, the 2000s brought providential circumstances: global private equity fundraising grew threefold between 2002 and 2006, with the top 10 funds raising between $8bn and $16bn. The value of LBO transactions also boomed from $80bn in 1999 to $440bn in 2006. Unsurprisingly, those alluring market conditions called for an increase in the number of players, with approximately 2700 private equity funds in 2006, 850 of them being devoted to buyouts. As one of its consequence the commoditisation of the LBO market came along with the gradual vanishing of 'cheap good deals'.

External factors have added to those internal tensions. Intensifying competition was also propelled by corporations that are back in an M&A market that reached an estimated $3.8 trillion in 2006. LPs' increasing degree of expertise and selectivity has fostered internal competition. From the mid-90s investment banks have also helped to reshape the industry, as middlemen between buyers and vendors, as well as advisers. Generalised banking pitches caused every player to be in possession of the same average amount of information, paving the way for greater market efficiency. The banks' role is also evidenced in the auction process, leading to mounting pressure on bids. Those factors have brought more efficiency to the markets – far from the early days of LBOs when deals depended on personal contacts.

But those changes have raised new challenges for PE firms. As funds strive to entice better informed LPs they have no choice but to promise high IRRs. But those are already high, at least on average. As *The Economist* stressed, "from 1980 to 2000 the average fund generated higher gross returns than investing in the S&P 500". The average IRR in Europe was estimated to be 13.7 percent at 2006 closing.

Besides – and thanks largely to the mounting efficiency of investment banks – competition on the markets for targets has caused both multiples and debt ratios to go up. Purchase multiples in 2007 were about 7.15x EBITDA (for a $1.85bn deal), compared to 5.75x in 2004. Debt multiples followed a roughly similar pattern, from 5.2x EBITDA in 2005 to 6.1x two years later. As for debt ratios, they reached 77 percent in 2007, of which 80 percent was classed as *in fine*.

Those challenges confront buyout funds with a major issue, one that may shape their future: what new sources can be identified for funds to build competitive advantages and come up with IRRs that meet LPs' expectations, in an environment where operations are put at risk by greater multiples and fast-growing debt leverage?

Not unlike Orwell's *Animal Farm* the PE industry is unequally rewarding. Profitability is closely related to size; average returns at large funds were twice as high as those at small funds, while medium entities fell in between. In addition, standard deviation among funds' profitability is significant. Economic performance of bought-out companies appears dramatically unequal. A recent report by Standard & Poor's found that 53 percent of the companies in the sample used failed to meet their EBITDA forecasts. Here too, EBITDA underperformance or overperformance has a high standard deviation (22 percent according to S&P). As a result, those funds that are determined to survive and secure access to cash on a long term basis cannot merely rely on 'traditional' levers – including financial engineering and tax integration – that are proving insufficient in a context of intense competition and commoditisation. They are now compelled to increase their companies' EBITDAs; in other words, create value through either side of the P&L statement.

But what about companies that have already been bought out once? Market intermediation and commoditisation are indeed translating into multiplying secondary LBOs. About 20 percent of LBO-controlled entities were sold to other PE firms in 2007, against less than 4 percent in 2001. More secondary LBOs means the development on the market of companies that have – theoretically – gone through a process of basic cost reduction, including purchases and WCR management. In their case value creation needs a wider array of deeper, more implicating, measures.

Building a competitive advantage will require scrutinising the market potential of purchased companies and thinking in terms of strategic positioning. This is a clear necessity for secondary LBOs, since cost levers were used in the course of the first LBO. Competitive advantages in the future are likely to rest increasingly on the ability to carry out successful growth strategies. Two different investment rationales –

build-up and rollout – can be chosen, each of which follows specific aims and introduces specific levers. First, funds need to define their aims, whether they intend to implement operational synergies or plan to boost sales efficiency. It is those very strategies that can provide the funds with an ability to loosen the grip, make up for the pressure produced by higher purchasing multiples, and implement momentum of value creation.

To phase in such strategies and make sure they are profitable, it is necessary to target companies that closely fit one's needs. That goal contradicts the particular conditions that characterise an intermediated market and lead to one-size-fits-all rather than custom-tailored operations. To match the expectations, the fund has to strike a deal with a target that until it was approached had never planned to be bought – not to mention the eventuality of a buyout. Convincing shareholders and completing such transactions requires specific skills and *savoir-faire* which are increasingly available from external advisers.

The challenges facing buyout funds demand renewed reflection on the essence of corporate value creation. Those on the right track will hold an advantage over the rest of the pack. In terms of economic value creation through build up and rollout strategies, poorly performing small funds clearly start the race at a disadvantage. But the dice are not yet cast. In those conditions, it is still unclear whether the market will go through concentration and further evolve toward a model split between niche-focused small funds (in terms of areas and industry) and large generalists.

Olivier Sibenaler is a principal and Mathieu Baudouin is a consultant at BearingPoint.

Is there a credit crunch in the mid-market?

BY MOUNIR GUEN

As many major financial institutions suffer from bone-crunching losses, their position, bullishness, and business outlook have been deeply affected. While many are pointing fingers at banks which aggressively offered debt packages to purchase companies, fuelling ever larger deals, it takes two to tango; more than a few general partners willingly took advantage of the buoyant credit markets to 'benefit their investors'. Consequently, the private equity market witnessed some amazing activity and a slew of acquisitions on an unprecedented scale. In 2007, $800bn of deals were executed, with almost $600bn of that completed in the first half of the year, according to Dealogic. This included record-breaking deals such as Blackstone's $38.9bn acquisition of Equity Office Properties and the $45bn acquisition of TXU by a private equity consortium led by KKR and TPG.

However, not all was rosy in private equity land. The most recent credit cycle has brought new tensions and new learning experiences for general partners who now suddenly understand the concept of responsible public ownership and the necessity of ensuring clarity of their intentions, especially in the public eye. Within the last year, private equity firms have come under intense scrutiny with respect to the transparency of their profits and operations. Their 'benefit to society' has been questioned. A number of the larger firms that had previously been humming along without a care in the world have been dragged into the spotlight and forced to defend their actions and their assertion that they actually improve the operations and profitability of their portfolio companies rather than add to national unemployment.

Meanwhile, the private equity universe has continued to expand. Deals, exits and portfolios grew larger. Average deal sizes increased 265 percent from 2000 to 2007, according to Dealogic. Funded by investors writing ever-larger commitment checks, mega funds emerged, still touting their middle market heritage. The definition of mid-market became so wide in the last few years that the sheer breadth of mid-market managers began to resemble the Grand Canyon. Then, as the risk appetite changed overnight, all went silent. Activity generated by financial institutions dropped dramatically, with fourth quarter 2007 activity falling 70 percent year on year from 2006.

However, it is in this broad middle market that we witness a private equity nuance. Here, general partners did not get caught up in the land of leverage, and were not as involved with the euphoria that swept through the larger end of the market. These general partners tended to have more of an operational focus, buying and building sound companies, or establishing platforms, focusing on growth and preparing companies to be market leaders that could weather market cycles. In fact, truly mid-market general partners continued to exit companies for a healthy profit in the last few years, riding the rising tides while still making investments at attractive acquisition multiples and not loading up their acquisitions with debt. While they could easily have taken on more debt in every acquisition, these general partners conservatively chose not to, as they wanted to position their companies for the future.

By leveraging prudently, they were buying insurance for their portfolio companies. And, like all good insurance programs, business protection has been there in a time of need. Today, these general partners have not missed a beat in the pace of their investments. While others wonder how they will put together the next deal, these mid-market private equity firms are as busy as ever in developing their portfolios. In contrast to the larger end of the market, mid-market deal activity gained 19 percent in the third quarter of 2007 over 2006, and increased 55 percent in the fourth quarter of 2007 over 2006, according to Dealogic. One point to note is that given the size of smaller transactions, new players in the form of local banks are stepping up to provide prudent financing.

We see these trends in the US mid-market, where a number of general partners who are raising successful funds up to $2bn have achieved great exit multiples, and continue to make interesting investments. We also see these trends in Europe where there is still a great deal of value and inefficiency to exploit in the middle market, particularly for the local players who have unparalleled networks in their respective markets.

Significantly, we also see this in the emerging markets where there is often conservative use of leverage (if any) while growth rates are the main focus and continue to be relatively strong. Funds raised in the emerging markets have grown exponentially in recent years. Between 2003 and 2007, the amount of capital raised has risen on an annual basis by 69 percent in the Middle East & Asia, 82 percent in Latin America, 90 percent in Emerging Asia and 132 percent in Central & Eastern Europe and Russia, according to Emerging Markets Private Equity Association. This is a trend that has been mirrored in investment activity, as a growing percentage of global private equity activity is attributable to the emerging markets. In 2001, they accounted for 4.5 percent of private equity fundraising and 3.3 percent of deal volume. By 2007, they accounted for 15.9 percent of fundraising and in the first half of the year, accounted for 7 percent of global LBO deal activity, according to Thomson. Additionally, there has been a marked increase in distressed investment, particularly in the last two years.

While others wonder how they will put together the next deal, these mid-market private equity firms are as busy as ever in developing their portfolios.

Ultimately, the recent events have had an impact even on the mid-market players who maintained a conservative approach. First, while the banks are open for business, the debt packages available today are not as attractive as they were 18 months ago. Second, valuations have come down on unrealised investments;

and since many investors in private equity use mark to market valuation techniques, the funds in their portfolios are currently showing lower performance even though the underlying companies may be doing fine. However, compared to the large end of the market where private equity firms are being forced to look at much smaller deals than would normally fit their strategy and also potentially share their larger deals with increasingly powerful sovereign wealth funds in order to finance them, the circumstances surrounding the mid-market are relatively insignificant. Furthermore, they will be short lived as the mid-market continues to exhibit resilience, opportunity and performance.

Mounir Guen is founder and chief executive of MVision.

The changing face of the MBO

BY OLIVER HOFFMAN

Management buyouts (MBOs) have become an established feature of the corporate landscape over the last 25 years. The concept itself is simple. Who better to buy a business than the people who manage it? The reality is more complicated and a whole industry of corporate finance advisers, corporate lawyers, bankers and venture capitalists has been spawned to help management teams (and the shareholders from whom they buy their businesses) through the buyout process. This article highlights the reasons MBOs have become so popular. Additionally it looks at the trends seen in the MBO marketplace in the last few years as a pointer towards the future of the MBO.

Why have MBOs become so popular?

In a nutshell, an MBO is the purchase of a business from its shareholders by the current management, usually with funds provided by a bank and/or third party equity providers.

The MBO has become such a phenomenon for three main reasons. First, it gives a business owner an alternative to selling to a trade buyer. Smaller businesses in particular are often difficult to sell as they can be below the radar and interest level of larger acquirers. The option of a sale to the management team therefore opens up another avenue of possibility to the owner. Although there is sometimes a financial downside for a vendor in a sale to management (as management teams do not have as deep pockets as some trade buyers) the upsides can be beneficial. With a sale to management the owner can sell without having to disclose potentially sensitive information to someone in the trade. Also confidentiality surrounding sale discussions can be better protected than when a business is being marketed to a wider audience.

Second, a plentiful supply of capital has helped. Pension fund managers and wealthy individuals alike saw the returns made by those that invested in some of the early MBOs and have allocated large amounts of cash to be invested in this market. The banks too have seen that there is profit to be made in lending to companies going through a buyout and have set up specialist leveraged finance teams to provide finance to this market.

Third, management teams have been lured by the prospect of making life changing amounts of money as well as taking control of their own destiny. This money making opportunity comes from financial leverage. In most cases, a management team buys all or most of the shares in the company with a relatively small amount of their own money. The bulk of the money is provided by third parties (banks and/or equity investors). Over the next four to five years they use the profits generated by the business itself to pay off the banks and investors. What they are left with is a business with little or no debt that can be sold, potentially making a very large profit for themselves. Tens of thousands of pounds are often turned into multi-millions for successful management teams.

But MBOs are not without their downsides. If a business veers off-plan and fails to deliver the profits required to pay off its borrowings, the outcome can be devastating. Surveys have estimated that up to a third of businesses that go through a buyout fail in their first few years with administration or receivership often a consequence. Most advisers operating in the MBO arena will argue that the majority of MBOs that go wrong do so because the MBO team overpaid for the business and burdened it with too much debt. Hindsight is a wonderful thing.

Higher risk than an MBO is a management buy-in (MBI). The principles of an MBI are the same as that of an MBO with the exception that the management buying the business do not currently work for the company they are buying. MBIs are particularly common in circumstances where the incumbent management team does not have the strength and depth to mount an MBO bid themselves. These are higher risk than MBOs as there is greater potential for problems in the business to be hidden by vendors and only unearthed once the company has been acquired.

Recent trends in the MBO marketplace

The importance of vendor finance. Changing attitudes of those that fund MBOs has led to changes in the way MBOs are put together and structured. The most notable development seen in the last five years is the increased role played by vendors in helping MBO teams, particularly in smaller businesses, achieve an MBO. In the 1980s and 1990s, it was commonplace for banks to provide 60 to 70 percent of the finance for an MBO with the balance coming from a VC.

In the early 2000s, many VCs saw greater profits to be made by financing larger transactions and moved away from smaller MBOs (i.e., those with a purchase price of below £5m). Management teams were unable to meet the price aspiration of vendors with bank borrowings alone and asked the vendors to fill the gap left by VCs by deferring payment of some of the purchase price, typically by two to three years. This 'debt plus deferred' structure has now become commonplace and has virtually replaced 'debt plus venture capital' at the smaller end of the market.

The secondary buyout. Having moved away from the smaller deals market but with massive funds provided by investors, VC providers are awash with cash seeking a home. As Corporate UK has become a well-fished pond for MBOs in recent years, VCs have been prompted to invest in businesses already under VC ownership. These situations, commonly known as 'secondary buyouts', typically involve one VC buying a business from another, enabling the first to crystallise its profit and return funds to its investors. Often new management teams are introduced as the first team cashes in its stake along with the outgoing VC.

A move away from MBIs. Having looked retrospectively at where they have made money and where they have lost it, the funding markets have moved away from financing MBIs in the last few years. This has lead to the 'BIMBO' – short for buy-in management buyout – a hybrid of an MBO and an MBI where an MBI team or individual leads the purchase of the business supported by the existing managers of that company. The perceived risk of this type of transaction for funders is lower as the inclusion of the existing management reduces the likelihood of problems arising within the business after purchase that were not previously identified.

A view of the future

The MBO market is likely to become increasingly polarised with a divide forming between large and small deals. With VCs focusing on progressively larger deals and bigger and bigger funds being raised for investment by them each year, secondary buyouts will soon become the norm for larger deals in the same way that debt plus deferred has become the norm at the lower end.

The appetite for MBOs from management teams, vendors and the financial community alike shows no signs of abating. While it will undoubtedly continue to re-invent itself, it is a fair bet that the MBO will be with us for many years to come.

Oliver Hoffman is a corporate finance partner at Mazars LLP.

CHAPTER FIVE:

Structuring and negotiating the deal

Preparing a company for sale to maximise value

BY RICHARD LIEBERMAN

Business owners and management are often so consumed with operating and growing their businesses they do not adequately prepare their company for sale. When those owners finally decide (or need) to sell their businesses, they may miss opportunities to maximise the value of their company or minimise the tax impact of the proposed transaction. Poorly prepared companies may even face a dearth of buyers for their business.

Deficiencies in key areas can discourage potential buyers from bidding for the company, delay the transaction (which increases the chances it will not close) or lead to a lower purchase price. Similarly, unaddressed problems can result in greater retained liability of the seller or reduced payouts on earn-outs. The expense of trying to resolve the issues while in negotiation often far exceeds the cost a seller would have spent fixing them before the transaction arises.

Conversely, sellers who adequately prepare their company for sale can be more opportunistic when engaging in transactions and often can negotiate better results for their equity owners, employees and other constituents. Transactions with prepared companies can close faster with less expense.

Sale transactions can result from a variety of circumstances. Prospective purchasers and their advisers often approach a seller. Sellers may seek to sell due to their impending retirement or the death of key personnel. Some will sell due to financial difficulties or a similar crisis. Others will sell as a strategic method of growing the business or to gain better access to capital, markets and products. Regardless of the reasons, a company that is prepared for sale will generally fare better in the sale negotiations than those that have not undertaken proper efforts.

When to prepare for a sale

To help maximise the value of a company (as well as the after tax net proceeds from the transaction), business owners should devote attention to preparing their company for sale as early as possible. Those preparations can even commence when preparing the company's organisational documents. Shareholder and operating agreements often identify the rights and obligations among the equity owners with respect to the sale of their interests. Addressing those issues at the outset can help owners and management avoid disputes at the time of a prospective transaction.

Starting early in the process can have additional benefits. For example, business owners can integrate a potential sale with their estate planning process, to help minimise estate and gift tax obligations. Those owners could benefit from valuing their business and transferring assets to their estate well before the sale. Similarly, converting the form of the business entity from one type to another, such as from a taxable corporation to a limited liability company, will have tax ramifications that should be carefully analysed with the company's advisers. Those actions could affect the net proceeds to the seller, but may need time to have a significant benefit.

Business owners can still do much to prepare for a sale even after discussions with the buyer have begun. The negotiation and due diligence process often provides adequate time to address many issues. Some may even be resolved with the knowledge, consent and perhaps encouragement of the prospective buyer.

Assembling an advisory team

Prospective sellers should consider the identification and engagement of experienced professionals to assist throughout the sale process. The advisory team typically includes investment bankers (sometimes called business brokers or advisory intermediaries) and legal, tax, accounting and financial advisers. In-house professionals, who know the buyer, and experienced and objective outside professionals can form a powerful advisory team.

Experts in other areas should be engaged as appropriate for the transaction. Knowledgeable advisers in various disciplines, such as information technology, can be added as needed. Purchasers entering into a new industry or market can benefit from hiring consultants to advise on those issues. International transactions often warrant engagement of qualified professionals in each jurisdiction.

Sellers should consider hiring legal counsel early in the process to assist with the engagement of the other professionals, to address regulatory and legal issues in structuring the transaction, to evaluate duties of the management to the equity owners and to serve as a resource to their client. Some acquisition intermediaries may discourage hiring counsel until later, to permit them greater freedom in structuring the business terms of the transaction, as well as the terms of their own engagement. Experienced counsel, however, should facilitate, not hinder, those processes, while helping the seller to protect its interests.

Preparing for a sale

Among the steps to prepare for a sale, sellers should consider evaluating the following issues. Of course, the list is not exhaustive, and the advisory team can identify other areas of review particular to the seller.

Company records. Buyers will scrutinise the company's contracts, customer correspondence, organisational documents, minute books, accounting, tax and financial records, patents and similar rights and other important documents.

Compensation arrangements. Sellers should evaluate whether key personnel need incentives to remain with the company during and after a sale. Employees react differently to change, and the loss of key personnel during a potential sale can adversely impact the proposed transaction. Sellers should not assume that the transaction process can be consummated in secret, and employees often know or suspect a transaction is in process long before management discloses the prospective transaction.

Employee policies. Companies should assure that appropriate policies and agreements are in place to protect its trade secrets, patents and other intellectual property. It is often difficult to implement those policies while trying to consummate a transaction, especially if the parties are trying to maintain confidentiality. Buyers will also review other company policies, plans and procedures to evaluate their adequacy.

Litigation and other known problems. Most companies have some problems, such as ongoing litigation, customer claims and similar issues. Appropriate resolution of those items can help maximise a company's value, but doing so often cannot be achieved prior to entering negotiations with the buyer. The advisory team can help guide the seller to the best method of presenting the matter to the buyer, as well as to help negotiate the impact of those issues on the proposed transaction.

Together with its advisers, business owners can take steps to prepare their company for sale. The advisers can also identify and negotiate with prospective bidders and prepare the company's sale strategy. An integrated team approach permits a business owner to benefit from the expertise of its team members and may relieve some of the burden on the seller, who must still operate the company throughout the process, as well.

Business owners would be well advised to adequately prepare their company for sale. The effort and expense should inure back to the seller in higher net proceeds and a faster and smoother process. Sellers can benefit from those preparations, regardless of the circumstances leading to the sale or when they commence the process, although greater flexibility remains for those who begin the process well before a prospective sale.

Richard Lieberman is chairman of the Corporate, Securities and Finance Department of Jennings, Strouss & Salmon, PLC.

Steps to a successful private company sale

BY FRANK A. MCGREW IV AND DUNN MILEHAM

Selling a privately held business may be the most important financial event in a business owner's life – years of hard work offer the prospect of financial security for life. However, without proper guidance and financial advice, this exciting moment can quickly turn into a misadventure in which the owner may not realise the full value of his or her company.

Before and throughout the process, a number of questions are inevitable. What is my business really worth? What is the right transaction structure? What can I do to make sure the transaction closes with minimal difficulty and maximum after-tax proceeds?

Selling a business is a complex and time-consuming process, and the addition of family members and close friends as employees and/or shareholders often adds to an already complex situation. In order to make the process as smooth as possible, goals and specific issues must be clearly defined with appropriate advisers at the onset of a prospective transaction. Clearly defined goals and objectives will allow the team of trusted advisers to seek out the 'best' deal for the seller to achieve maximum benefit. However, it is important to remember that the 'best' deal may not necessarily provide the highest price.

Private companies are sold for a number of reasons. Liquidity, personal balance sheet diversification, restructuring, growth capital needs, ownership transition and succession planning are among the most common reasons business owners cite for selling their businesses. While the sale of the business in accordance with terms desired by the owner may be the ultimate outcome, the means to the end should start well in advance of the liquidity event. In fact, it is never too early to plan for a sale. From day one, business owners can have a positive impact on the outcome of the liquidity event by focusing on the following key issues:

Finances. While many private businesses start small and use 'off the shelf' accounting software, it is important to keep detailed financial records and increase bookkeeping / accounting functions as the business grows. 'Owner expenses' should be kept to a minimum and should be clearly identified. Audited financial statements (or, at the minimum, reviewed statements) will be viewed favourably by both strategic and financial buyers and will expedite the process.

Management. Business owners should build a competent, independent middle management team. During diligence, buyers will always question the capabilities of the management team. An average to poor team can detract value, while a solid group can increase value and interest in the business. Additionally, while the seller of the business may take his proceeds and retire to the beach, the ongoing viability of the company may be left in the hands of its management. In certain instances where the seller may have some continuing interest in the ongoing financial performance of the business (via an earn out, stock consideration, etc.), the capabilities of the management team may have a material impact on the seller's ultimate financial consideration.

Employees. Employees are the backbone of a company. Unlike the owner, and in some cases the management, many of the employees will stay with the business post-transaction. Business owners may consider having key employees sign confidentiality and/or non-compete agreements in order to keep proprietary business processes and trade secrets in-house. When a sale process commences, owners should consider notifying 'key' employees of the process and keep them informed of changes. Unannounced unfamiliar faces lurking around in suits during diligence may cause undue angst among trusted and loyal employees when their continued focus is needed more than ever.

Legal structures / tax implications. When forming a business, owners should consult with attorneys and tax professionals regarding the pros and cons of forming an S-corp versus a C-corp. A number of variables will influence this decision, and a choice of one corporate structure over another may hinder a process or leave the business owner with an undesirable tax burden.

Customer base. A large and diverse customer base with identified new business targets can add value to a company and ease buyer concerns about customer concentration. Owners should maintain detailed prospect reports and evidence of successfully growing the customer base.

Advisers. Last but certainly not least, business owners should build a team of trusted financial and legal advisers. Throughout the growth of the company – from inception to sale – an attorney (or firm) well versed in corporate law will be an invaluable resource. The second key member of the team should be an external accountant, preferably from a regional firm with dedicated tax and audit capabilities. An investment banker skilled in M&A and also knowledgeable about the particular industry is the third key team member. Working in conjunction, these three advisers will be able to orchestrate a transaction that fulfils the seller's desires while minimising disruption to the business.

A key role of the advisers, particularly the investment bankers, is the marketing process. An investment banker who understands the industry in which the company competes is imperative. Bankers lacking industry knowledge will be unable to target the marketing to the most likely set of prospective buyers.

Relationships with both strategic and financial buyers is key to a competitive process, as there may be pros and cons of a transaction with each. Financial buyers tend to (i) seek above average returns (although they are potentially more reasonable now than in recent years); (ii) look for experienced senior management teams with sound growth strategies; (iii) typically invest in a preferred security and require majority control; (iv) 'partner' with management; (v) prefer capital be used for growth; (vi) look to exit the investment in a set timeframe (three to seven years); and (vii) require audited financials.

On the other hand, strategic buyers (i) can be readily identified and are increasingly global in nature; (ii) may be able to pay a premium price due to synergies or cost elimination; (ii) can use stock as currency if they are a public company; (iii) may have an upper level management which is 'expendable'; and (iv) may have lighter diligence requirements due to knowledge of the industry.

While no two sale transactions are the same, companies that yield premium valuations in today's market share certain similar characteristics. First, they hold a leading position in a viable industry. Second, they are led by a strong management team. Third, they enjoy sustainable competitive advantages. Fourth, they have achieved outstanding financial performance. Finally, they have attractive growth characteristics with limited quantifiable downside risk.

Success, however, does not happen overnight, and a sale process should not be taken lightly. An emphasis on pre-sale preparation, data validation during pre-marketing diligence and well crafted marketing materials presented to qualified buyers will ensure a competitive process that yields the most desirable outcome to the seller.

Frank A. McGrew IV is a managing director and Dunn Mileham is a vice president at Morgan Joseph & Co. Inc.

Non-binding preliminary agreements: use 'good faith' with caution

BY ROBERT COYNE AND KEVIN EVANS

Business negotiations often reach a stage at which one or more parties want what they have agreed to in principle to be recorded in writing. The parties may sign a term sheet, letter of intent or heads of agreement – all variations on a common theme. These preliminary agreements spell out, in summary fashion, the key terms of the proposed deal. These preliminary agreements are often stated to be non-binding, such as by the use of the words, 'subject to contract', or 'subject to the execution of a definitive agreement'.

One party may request the inclusion of a mutual obligation to negotiate the definitive agreement 'in good faith'. This request may be a difficult one to reject – why wouldn't each party agree to negotiate in good faith to finalise the deal? It may be tempting for a party to conclude that such a statement is harmless, since the term sheet is non-binding.

If, for whatever reason, one party changes its mind, can it simply walk away from the non-binding arrangement? Does it make a difference if the term sheet includes a statement to 'negotiate a definitive agreement in good faith'?

This article considers the differing impact of a provision to negotiate in good faith in the common law systems in the United Kingdom (no impact), Australia (some impact), and the United States (a significant impact). Although the common law in these three jurisdictions has many similar attributes, the ramifications of cavalierly using common business terms such as 'good faith' can be very different.

United Kingdom

Generally the English courts are reluctant to enforce obligations to negotiate in good faith, whether implied or express, because such a concept is perceived to be irreconcilable with the parties' freedom of contract. In addition, 'good faith' is considered vague, a type of 'agreement to agree' and therefore too uncertain to enforce. It is also difficult to say whether the termination of negotiations was brought about in good or bad faith. Moreover, since it is difficult to determine whether good faith negotiations would have produced a final agreement or what the terms of that agreement would have been, how can the loss for breach of any good faith obligation be determined? In the leading House of Lords case of *Walford v. Miles (1992)*, the court said: "While negotiations are in existence, either party is entitled to withdraw from these negotiations at any time and for any reason. There can be thus no obligation to continue to negotiate until there is a proper reason to withdraw. Accordingly a bare agreement to negotiate has no legal content."

However, the inclusion of a provision to negotiate in good faith was considered more recently by the English Court of Appeal in the case of *Petromec v. Petroleo Brasileiro (2005)*. The court commented that it did not consider that *Walford v. Miles* was binding authority that an express obligation to negotiate in good faith would be completely without effect. It suggested that when the parties enter into a written contract that includes a provision for good faith negotiations, and in particular when legal advisers have been involved, then it may be appropriate for such a provision to be enforceable.

Thus, when it is clear that the term sheet is not binding and is only a 'bare agreement to negotiate', then Petromec would have no impact on the traditional position espoused in Walford. Under English law, there is no recognition of an implied obligation to negotiate in good faith, and the inclusion of an express provision does not, in the absence of a binding agreement, limit a party's ability to walk away from the negotiations.

Australia

The existence and scope of an obligation to negotiate in good faith is not yet settled in Australia. Traditionally, Australia has followed the English courts and been reluctant to recognise an obligation to negotiate in good faith. However, Australian courts have recently appeared more willing to depart from this position. In *Coal Cliff Collieries v. Sijehama (1991)*, the validity of an express agreement to negotiate in good faith was considered. The court rejected the proposition that no promise to negotiate in good faith would ever be enforceable by a court. Subsequent cases in Australia have followed this approach.

How does the current state of the law in Australia impact on our non-binding term sheet scenario? Although an implied contractual duty of good faith is recognised in Australia, both under common law and statute, it is not imposed on all contracts. While the courts may seek to imply a duty of good faith in the negotiation of contractual obligations, they will not override a contract's express language. The express non-binding nature of the term sheet makes it likely that the Australian courts would not imply an obligation to negotiate in good faith when there is a non-binding term sheet.

But what of the express obligation? It is generally accepted that parties may by contract bind themselves to negotiate in good faith. But there remain practical difficulties with this concept. Significantly, the courts have held that any express obligation to negotiate in good faith needs to be sufficiently specific as to the elements of the obligation. In our example, because no attempt has been made to define what is intended by the obligation, or what should happen if good faith negotiations break down, the courts are again unlikely to enforce the obligation.

If parties to a term sheet wish to bind themselves to negotiate in good faith in reaching a definitive agreement, because the concept of good faith is uncertain and evolving, they should define what it is that they mean by good faith. Even in the scenario of a binding obligation to negotiate in good faith, a party's obligations under Australian law are not onerous. Generally, the obligation can be fulfilled by simply taking part in the process of negotiations. Beyond this, there is no requirement that a party act for or on behalf of or in the interests of the other party, nor does it require a party to act otherwise than by pursuing its own interests.

United States

Any general statement of the law in the US is fraught with problems. English courts have only to consider decisions of higher English courts. Australia, which also has a federal system, has state courts that tend to take notice of the developments in other states and a High Court that ultimately resolves questions of contract law for the whole of Australia. In contrast, in the US there is no effective review of state law by the US Supreme Court. As a result the common law of what it means to agree to negotiate in good faith develops independently in 50 jurisdictions. That being said, it is possible to extract some general guidance.

The obligation to negotiate in good faith arises from either an express or implied obligation in an agreement. When the obligation does not exist, the traditional theory of freedom of contract applies and a party is free to walk away from a deal and break off negotiations for any reason.

Does a term sheet that expressly states its non-binding status, as in our example, nevertheless imply a binding obligation to negotiate? The watershed case is *Teachers Insurance & Annuity Association of America v. Tribune Co. (1987)*, in which the applicable term sheet stated that it was non-binding but did not expressly contain any obligation of good faith. In this case the court identified a type of preliminary agreement between parties that, although not requiring that the final contract be concluded, created an obligation on the parties to negotiate in good faith, what the court called a 'binding preliminary agreement.' Although a number of cases have followed in Tribune's footsteps, it is rare that when the parties have expressly stated their intention that the preliminary agreement is non-binding pending the definitive agreement, a court will impose an obligation to continue good faith negotiations.

There is little doubt that US courts will recognise express obligations to negotiate in good faith. In *Itek Corp. v. Chicago Aerial Industries (1968)*, a letter of intent containing both a no binding effect clause and a provision stating that the parties "make every reasonable effort to agree upon and have prepared as quickly as possible a contract", was found by the Delaware Supreme Court to impose an obligation to negotiate in good faith. Similarly, in the Massachusetts case of *Schwanbeck v. Federal Mogul Corp. (1992)*, a statement that: "This Letter of Intent is not intended to create, nor do you or we presently have any binding legal obligation whatever…," but then went on to say: "…however, it is our intention, and we understand, your intention immediately to proceed in good faith in the negotiation of such binding definitive agreement", was held to be a contractual obligation independent of the prior disclaimer that the letter was non-binding.

Itek and *Schwanbeck* are examples of how otherwise non-binding letters of intent may impose a duty to negotiate in good faith. But what does this duty entail?

Good faith is defined in the Uniform Commercial Code as "honesty in fact in the conduct or transaction concerned". However, the UCC deals with the performance of already concluded contracts, and not with good faith obligations in the pre-contractual stage. What constitutes pre-contractual good faith is an open issue. Clearly, certain actions such as fraud or duress, or other 'bad faith' conduct, will violate any good faith standard. Additionally, some commentators suggest that under an agreement to negotiate, the good faith standard ordinarily requires: (i) actual negotiations with no imposition of conditions that were not contemplated by the parties; (ii) disclosure of enough about parallel negotiations to give a reasonable opportunity to match competing proposals; and (iii) continued negotiation until impasse has been reached unless there is another justification for breaking off the negotiations.

Commentators have also suggested conduct permitted by the good faith standard. For example, an obligation to negotiate in good faith should not require a party to negotiate exclusively, or for any specific length of time, or to continue negotiations if its counterpart is not acting in good faith, or if market conditions change, or indeed if the opportunity to conclude the deal with a third party comes along.

Finally, in the event of a breach of an obligation to negotiate in good faith, what are the likely consequences? The US courts have a number of remedies available. However, since it is not possible to determine whether good faith negotiations would have produced an agreement at all, or what the terms of that agreement would have been, certain remedies such as specific performance, or 'expectation damages', i.e., damages based upon the expected profits that the aggrieved party would have received from the transaction, are inappropriate. The more likely result is for a court to award 'reliance damages'. The aggrieved party is compensated for any loss resulting from its reliance on the other party's agreement to negotiate in good faith. The purpose of this measure is to put the party in the same position in would have been in had the agreement to negotiate in good faith not been made. It is likely to cover out-of-pocket expenses, but not the lost profits that the initial term sheet contemplated or lost opportunity costs. That said, the more advanced the negotiations towards a definitive agreement, the more likely that an aggrieved party will seek to argue for lost opportunity costs or damages to its business that may have resulted from the impact on employees, suppliers and customers of the failed negotiations.

Conclusion

Cross-border deals are now the norm. The cavalier use of commonly used terms such as 'good faith' across different jurisdictions can have unexpected consequences. In the context of preliminary agreements, particular attention should be paid to any language that suggests that there is an obligation to continue negotiations, or otherwise negotiate in good faith. Consider including explicit disclaimers reserving each party's right to terminate negotiations at any time and for any reason. Resist the inclusion of a 'good faith' obligation to negotiate. Alternatively, spell out precisely what needs to be done to comply with this obligation, or set forth the consequences for breach of this obligation, such as a termination fee.

Robert Coyne is a director and co-chair of the Cross Border Transactions Group, and Kevin Evans is Counsel, at Gibbons P.C.

Auctions in the M&A process

BY JUSTIN PETTIT

Despite the increased use of competitive auctions, the balance of power between financial sponsors and corporates in today's environment is in flux. The balance of power now has more to with the credit markets and the availability of capital – the credit crunch has put strategic buyers back into the drivers' seat for now. Neither strategic buyers nor financial sponsors generally prefer auctions. However, whether they were called and managed as a formal auction or not, the sell-side process has always at least feigned some element of a 'book-building' process designed to generate interest and enthusiasm in the negotiation. What has changed are the social norms around its visibility.

Auction pros and cons

Sellers like auctions because the process is quick, efficient, and it gets things over with in one fell swoop.

There can also be situations where companies are legally compelled to hold an auction. Obtaining a fair and reasonable price is a fiduciary responsibility of the directors in any public company – this may, or may not, be best achieved through an auction process. Furthermore, there are many regulated companies, where regulators may have preferences. Finally, encumbered assets can require lender approval, which may also affect the method of disposition.

Regulators may believe that a formal auction necessarily equates to the best price possible, and thus best meets the needs of their primary constituents. However, this may not be the case. For example, a business auctioned through a tender offer with no representations or warranties will typically clear a lower premium than in a negotiated transaction.

And there is evidence to suggest that auctions deter strategic buyers and that sellers are unable to extract the maximum value from a financial buyer. Buyers are suspect both around the fundamentals of auctioned assets, as well as the likely clearing price that will need to be paid.

Auctions do seem to be a more familiar process to the financial sponsors. Strategic buyers prefer to look at opportunities before they are formally auctioned. Banker books are regarded with scepticism not only because we know the ideas have been shown to hundreds of others to bid up the price, but also because there is often a taint associated with businesses that are put up for sale. Ultimately, auctions can deter any buyer that is especially price-sensitive.

Private negotiation is far less disruptive to the business being sold – the customers, employees, and vendors, need not be unnecessarily involved and worried with the transaction. Thus, value can be preserved. In many industries, the key players all know each other, and the natural owners of different assets can be identified and approached through quieter channels.

Formal auctions are not necessary, but visibility and dialogue certainly are. A proactive out-reach to the close circle of natural buyers can be done quietly. All auctions are not created equal – in fact, there is a spectrum of tactics. There are a number of auction methods that can be used. Managed book building, discriminatory auctions, and uniform price auctions are alternative approaches to dialogue with multiple potential bidders. The transparency of formal auction methods can lead to more competitive pricing, but actually can work poorly in cases vulnerable to inaccurate information.

For example, where the number of investors and the accuracy of investors' information is endogenous, managed book building controls investor access, allowing reduced time and risk for both buyers and sellers. It also controls spending on information acquisition, thereby limiting underpricing. Interestingly, the US book building method has become increasingly popular for IPOs worldwide over the last decade, whereas sealed bid IPO auctions have been abandoned.

Key success factors

There are many common mistakes made in auctions. Many companies fail to prepare adequately, often seeing the auction as the end rather than a simple means to an end. In this preparation the development of a clear and compelling 'equity story' of about the business, strategy and 'right to win', markets, competitive dynamics, advantages, risks and prospects is essential. Advance planning is essential – the seller should conduct their own in house due diligence to surface the relevant issues and avoid any surprises.

Strategies can be deployed by the seller to maximise the sale proceeds in an auction. There are many degrees of freedom in the value proposition, and price is but one of them. Timing, consideration and risk, stapled financing, tax, governance, control, people and chemistry, are all equally important issues. The maximisation of any one of these elements, such as price, can be achieved through the careful calibration of the other elements, based on your knowledge of what else matters to each of the potential buyers.

There are ways the buyer can increase odds of being the successful bidder in an auction. There are many elements to the value proposition beyond price per se, though that is an obvious starting point. The form of consideration – cash or stock – and its risk also matters. Even in comparing all stock deals, risk can vary. M&A collars can be used to tailor the risk profile of stock deals to bridge differences in outlook between buyers and sellers. Similarly, deal structure also matters. Deals may be structured differently for advantageous tax treatment, alternative governance structures, etc. Finally, deal terms around timing, board seats, control, management, etc., are often more important issues than deal price.

Auctions of the future

Sellers are increasingly attempting to 'clean-up' the target's operations in advance of conducting an auction, even to the point of investing capital, making changes to management, and revising strategies. They are also increasingly making sure that any contingent risks in the business are resolved or mitigated.

In terms of the balance of power

going forward – if auctions will take precedence in future transactions, or if privately negotiated deals ultimately are preferred, the answer is most likely some hybrid that falls between these two extremes. A professionally managed process that quietly targets the (limited) natural circle of interested parties, and combines the rolling disclosure of private negotiation with the competitive bidding of an auction mechanism.

Fix versus sell: the portfolio coherence perspective

When a stock languishes, delivering total shareholder returns below the cost of capital and trading at valuations below publicly-traded comparables, buy-side and sell-side analysts call for bold change to serve as a catalyst for the stock and a revision to investor expectations (in some cases, operating performance and business integration are more problematic than portfolio composition per se). We often see opportunity for a much greater degree of 'portfolio coherence' – greater integration and complexity reduction at each of the intersections of business segment and value chain activity. Correlation between portfolio coherence, and financial measures of performance, growth, and valuation is typically strong.

For example, our initial estimate of Citi coherence is roughly 45 percent, far below the level we expect was envisioned for this portfolio. While Citi could improve coherence through a streamlining of its portfolio (e.g., auction assets), it could also achieve a much higher level of coherence through operational means while maintaining the existing portfolio composition. An improved articulation of portfolio strategy, including a roadmap for portfolio coherence, plus improved execution, manifesting in enhanced growth and returns on equity, can be even more effective routes to sustainable value creation than a change in portfolio composition.

Justin Pettit is a partner at Booz Allen Hamilton.

Domestic versus foreign acquirers: managing an international sale process

BY DARREN REDMAYNE AND SAURIN MEHTA

There is a rising level of cross-border acquisition activity occurring among European and US companies and private equity firms. As these entities increase their appetite for international targets, it is prompting business owners to scrutinise the advantages and commensurate challenges of selling to a domestic versus foreign acquirer.

This article discusses the common issues a seller must consider when marketing a business that is likely to attract international interest. A seller must be thoroughly prepared to ensure a smooth sale process. In particular, we will examine the following: (i) the relative merits of selling to a domestic versus foreign acquirer; (ii) how to manage a foreign buyer during the sale process; (iii) recognising localised issues; and (iv) understanding the due diligence process.

Although it is virtually impossible these days to discuss globalisation without some reference to China or India, transatlantic M&A activity between Europe and the US still remains robust. In 2007, there were over 1500 transatlantic deals with a total disclosed value of nearly $625bn, according to Mergerstat. An October 2007 Mergerstat survey found respondents optimistic that transatlantic M&A will continue, with 77 percent believing the volume of deals will increase or remain the same over the coming year. Recognising and appreciating these trends, this article revolves around European firms acquiring US-based assets and vice versa.

Merits of domestic and foreign acquirers

When deciding whether to choose a foreign acquirer over a domestic acquirer, a seller will commonly ask 'Is it worth the hassle?' This question is rooted in several complex themes – familiarity, transaction risk and the long-term fit of the business within the new organisation. All are critical to ensuring a successful sale.

Human instinct gravitates towards familiarity and cautiously approaches the unknown. Domestic buyers are naturally more familiar with targets in their own country and the market dynamics impacting those assets. The buyer and seller enjoy cultural similarities – the business customs are identical, people act in a similar manner and there are no language barriers. However, this same familiarity may also lead to seller trepidation when contacting domestic acquirers which are deemed competitors. The prospect of disclosing critical information to the enemy often causes sellers to hesitate. Conversely, sellers frequently see foreign competitors as less threatening, partly, and due to the foreign acquirers' lack of familiarity with, and presence within, the local market.

The second aspect sellers must consider is transaction risk. Although risk is inherent with any buyer, there typically is heightened concern surrounding a foreign acquirer's ability to secure financing and complete due diligence, both of which directly impact certainty of closing. A foreign acquirer and its lender may require extra time to familiarise themselves with local accounting principles and business standards. In an effort to expedite the process of securing financing, the seller's adviser may recommend the buyer work with the lender's local offices or affiliates. If unavailable, the foreign acquirer may be best served teaming with a financier in the target's country instead. Of course, financing is a non-issue if the buyer is a strategic that can write a cheque from its cash-laden balance sheet or has pre-established credit lines dedicated to acquisitions.

The third, and perhaps most important, merit to evaluate is the long-term fit of the selling business within the new organisation. A domestic acquirer may fold the acquired asset into an existing division, lessening management's independence and control. Synergies tend to be focused on cost cutting initiatives. A foreign acquirer, on the other hand, is likely to view the target as an entry vehicle into a particular geographic market, and its valuation may reflect a market entry 'premium'. The seller's management team is critical, as they will be relied upon to run the business post-acquisition while the parent company sits thousands of miles away. Further empowering management is the potential opportunity to 'play with a larger train set', given the revenue synergies a foreign owner may provide via international growth opportunities.

How to manage a foreign acquirer during the sale process

A seller's adviser can take actions at every stage of the marketing process to ensure maximum participation by foreign acquirers (especially strategics). At the onset, a strategic buyer carefully weighs the resources required to participate in *any* sale process. This bar is even higher for a target 3000 miles away, thus requiring additional time to garner the buyer's blessing to pursue the opportunity. By contacting foreign acquirers a few weeks earlier than domestic buyers, a seller may level the playing field and prevent domestic parties from moving too far ahead and scaring off international interest. The adviser may also consider using its local offices to introduce the target (in the local language) to maximise marketing effectiveness. Once a foreign party is engaged in the process, the seller may contemplate additional actions to intensify interest, such as conducting a mini 'road show' on the potential buyer's home soil, which also gives them a chance to meet and evaluate several potential owners early in the marketing process.

A foreign acquirer is likely to view the target as an entry vehicle into a particular geographic market, and its valuation may reflect a market entry 'premium'.

The strategies to maximise foreign acquirer participation continue into the latter stages of a transaction. For instance, a dinner the evening before a site visit is often an effective icebreaker, leading to a more productive, informative meeting the following day. The opportunity to meet in a less formal setting may help overcome some of the uncertainties and cultural differences that exist between the buyer and seller. In due diligence, the use of electronic data rooms is a must for any target hoping to solicit international interest. The ability of a buyer and its vendors to access information online anywhere in the world, at anytime, neutralises the inefficiencies and costs that may make foreign buyer participation otherwise prohibitive.

Recognising localised issues

Just as every deal has its nuances, every region has its unique hot buttons. For example, in the UK, pension-related matters are a top priority. Meanwhile, environmental issues are a primary focus in the US. Even more divergent are UK and US perspectives on representations and warranties. In the US, a buyer and seller may engage in a bitter debate over the reps, warranties, caps and indemnifications provided in a purchase agreement. Conversely, the *only* rep a UK financial sponsor provides is that the group owns the shares it is contemplating selling. A knowledgeable adviser, particularly one with a local presence in key geographies, can quickly discern those issues on which a foreign buyer will focus, allowing the seller to proactively address such concerns before they become an impediment to the sale.

Understanding the due diligence process

A discussion of domestic and foreign acquirers is incomplete without highlighting that the due diligence process is notably different in the US and Europe. In the US, independent vendors (primarily large accounting firms) play a prominent role in finalising the due diligence process. However, diligence is backend loaded, as these advisers are typically not hired by the buyer until after entering into an exclusivity period with the seller. In Europe, the seller will often engage an independent accounting firm to draft a due diligence report *before* starting the sale process. By having this report completed earlier, the seller mitigates the risk of a buyer backing out of a transaction during the exclusivity period and the buyer is able to more accurately assess the target prior to investing substantial human and financial resources. Once the exclusivity period begins, the independent accounting firm ceases to work on behalf of the seller and instead, provides additional services, as required, to the buyer.

If a seller decides to move forward with a foreign acquirer, the buyer is well advised to use locally-based legal counsel and due diligence vendors. Though a small nuance, the use of professionals with domestic knowledge and experiences is critical to ensure a speedy diligence process with minimal hurdles.

Conclusion

So what does this tell us when choosing between domestic and foreign buyers? Unfortunately, the most common answer is 'It depends.' Every deal has unique dynamics that impact which buyer is best suited for a given target. The seller must sift through these complexities to determine whether and how to include financial buyers in its sale process.

One thing that is certain, however, is that corporations and private equity groups in Europe and the US continue to remain hungry for acquisitions. Financial sponsors have raised record equity capital over the last few years and despite the recent credit crunch, moderate liquidity still exists for debt cheques under $200m. Valuation multiples and debt pricing for targets with sound fundamentals remain reasonable and buoyed by competition among strategic and financial buyers. Perhaps most importantly, many European firms are capitalising on the opportunity to acquire US targets at 'bargain' prices given the continued strengthening of the euro over the dollar.

While possibly daunting at first, a seller is well advised to consider foreign buyers in an effort to generate the highest value and best terms for its asset. With the aid of an experienced adviser, a number of strategies are available to maximise foreign buyer participation in a sale process. The vigilant execution of these techniques may enable a seller to capture the coveted 'entry premium' a foreign buyer may place on a target designated as a market entry vehicle.

Here, we have covered issues related to US and European buyers and sellers. As India, China and other developing regions continue to become more acquisitive and alter the M&A landscape, the domestic versus foreign buyer debate is certain to evolve over the next several years.

Darren N. Redmayne is a managing director and UK CEO, and Saurin Y. Mehta is a vice president, at Lincoln International, LLC.

Going global: successfully negotiating multi-jurisdiction transactions

BY RICHARD R. WILLIS, CHRIS G. BAUGHER AND ANTHONY M. BALLOON

With the continued development of the 'global' economy, more and more businesses find themselves looking for acquisitions, joint ventures and strategic alliances outside of their home country. As the world globalises, it is only natural that transactions themselves all take on an increasingly global character. For example, the recent decline of the US dollar relative to other major currencies has served to hasten this phenomenon as many outside enterprises look to invest in the United States. It is almost inevitable that transactions in a foreign jurisdiction, and potentially across multiple jurisdictions, are increasingly on the horizon for companies that once only dealt within national boundaries.

While issues will vary not only from transaction to transaction, but also from jurisdiction to jurisdiction, there are certain principles that, if followed, will facilitate the smooth operating of a transaction and considerably enhance the likelihood of a successful deal for all involved. The general principles in this article may serve as areas of emphasis to inform the considerations and preparations for a transaction, whether acquisition, divestiture, joint venture or strategic alliance, or any of the other myriad of deals that are being made, everyday, across borders all over the world. The goal is to provide a few select insights that may be used in most any transaction context.

A deal in a foreign jurisdiction is both similar to – but simultaneously different from – any other domestic deal a company undertakes. Failure to appreciate this critical tension can at best make a deal more difficult and expensive than preferred. At worst, it can either derail a deal prior to closing or create unnecessary post-closing challenges.

Note, however, that the below commentary is quite selective and is meant to include among its audience not just dealmakers who are accustomed to transactions in many jurisdictions, but also those who are venturing into a foreign jurisdiction for the first time.

Understand the legal system involved

The jurisdiction in which the transaction occurs, and the structure and type of the legal system, may have a significant impact on the transaction and transaction documents. While this point may seem obvious, it bears emphasising as understanding the structure of the legal system involved in the transaction is key to understanding both the structure of the team (particularly local advisers), as well as the universe of law potentially applicable to the transaction. For example, contrast the federal system in the US with the European Union. A transaction in the US may involve aspects of federal law (e.g., taxation, antitrust filings, environmental regulations or securities registration requirements), together with state law (e.g., the body of 'corporate' law applicable to the transaction and state employment law) and local law (e.g., zoning, commercial incentives). In contrast, a European transaction typically focuses primarily on the law of the relevant member state or states.

Further contrast can be drawn between common law and civil law jurisdictions. A dealmaker from a civil law jurisdiction, such as a typical continental European country, should be generally familiar with the length, detail and content of deal documents from other civil law jurisdictions (even if some of the norms that operate within that document are decidedly different). But if that dealmaker moves to a common law jurisdiction such as the US, Ireland, the UK or Canada (excluding Quebec), the familiarity may wane. The basics will largely be the same, but the detail and, frankly, length at which concepts are expressed will be decidedly different. A US deal will have a relatively long purchase agreement, and the impact of what is unwritten in the agreement, while not as overarching as typical civil law principles, can be significant (e.g., Delaware case law on fiduciary duties and deal protection, obligations under the Foreign Corrupt Practices Act, state employment law enforcement principles such as the ability for a court to 'blue pencil' an otherwise unenforceable agreement).

Appreciating these differences is critical. In civil law jurisdictions, the various civil codes will inform the meaning and interpretation of contractual relations, and contractual provisions, to a much greater extent than in common law jurisdictions. Thus, the agreements can be shorter because there are codes which help give meaning to what the contracting parties have agreed. The unwritten hazard, however, is that civil codes can, in certain instances, imperil the ability of the unwary to affect their intended deal. Accordingly, in a civil law jurisdiction, it is vital to talk specifically – and frequently – with local counsel about the impact that civil code provisions may have on a transaction.

Put together the right team

Putting together the right deal team is fundamental. As a general principle, the more jurisdictions involved in a transaction, the larger and more complex the deal team will be. While a single jurisdiction transaction may often involve substantive experts focusing on various substantive aspects of any given transaction (tax, real estate, employment, environmental, perhaps a litigation assessment, etc.), a multi-jurisdiction transaction typically will involve, at least incrementally, more such 'experts' and perhaps exponentially more. Contrast, for example, an acquisition confined in scope to the State of Georgia in the US and an effort to purchase a pan-European business that operates in each of the UK, Germany, and Poland. The Georgia acquisition likely can be conducted by the company's home country legal and tax advisers plus local counsel in Georgia, who should be familiar with both Georgia corporate law as well as any federal requirements (e.g., antitrust notifications). The European transaction, however, likely will require local legal and tax advisers in no less than three jurisdictions, and likely more depending on whether a tax advantageous acquisition vehicle (e.g., a Benelux entity) is involved.

When assessing and executing a multi-jurisdictional deal – particularly when entering a new or unfamiliar jurisdiction – it is important to rely on local counsel to assess both cultural and market issues, as well as where local issues may be brought to bear. Understanding key notifications, regulatory or government reviews, required approvals and their impact on a transaction is important.

In the context of the deal team, strong leadership is invaluable – at the business level and at the transaction negotiation and execution level. The legal and tax advisory team must be well-organised. In that regard, a party typically has three options: manage the team in-house (e.g., via the general counsel); look for a one-stop shop to manage resources within its own geographic footprint (e.g., a Big Four accounting firm or a 'global' law firm) or rely on an experienced outside M&A adviser (e.g., the outside law firm with whom the business has a longstanding relationship) to coordinate the team and assist in selecting local counsel.

Process and communication matter

The more jurisdictionally complex the transaction, the more the negotiation process and deal team communication become important. A deal team leader cannot coordinate the transaction unless there is regular communication. Experience suggests that communication or lack of effective communication is consistently a challenge in multi-jurisdiction transactions. The reason is simple: the number of participants and advisers is greater than those typically involved in a domestic transaction. Accordingly, it is essential that the entire team is well-informed and moving toward the shared goal. As new issues emerge, identifying them and their implications, and gathering necessary input from the team, is essential. This fluidity demands leadership and the accompanying accountability.

While the above principles are not exhaustive, the tenets will serve parties well in any circumstance. The dealmaker who understands the legal system, has a team of local experts, and leads the deal team through communication and coordination should be equipped to meet the many challenges which will arise in transacting business in new jurisdictions, multiple jurisdictions and throughout the world.

Richard R. Willis and Chris G. Baugher are partners, and Anthony M. Balloon is an associate, at McKenna Long & Aldridge LLP.

Key issues in structuring and negotiating leasing company acquisitions

BY DREW S. FINE AND ALEXANDER M. KAYE

The past few years have seen heightened M&A activity in the leasing company sector. Successful bidders in leasing company auctions have included strategic buyers, private equity players and both US and non-US investors. The acquisition of a leasing company involves many of the issues that confront buyers and sellers in typical M&A transactions, as well as a number of leasing and finance related matters that are specific to acquisitions in this space. This article will discuss certain material issues that need to be considered, as well as the key pitfalls to avoid, when structuring, negotiating and drafting an agreement for the acquisition of a leasing company.

Structuring the transaction

Although a leasing company acquisition can take many forms, the most common structures often involve one of the following three alternatives: (i) the purchase of the entire company (i.e., the stock of the upper tier Holdco); (ii) the direct purchase of the underlying assets (e.g., a portfolio of aircraft); or (iii) the purchase of the special purchase vehicles (SPVs) which hold the underlying assets.

Purchase of Holdco. In the first method of acquisition, the acquirer purchases the entire leasing company. This is accomplished through the transfer to the purchaser of all of the outstanding shares of stock (or other equity interests in) the upper-tier Holdco – the entity which owns all of the asset-owning subsidiaries.

Among the advantages of structuring the transaction in this manner is the mechanical simplicity of consummating the acquisition. There is no need to go through the sometimes cumbersome process of re-registering the tangible assets in the purchaser's name. In addition, because the company itself is being sold (as opposed to the underlying assets), it will often not be necessary to obtain third party consents to the assignment of the company's contracts (although care should be taken to make sure that 'change of control' provisions, if any, are addressed appropriately). This helps to shorten the time period between signing and closing and removes uncertainty from the deal, as the occurrence of the closing does not need to be made contingent on the receipt of such consents.

However, one of the key disadvantages of the Holdco-purchase structure is that, by purchasing the equity of the entire company, an acquirer will generally be unable to leave behind any assets or liabilities of the company being acquired, whether known or unknown. The reality of taking on all of the acquired company's known liabilities, and the possibility of taking on unknown liabilities (such as potential lawsuits, undiscovered environmental claims and employment-related liabilities) necessitates a full, traditional legal and financial diligence of the target company, along with its attendant costs.

Purchase of assets. The second method of acquisition, the direct purchase of the actual underlying assets (e.g. the 'metal' of the aircraft, ship, rail car, container, etc.) addresses the major downside of the first method. It is possible to structure an asset purchase agreement so that only the desired assets are acquired, thereby significantly limiting the buyer's exposure to the liabilities that would otherwise be transferred with the purchase of an entire company. Of course, an acquirer who also takes an assignment of the operating leases will by contract law be assuming the obligations and liabilities arising under those leases.

However, despite its seeming conceptual simplicity from a legal point of view, the direct purchase of transportation-related assets is a complicated transaction in a mechanical sense. The direct transfer often requires complying with government approvals or formal registration with official registries, and may have incremental tax consequences to both sellers and purchasers. As an example, aircraft are often registered in the country where the lessee is located. If a purchaser purchases a portfolio of 100 aircraft on lease to 30 lessees located in 25 countries, then the seller and purchaser may need to make appropriate local filings and registrations in all 25 countries to consummate the purchase. Also, since the underlying leases will also need to be transferred to the purchaser, there may be a need to involve all 30 lessees in the transfer process. Planning for and accommodating these issues requires in-depth knowledge of the nuances of the various laws which may come into play. In addition, it is wise to consult with local counsel in the various jurisdictions where assets reside prior to scheduling a definitive time and place of closing.

Purchase of SPVs. Many leasing companies put their leased-assets into SPVs for a variety of reasons, including limiting the spread of potential liability and for ease of transfer. Another method of acquisition can be effected through the purchase of all of the outstanding equity interests in each asset-owning SPV. This form of acquisition marries the simplicity of a stock transfer with the benefits of a direct asset purchase. For example, SPVs often have no employees, are party to very few contracts (other than the operating leases) and own no real estate. Therefore, although the liabilities of the SPV are not retained by the seller (but remain with the SPV), it is likely that the liabilities just relate to the assets being purchased, as most of the these asset-owning entities were formed and structured solely for the purpose of holding the relevant assets.

However, care should be taken during due diligence to confirm that the SPV did not take on additional liabilities since formation (and appropriate representations to that effect should be included in the definitive acquisition agreement). For example, an SPV may have guaranteed debt incurred by the seller unrelated to the assets being acquired. Structured correctly, a transaction involving the acquisition of special-purpose entities will grant to the buyer ownership of the assets in a manner which ideally reduces the key concerns raised by the other two methods: the mechanical and timing considerations involved in a direct asset transfer, and the difficulty of 'leaving liabilities behind' in a Holdco acquisition.

Diligence

The possibility of any of these transaction structures yielding the expected trouble-free results depends in large part on the adequacy of the diligence performed prior to and contemporaneous with the drafting of any purchase agreement. Thorough legal and financial due diligence is the foundation of any successful corporate acquisition. Among other things, a good due diligence investigation will help a savvy buyer: (i) uncover contingent or hidden liabilities; (ii) better understand the day-to-day operations of the business; (iii) determine the key areas of weakness in the business, as well as the areas having the most potential for growth opportunities; and (iv) determine whether its proposed purchase price is justified by the financial condition, results of operations and prospects of the business.

In addition, a good diligence investigation will often uncover areas of concern that a buyer may want to address through seller representations (and accompanying indemnification obligations) in the purchase agreement. More importantly, a thorough diligence examination allows a buyer to discuss its concerns with the seller prior to entering into the definitive acquisition agreement.

In the context of leasing company acquisitions, due diligence encompasses both corporate diligence (of the target company or SPV) and the particularly specialised expertise required for asset and lease diligence.

Depending on the size and value of the assets involved in a particular deal, asset and lease diligence may be a long and exhaustive process or a relatively short one. Deals involving large and expensive assets, such as the acquisition of dozens of aircraft then under lease, may require physical inspections of each aircraft and the production of highly detailed lease summaries. Whereas the purchase of a large pool of standardised leased office equipment may merit no physical inspection and shorter, less complicated lease summaries, highly sophisticated deals may involve a mix of assets, including assets which have yet to be produced or which may be acquired only upon occurrence of certain conditions (such as the conversion of a passenger jet into a freighter jet). Such deals require customised diligence which matches the sophistication of the deal.

Lease and financing due diligence, particularly of moveable assets, demands a specific analysis of the terms and covenants which govern the relationship between the lessor and lessee. It is important to understand at the outset of the diligence process that provisions which are fairly routine in other contracts can present a costly, even insurmountable obstacle to the successful completion of a deal, if present in a lease or other financing document. For example, the added expense of negotiating around a change-in-control provision may make a deal prohibitively expensive for both the seller, who must get a waiver of the condition, and the buyer, who may not be able to afford the risk of enforcement if a waiver cannot be obtained. Even where added expense is not an issue, a deal may be delayed while experts assess the risks involved with moving forward with a transaction.

Also, there are many complicated lease structures and provisions which contain traps for the unwary, such as: (i) the right of a lessee to purchase the asset at a bargain purchase price; (ii) the right of a lessee to return the asset in a poor condition; (iii) underinsured assets; (iv) the obligation of the lessor to make substantial contributions to the maintenance or other costs related to an asset; and (v) lease arrangements where a third party (which may or may not be creditworthy) holds title to the asset. Also, where the assets to be purchased are located in many countries around the world, it may be desirable to retain local counsel in each jurisdiction who can advise the purchaser of the burdens of repossessing the assets in the particular jurisdiction should the lessee default.

Approvals

In addition to the standard approvals, consents and government filings that must be obtained or addressed in an ordinary acquisition (e.g., permit transfers, HSR antitrust clearance), a leasing company acquisition may require additional approvals and filings depending on the types of assets involved. Moveable assets are often located in multiple jurisdictions; approvals (including anti-competition clearance) may therefore be required based on the location of the asset, where the asset (such as an aircraft or ship) is registered or flagged, and/or where the SPV which owns the asset is incorporated. Acquirers must also comply with any formal procedures required to transfer title to the assets.

Other terms

A definitive agreement for the acquisition of a leasing company will contain customary representations and warranties with respect to the company and its business and operations. However, one notable exception to the 'rep package' normally found in a purchase and sale agreement relates to the condition of the assets being sold. In connection with a sale of moveable assets, the assets are typically sold 'as is' 'where is' since the assets are typically in the possession of the lessee and the seller has no ability to put the assets in any particular condition. Accordingly, it is expected that the buyer will perform due diligence on the assets. Additionally, although the seller may indemnify the buyer for breaches of general representations, warranties and covenants, it will typically not provide indemnity protection for losses relating to the condition of these assets.

There are not many covenants unique to the acquisition of leasing companies. Generally, a purchase agreement will contain covenants: (i) restricting the amendment of current leases; (ii) prohibiting optional modifications to the assets; and (iii) prohibiting liens on the assets (with exceptions for 'permitted liens').

Indemnity clauses generally provide for cross-indemnity, with the seller responsible for risks attributable to the period prior to the sale and the buyer responsible for risks attributable to the period after the sale.

Another key consideration for an acquirer is management. In a highly specialised field such as leasing, an acquirer will need an experienced management team. If the acquirer does not have this expertise, it should condition its obligation to close on the entering into of satisfactory employment arrangements with key members of management.

Closings – scheduling and structuring closings

The closing of any deal implies timing concerns involving both the scheduling of individual availability and coordinating the distribution of documents and the delivery of the assets (if needed). There are particular concerns with moveable assets, especially transportation assets, which may not be evident to parties who do not regularly conduct business in the field. These added concerns can impose both a financial and time cost if not anticipated and properly coordinated.

Transfer tax

When selling moveable assets, the location of the asset at the time of the transfer may determine whether a transfer tax needs to be paid. Transfer tax laws vary by jurisdiction. For example, transfer taxes are not consistently and uniformly imposed within the US, let alone internationally. In any event, tax counsel in the relevant jurisdictions should carefully examine this issue. Generally speaking, the parties can best ensure that the transaction will not trigger a transfer tax that could have otherwise been avoided by either: (i) waiting to close until the assets are located in a 'tax-friendly' jurisdiction; or (ii) structuring a staggered closing so that the transfer of any particular asset only occurs when such asset is located in such a jurisdiction.

Conclusion

When properly structured and conducted, leasing company acquisitions can be exciting and lucrative opportunities, but like all complex deals, such acquisitions can also be an expensive trap for the unwary. Only investors who recognise the need for industry expertise and have acquired or are willing to acquire that expertise can hope to be rewarded.

Drew S. Fine and Alexander M. Kaye are partners at Milbank, Tweed, Hadley & McCloy LLP.

Drafting material adverse change clauses

BY JEFFREY ROTHSCHILD, NICK AZIS, PATRICE CORBIAU, DENNIS WHITE AND ABIGAIL REED

Merger and acquisition contracts typically feature a material adverse change or material adverse effect (both abbreviated here to MAC) clause, under which a buyer may exit the deal or renegotiate terms if an unforeseen material adverse business or economic change affecting the target company occurs between executing the acquisition agreement and closing the transaction. A MAC clause also provides the seller with a means of qualifying certain representations and warranties so that immaterial breaches are ignored (at least for purposes of closing). MAC provisions are heavily negotiated, with buyers seeking broad MAC clauses for maximum flexibility to exit the transaction. Not surprisingly, sellers prefer narrow MAC clauses to ensure that the transaction closes at the agreed-upon price. Understanding how courts view these MAC clauses, as well as recent trends in their drafting, is essential in negotiating M&A transactions.

MAC clauses in the US

Below are details of a few cases regarding MAC clauses which have been litigated and decided.

In *In Re: IBP, Inc. Shareholders Litigation*, 789 A.2d. 14 (Del. Ch. 2001), the merger agreement contained a broad MAC clause with no carve-outs. Tyson Foods asserted that IBP, the target, had suffered a material adverse effect because its first quarter 2001 earnings were 64 percent behind those for the first quarter of 2000. However, the Delaware Court of Chancery did not regard this downturn as affecting IBP on a long-term basis. In the standard set by the court in *IBP*, a party seeking to invoke a MAC clause and terminating a deal faces the high burden of proving that the events claimed to be a MAC "substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the [MAC] should be material when viewed from the longer-term perspective of a reasonable acquirer". The court determined that IBP had not suffered a MAC, and, as a result, Tyson Foods was forced to complete the purchase.

Frontier Oil Corp. v. Holly Corp,. C.A. No. 20502 (Del. Ch. Apr. 29, 2005), which embraced the standard set forth in *IBP* as Delaware law, also demonstrated the importance of carefully crafting MAC clauses. The court noted that the phrase 'would have' or 'would reasonably be expected to have' a MAC, as used in the agreement at issue, created an objective test with a significantly higher threshold than the wording 'could' or 'might'. This standard requires a buyer to examine not only current conditions but also the future, and to produce evidence of a long term downturn.

The MAC clauses at issue in *Frontier Oil* and *IBP* were similar in that they both contained a qualifier that a given effect 'would reasonably be expected to' have a MAC, requiring the seller to consider the impact of possible future events. The 'reasonably expected' qualifier continues to make frequent appearances in MAC clauses today. However, the MAC clause in *Frontier Oil* also excluded certain events, such as general economic, regulatory or political conditions or changes; financial market fluctuations; and general changes in the petroleum industry. These carve-outs are also frequently seen.

In several recent cases, the declaration of a MAC was the basis for 'busting' a transaction without the dispute even coming to trial.

Recent litigation in Tennessee, in which Genesco filed suit against the Finish Line Inc. and Headwind Inc. (collectively, 'Finish Line') in the Tennessee Chancery Court, also demonstrated the importance of careful drafting. Genesco sought specific performance of a merger agreement under which Finish Line was to acquire Genesco. In December 2007, the court granted specific performance, ordering Finish Line to complete the merger. Although the court found that a MAC had occurred with regard to Genesco's financial condition, the court held that its financial decline fit within a carve-out to the MAC clause contained in the merger agreement, since it was due to "general economic conditions" and was not "disproportionate to the financial decline of others in its industry".

Calling a MAC as a basis to renegotiate

In several recent cases, the declaration of a MAC was the basis for 'busting' a transaction without the dispute even coming to trial. *SLM Corporation v. J.C. Flowers II L.P., et al*, commonly referred to as the Sallie Mae case, was a closely watched and recently settled Delaware Court of Chancery case, which involved a merger agreement for the $26bn sale of Sallie Mae to a consortium of investors led by J.C. Flowers II L.P. According to Flowers, new federal legislation that reduced federal subsidies to student lenders and impacted on Sallie Mae's earnings amounted to a MAC, and buyers should have been allowed to terminate the deal without paying the agreed-upon $900m break-up fee. Sallie Mae disagreed and sued for a declaration that no MAC had occurred and that defendants had unlawfully repudiated the merger agreement. The dispute never went to trial. The parties' settlement called for the defendants to refinance $30bn of Sallie Mae debt. Similarly, Kohlberg, Kravis, Roberts & Co. and Goldman Sachs pulled out of an $8bn buyout of stereo company Harman International Industries, claiming that Harman's financial condition was unacceptable and a MAC had occurred. However, the litigation was avoided and the acquisition was terminated, when the former buyers agreed to buy $400m of Harman convertible debt securities.

MAC clauses under UK law

MAC clauses are frequently used in UK M&A transactions, but their structure and content differ, depending on whether the transaction is of private or public nature.

In private company M&A, a MAC clause may take the form of either a condition to completion or, more likely, a warranty that no MAC has occurred since a specified date. The buyer will try to negotiate that the warranty is repeated at completion so as to have a termination right exercisable if the warranty, when repeated at completion, is not true. A typical private company MAC clause will contain similar exceptions as in a US transaction.

In public company M&A, it is standard practice for a UK offer document to contain a MAC clause (expressed as a condition to the offer), the wording of which is largely standardised, as follows: "[save as publicly disclosed] no adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects or operational performance of any member of the Group which in any case is material in the context of the wider Group taken as a whole". However, unlike in the private company context, there are no negotiated exceptions since the UK regulation prescribes the circumstances when a condition may or may not be invoked.

The most significant case law regarding a MAC clause in the public company context was the Takeover Panel's ruling on WPP plc's offer for Tempus Group plc. WPP plc's offer had been announced in August 2001, and WPP argued that following the events of September 11, 2001, a material adverse change had occurred. The Takeover Panel took the view that those events, although exceptional, unforeseeable and a contributor to the decline that had already affected the advertising industry, did not undermine the rationale for the terms and the price of WPP's offer, which were Tempus' long-term prospects. The Takeover Panel stated in this instance that to meet the material significance test "requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous to something that would justify frustration of a legal contract". As a result, the Takeover Panel held WPP to its offer. More recently, the Panel has stated that a bidder need not demonstrate legal frustration, but it must demonstrate the events are of considerable significance, striking at the heart of the purpose of the transaction.

MAC clauses under Belgian Law

Although MAC clauses were only recently introduced in Belgium, their use has now become quite common. It is premature to generalise any Belgian trends related to MAC clauses. However, it is interesting to note that, in Belgium, as in the US, parties will often claim a MAC as the basis for a renegotiation of the contract, rather than an immediate termination. If one of the parties to the transaction wishes to protect itself from a specific event, that should be provided in a separate contractual clause, rather than relying on a general MAC clause.

Drafting MAC clauses in light of case law and recent disputes

Following the *IBP* and *Frontier Oil* decisions, in which buyers were unsuccessful in invoking a MAC to exit a deal, M&A practitioners began drafting agreements where a 'material change' was defined more precisely (for example, a material change would occur if a target's revenues dropped 10 percent). The generally seller-friendly environment of the last several years has seen more frequent utilisation of exceptions to MAC clauses. For example, it was common for a buyer not be able to claim a MAC for changes resulting from general economic, financial, regulatory or market conditions, so long as the changes have not affected the target in a 'materially disproportionate' manner as compared to other similarly situated companies.

However, given the expected downturn in M&A activity and tightening of credit markets, the trend in deal terms generally and MAC clauses specifically may be starting to shift in favour of buyers as they seek more flexibility in terminating transactions. If a buyer has identified certain concerns regarding a target, those concerns should be addressed specifically, either in a tailored MAC clause or as a separately stated closing condition.

Regardless of the relative bargaining power of buyers and sellers in the marketplace generally, or in the context of a particular deal, MAC clauses remain important mechanisms for terminating a transaction and special care should be taken drafting them with precision.

Jeffrey Rothschild, Nick Azis, Patrice Corbiau and Dennis White are partners, and Abigail Reed is an associate, at McDermott Will & Emery LLP.

Deal certainty and recent dislocations in the credit and M&A markets

BY DEREK STOLDT

Deal certainty has always been a key component in mergers and acquisitions, but the recent difficulties in closing transactions have underscored its importance. This article analyses trends in deal certainty and the impact of the recent dislocations in the credit and M&A markets.

In the context of M&A auction dynamics, the bidder with the highest price is usually the favoured buyer, but a bid with significant execution risk is not an appealing option regardless of whether that bid carries the highest price. Sellers are understandably concerned that a failed sale process will leave the target being viewed as damaged goods. As a result, sellers and their advisers carefully focus on the closing conditions proposed by bidders. Here, we examine three typical and significant closing conditions: (i) material adverse change (MAC) condition (taking into account any carve-outs); (ii) bring-down of representations; and (iii) financing contingency.

MAC condition

The typical MAC condition permits a buyer to refuse to close the transaction if a material adverse change on the business, operations, assets or financial condition has occurred from a specified date or is reasonably likely to occur. Generally speaking, the purpose of the MAC clause is to assure the buyer and its lenders that at closing the target will look substantially as it had been represented to look at the signing of the transaction. *IBP v. Tyson*, the leading Delaware Chancery Court case on the interpretation of MAC clauses, makes it clear that MAC clauses are a high bar to clear. In that case, the judge explained the purpose of MAC clauses as a "backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner". The court elaborated that 'durationally significant' meant a period measured in years rather than months. In that opinion, the court admonished parties to purchase agreements to adopt closing standards specific to the deal rather than to rely on generic MAC conditions. Notwithstanding the court's encouragement, our annual survey of key LBO terms shows that MAC clauses remain pervasive, with 94 percent of deals in the survey utilising a MAC condition.

MAC carve-outs

While a MAC condition sets a high threshold, sellers have been able to raise the bar even higher by introducing 'carve-outs' to the MAC standard. MAC carve-outs are categories of changes that may not be taken into account when measuring whether a MAC has occurred. Common MAC carve-outs include changes due to general economic downturns; changes in the industry of the target; changes in law or GAAP; war or terrorism; and announcements or pendency of the proposed transaction. By adding carve-outs, sellers further shift the risk of adverse changes to buyers.

Our survey shows that the use of MAC carve-outs has increased significantly in recent years. For example, carve-outs based on changes in a target's industry increased from 50 percent in deals signed in 2002/2003 to 86 percent in 2006/2007. The use of carve-outs based on changes in laws was even more dramatic, increasing from 10 percent to 79 percent over the same period. Similar increases can be seen in each of the other commonly-used carve-outs.

The overall effect is to make it more and more difficult to establish that a MAC has occurred, thereby increasing deal certainty for the seller but putting the buyer and the buyer's lender at greater risk in the event of unforeseen changes, regardless of their cause. The lender in the leveraged buyout can be placed in a particularly difficult position when a MAC occurs that is excused by a carve-out. The lender still needs to make the loan (and try to sell a portion of the risk to other institutions) at closing but the company may be in a substantially worse condition than when the lender signed its commitment letter.

Recent transactions have shown how important MAC carve-outs can be. In June 2007, Finish Line, Inc. entered into an agreement to acquire fellow footwear seller, Genesco Inc. Shortly after the parties signed the purchase agreement, the target's earnings slid significantly to a level among its lowest in 10 years. Importantly, the businesses of other companies in the footwear industry and the general economy similarly declined. At the same time, the credit markets dried up. The deal stalled and the target sued the buyer and its lender to compel closing. The purchase agreement included a MAC closing condition with a series of carve-outs, including one that excused "changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business". The court held that a MAC had in fact occurred but that the MAC was caused by a general decline in the economy and the target's industry. This transaction stands as a stark example of the importance of MAC carve-outs: without the carve-out, the buyer and its lender would have been excused from closing the transaction, but with the carve-outs, the deal was compelled to move forward.

Recent transactions have shown how important MAC carve-outs can be.

Several other troubled deals moved forward based on similar fact patterns. In light of these experiences, we would not be surprised if buyers began to push back against the use of carve-outs. However, in the current market, there are still many buyers pursuing few high quality targets. As a result, sellers' negotiating power continues to be high. We can expect lenders to push to delete MAC carve-outs both in the purchase agreement and their commitment letters.

Bring-down of representations

The concept of MAC and the corresponding phrase 'material adverse effect' (MAE) are central to another key closing condition known as the 'bring-down' condition. Typically, the seller and target make a series of representations and warranties at the time of the signing of the purchase agreement. The bring-down condition measures the extent to which those representations and warranties remain accurate at closing. The bring-down condition usually utilises one of two subjective standards. The more buyer-friendly standard would excuse closing unless each representation is true and correct at closing in all material respects. The less stringent, more seller-friendly standard would excuse closing only if the inaccuracy of the representations and warranties taken as a whole would result in an MAE. Not surprisingly, buyers prefer the materiality standard because it ensures that the business will look much like it did at signing. The MAE standard permits greater changes in the business between signing and closing without permitting the buyer to refuse to close the transaction.

Traditionally, the MAE bring-down was used in public company deals, while the materiality standard was used in private transactions. Our survey shows that the MAE bring-down standard has become more pervasive over time. In 2004, only 43 percent of the transactions in the survey used a MAE standard and the remainder used the stricter standard. Transactions signed in 2006/2007 used the MAE standard 71 percent of the time, a two-fold increase from 2004.

In recent years of frenetic activity, buyers have sought to stand out in auctions by offering or agreeing to the MAE bring-down standard; we will watch to see if this trend levels off. We expect these points to be hard-fought and to test negotiating power from deal to deal.

Financing contingencies and reverse break-up fees

The financing contingency or 'financing out' permits the buyer to refuse to close the transaction if it is unable to raise the necessary third-party funds to pay for the acquisition. In the typical leveraged buyout, the target's own financial condition serves as the basis for the acquisition financing. Therefore, if the condition of the target falters, the financing is that much more likely to fail.

Our survey is based solely on private acquisitions that are funded by 144A debt transactions, which can often take months to arrange, so it is not surprising that the vast majority of transactions in the survey (78 percent overall and all deals in 2006/2007) include a financing contingency.

The pervasiveness of financing contingencies has led to a common practice in public-to-private transactions in the US known as a 'reverse break-up fee'. The reverse break-up fee provides that the buyer must pay a fee to the target if the financing contingency is exercised and the deal does not close. However, as the recent credit crunch unfolded, we saw that some buyers used the reverse break-up fee to their advantage – some buyers and their lenders believed it was economically advantageous to pay the reverse break-up fee and terminate the agreement rather than to proceed with an acquisition they viewed as over-priced in light of troubled market conditions. In other cases, the threat of termination of the agreement based on a combination of the financing contingency and a claimed MAC condition (whether or not such claim was justified) led to renegotiations of price and other deal terms.

Sellers have been fighting for removal of financing contingencies altogether, but may find buyers increasingly unwilling to remove them. One alternative is to rely on reverse break-up fees at levels that create significant incentives to close the transaction.

Effect on deal dynamics

The large number and high-profile nature of transactions that have turned sour recently are likely to result in an increased focus on the entire package surrounding deal certainty. In the current environment, the main players are even farther apart than ever. Sellers are seeking as much certainty to closing a deal as possible. Buyers are still eager to do deals, but may be unwilling to take the risk of funding the entire transaction if the debt markets continue their dislocation again or if earnings of the target fall off. Lenders have more LBO loans on their books than they can syndicate and are reluctant to sign on to new deals unless they can be assured the debt can be syndicated at closing. We can expect all three to fight their corners as hard as possible.

Derek Stoldt is a partner at Kaye Scholer LLP.

Drafting and negotiating purchase agreements to anticipate challenges

BY MARC C. D'ANNUNZIO AND WAYNE N. BRADLEY

'Nothing good can happen between signing and closing'. This time-worn adage makes the point that the longer the period between the time a deal is signed and its closing, the greater the likelihood that some circumstance arises that gives a buyer second thoughts or creates grounds for a renegotiation of the price or other material terms.

This saying has been amplified by recent events. After the tightening in the credit markets that began in the summer of 2007, buyers, financial sponsors and lenders alike have scrutinised their agreements for ways to avoid or renegotiate deals that looked less appetising in the new, uncertain market. This reality makes the negotiation and drafting of these agreements even more important, so that parties can ensure that these risks, and their consequences, are appropriately addressed.

This article will briefly identify and discuss certain common issues and the ways in which agreements can address them.

The material adverse change condition

The 'material adverse change' (MAC) clause is a fixture in acquisition agreements – and for the majority of its existence, its basic recitation has been remarkably standardised. Conceptually, it provides that a buyer is not obligated to close a transaction if the target has experienced, or is reasonably likely to experience, a material adverse change in its business after the agreement is signed. It is also customary to include a list of exceptions to events that would otherwise constitute a MAC – for instance, effects caused by force majeure events or changes in generally accepted accounting principles.

A number of recent Delaware court decisions have addressed a buyer's use of a MAC clause to walk away from a signed deal. These decisions have solidified the notion that a MAC clause generally covers only those instances where (i) events were unknown by the buyer at the time the agreement was signed, (ii) those events have a long-term, significant negative impact on the target's business, and (iii) had the buyer known of them, it would not have agreed to the deal. As a result, most M&A practitioners agree that relying on a general MAC clause to cover known, specific risks is not the best approach, and advise that where a buyer is aware of a specific risk, that risk should be addressed and allocated elsewhere in the contract.

In recent years, the availability of affordable credit and the boom in private equity fundraising, coupled with a lack of quality acquisition targets, have resulted in an M&A market where sellers have enjoyed considerable negotiating leverage. This has manifested itself in the negotiation of several additional MAC carve-outs – such as for 'changes in securities markets' and 'changes in the trading price or volume of target's stock' – which further limit instances where a skittish buyer can allege that a MAC has occurred.

In today's uncertain environment, buyers have attempted to walk away from signed deals, and a number of them have relied on the MAC clause as a basis for doing so. Take, for instance, the proposed purchase of Genesco Inc. by Finish Line Inc. After Genesco's second quarter 2007 earnings announcement, which was well below expectations, Finish Line and its lender, UBS Securities, alleged that a MAC had occurred and sought to use that as a reason to walk away from their obligations. In response, Genesco sued Finish Line seeking to compel it to close the deal. In awarding in favour of Genesco, a Tennessee judge noted that the material adverse change in Genesco's earnings was part of an industry-wide slowdown in shoe sales and thus was carved out of the definition of a MAC. While this dispute has not yet been finally resolved, it illustrates the importance of the MAC clause and its various exceptions.

Go-shop provisions

A related issue is the extent to which a target – usually a public company – can agree to a 'locked up' deal, where the target is compelled to close the deal even where a third party makes a superior offer to acquire the target after the initial acquisition agreement is signed.

The Delaware Chancery Court's 2003 *Omnicare* decision injected much uncertainty into what had been a fairly well-settled area of M&A practice. While *Omnicare's* facts were somewhat unique, and Delaware judges have narrowed its application in subsequent decisions, it generally stands for the principle that a public target cannot agree to deal protections that effectively preclude its board of directors' ability to consider and take competing, and possibly superior, offers. *Omnicare*, coupled with the seller-friendly market conditions of the last few years, has greatly enhanced a target's ability to negotiate more latitude to consider competing offers.

A prime example of this leverage is the 'go-shop' provision. It enables a target, rather than engaging in a traditional auction or market check prior to signing a definitive agreement with a buyer, instead to conduct that market check *after* the definitive agreement is signed. In effect, the target takes its signed deal to the market for a predetermined period, using the buyer as a stalking horse. While the legality of go-shops have not been challenged to date, they represent an interesting response to recent Delaware case law and the changing market environment.

Break-up fees

In public company acquisitions, it is common practice that a break-up fee is paid to the buyer if the deal does not close because of certain events – most frequently, if a competing offer for the target emerges from a third party, and the target terminates its agreement with the buyer to enter into the new deal. After years of evaluation and scrutiny by courts, it is commonly accepted that, in most circumstances, these break-up fees will be enforceable if they are in the range of 2-3 percent of the total transaction value.

Again, however, given the leverage that sellers have recently enjoyed, increasing numbers of targets have successfully negotiated the inclusion of a 'reverse break-up fee' payable to the target if a deal does not close. Initially, these fees applied only to terminations caused by the buyer's failure to procure financing; however, they have since been broadened to include other termination events as well.

Indeed, in 2008 a remarkable trend has occurred. Of the seven largest private equity deals announced in the first two months of 2008, none provide for the remedy of specific performance. Instead, in these transactions the reverse break-up fee is the sole remedy of an aggrieved seller. In these circumstances, it can be argued that the purchase agreement effectively becomes an option, with the reverse break-up fee being the cost of that option.

Purchase price adjustments

The effects of a choppy market can be mitigated through purchase price adjustments. A common example is a net working capital adjustment, which adjusts the final purchase price to be paid up or down depending on the target's net working capital as of the closing date.

However, given the current economic environment – and in particular, the marked weakness of the US dollar in world markets – purchase price adjustments may be used to mitigate other risks, such as foreign exchange risk. A US target, for instance, could insist on a purchase price adjustment to protect it from further devaluation in the dollar after an acquisition agreement is signed. Typically, these adjustments are not infinite, meaning that there is some 'collar' after which no further adjustment is made; however, they can provide additional protection to parties in an uncertain market.

In sum, while the above provisions of acquisition agreements have always been important, their importance has been renewed and invigorated by the uncertain market conditions that M&A players must navigate. Careful drafting and negotiation of these and other provisions can ensure that companies protect against these risks to the extent practical.

Marc C. D'Annunzio and Wayne N. Bradley are partners at McKenna Long & Aldridge LLP.

Effective earn-out provisions in sale & purchase agreements

BY MURRAY LANDIS AND GREGG MCCONNELL

Earn-out provisions are a powerful tool when determining the purchase price in the sale of a business or company. A successfully negotiated earn-out provision will help to bridge the expectations gap between the positions of the buyer and seller and link the purchase price to the future performance of the business. An earn-out can be linked to any number of business performance indicators or measures (including EBIT, sales and total revenue). Where an earn-out is linked to the earnings of a business more difficult considerations arise in relation to determining the net profit which is more likely to be negatively impacted by factors within the control of the buyer.

There are many reasons for the parties to include an earn-out in a sale and purchase agreement (SPA). These reasons include: (i) creating an incentive for the seller to remain involved in the business for a period following the sale; (ii) creating an incentive for the seller to ensure transitional arrangements, including maintenance of existing customer and supplier relationships, occur with minimal disruption; (iii) reducing the risk exposure of the buyer should the business not meet the required performance indicators or measures; and (iv) increasing the benefit to the seller should the business achieve or exceed required performance indicators or measures.

Certainty of the earn-out measure

An essential element of an effective earn-out is that it, and the manner in which it is calculated, is sufficiently objective to provide a certain outcome for both parties.

The SPA should specify: (i) the mechanism, defined with sufficient detail (for example, an earn-out measure based on a multiple of EBIT should define EBIT to avoid dispute); (ii) any inclusions and/or exclusions from the calculation which are unusual (for example the treatment of non recurrent or extraordinary items). The seller may argue that certain expenditures associated with long term planning by the buyer should be excluded from the calculation of EBIT; (iii) whether and if so how separate management accounts for the business sold should be prepared to properly reflect its performance if the buyer acquires other businesses or integrates the business acquired into wider operations; and (iv) the procedure for calculating and verifying the earn-out measure, including the dispute resolution procedure.

Parties often find it useful to annex to the SPA an example calculation of the earn-out measure. In addition to assisting in the subsequent interpretation of the earn-out provision, annexing an example calculation causes the parties to give due consideration to the earn-out procedure prior to execution of the SPA, thereby minimising the potential for a dispute.

Balancing the interests of seller and buyer

A common problem facing a seller in

cases where the parties have agreed to a component of the purchase price comprising an earn-out payment is that the seller is likely to have no or limited control over the operations of the business following the sale. As such, the seller will not be in a position to maximise the earn-out by controlling or influencing the performance of the business. For this reason, a seller should ensure that the SPA provides it with appropriate protections for the earn-out.

Typical protections take the following forms: (i) the seller or its nominee taking a position on the board of the company and/or continuing as a key manager; (ii) the buyer agrees to conduct the business in accordance with a business plan (which should be annexed to the SPA) at the time of sale; and (iii) agreement on a list of decisions that must be approved by the seller before they are made by the buyer (for example, a change in the focus of the business or an acquisition or divestment of a major asset or investment).

The seller's desire for protection of the earn-out is, in most cases, in conflict with the buyer's desire to control the business it has acquired. Although both parties may be motivated to maximise the performance of the business after sale, the buyer is in the better position to avoid paying the seller what he expects if the calculation of the earn-out is not adequately documented. In practice, negotiating the terms of an earn-out is a balance of the inherent risk tension between a buyer and a seller.

Commonly the fixed sale price will be lower where there is no earn-out mechanism. Removing the risk of the upside or downside also removes the cost/reward. In some cases the opposite can be true (for example a business sold with rising performance expectations or in a hot market).

Earn-out provisions like other post completion adjustments are one of the more common areas for dispute between buyers and sellers and appropriate dispute resolution mechanisms should always be included in the sale agreement to deal with these.

Murray Landis is a partner and Greg McConnell is a senior associate at Middletons.

Risk allocation – driving force behind the M&A process

BY WALT LEMANSKI

Although the purchase and sale of a business is a complex process driven by many different, and often competing, concerns of the buyer and seller, one of the most important functions of the M&A process is to allocate the risks inherent in any M&A transaction between the transaction parties. Depending on the structure of the transaction in question and the circumstances surrounding it, M&A practitioners have access to a number of different tools to assist the parties in risk allocation. Once specific risks have been identified, creative combinations of these tools can often be used to bypass negotiation deadlocks and create a risk allocation structure that permits the deal to go forward in a manner acceptable to all parties.

In order to properly allocate risks, the parties, in particular the buyer, must have a common and detailed understanding of the various legal, financial and business risks affecting the M&A transaction. The primary source of this information is usually the buyer's due diligence of the seller. Other important sources are often the buyer's knowledge of the seller's industry and the associated legal and financial environments. Once risks are identified, each party must evaluate the potential exposure inherent in each identified risk and the impact of that exposure on the overall value of the M&A transaction from the point of view of that party. Risks can then be allocated among the parties using the tools described in this article.

The first, and most obvious, tool for allocating risk is the purchase price itself. In the ideal world, the purchase price agreed upon by the parties would take into account all known risks associated with the proposed transaction and the quantifiable exposure associated with those risks. Certain types of unquantifiable exposure can also be allocated by making some portion of the purchase price contingent on the occurrence of certain events. Contingent price mechanisms (often referred to as 'earn-outs') are usually used to allocate business and financial risk and are often tied to the target's quarterly or annual financial results (e.g., earnings, revenues, etc.) for some period following the closing of the transaction. Often, the additional purchase price paid in connection with an earn-out is calculated using a formula based on the specific performance measures with a minimum level of performance required for any payment and an overall cap on the total payment amount. Earn-outs can also be tied to specific business goals such as the retention of certain employees or customers or meeting production targets during a defined period. In truth, an earn-out can be tied to any risk factor associated with the target business as long as the results on which it is based can be adequately defined and verified.

Another effective pricing tool is the post-closing purchase price adjustment. These adjustments are used to increase or decrease the purchase price (via a 'true up' payment from one party to another) at some point after the closing of the M&A transaction in order to allocate risk associated with one or more matters, usually financial, that affect the value of the target and cannot be precisely determined prior to closing. Frequent uses include adjustment for unexpected changes in the current assets and/or liabilities of the target (often referred to as a 'working capital adjustment'), valuation of inventory or even the costs associated with certain events expected to occur after the closing, such as settlement of litigation.

While in theory adjustment of the purchase price would seem to be the ideal way of handling risk allocation in an M&A transaction, in practice many factors affect this tool's utility. First, the purchase price is often agreed upon early in the process (often in a letter of intent) when a significant part of the information necessary to determine risk is not yet available to the buyer and, in some cases, may not even be known by the seller. Once this information becomes available, sellers are usually reluctant to accept any reduction in the agreed upon purchase price. Also, many risks may not be known at the time of the closing or the potential exposure may not be quantifiable in a way that lends itself to a pre-closing purchase price adjustment. Even contingent price mechanisms and post-closing purchase price adjustments are inherently limited in the types of risks they can effectively allocate, and can be very difficult to implement in public company acquisitions. As a result, practitioners often need to look to other risk allocation tools.

Risk can also be allocated through the legal structure of the M&A transaction. Whether a transaction is structured as an equity or asset acquisition, merger or some type of hybrid will, as a matter of law, affect whether the buyer acquires or the seller retains a number of risks. Asset acquisitions generally favour the buyer with regard to most risks while equity acquisitions are usually more favourable to the seller. To a large extent, risk allocation in mergers is defined by the applicable state statute. While in many circumstances the structure of an M&A transaction may be predetermined by overriding factors such as tax, regulatory or contractual considerations, the parties should nonetheless be mindful of the risk allocation effect of the deal structure and, where possible, adjust the structure to meet risk allocation considerations. Even where the overarching structure is predetermined, it may be possible to take advantage of a multi-step or hybrid transaction to allocate specific risks. As an example, it may be possible to assign certain assets or liabilities (and thereby allocate the attendant risks) to a subsidiary of the target and subsequently spin off the subsidiary or distribute the assets and/or liabilities directly to the target's owner.

If a risk cannot be allocated through either a purchase price or structural tool, there are also a number of contractual tools available. To the extent that allocation of a risk requires one or more parties to perform certain actions after the closing of the transaction, the transaction documents should contain covenants specifying the actions to be taken and the associated timeline for compliance. Allocation of unknown or general risks and confirmation of actions required to be performed prior to closing can normally be accomplished through appropriately devised representations and warranties. To be most effective, representations and warranties should not be generic but should be tailored to the applicable industry, regulatory and financial environment and specifics of the target identified through buyer due diligence.

Contractual representations, warranties and covenants allocate risk by providing a contractual remedy to the injured party. While a breach of contract claim is one way to enforce this remedy, a far more common approach in M&A transactions is for the parties to provide indemnification in the event of a breach. The indemnification tool is very flexible and can be tailored to further allocate transaction risk. The intent of indemnification is to make a party whole for damages suffered in connection with the occurrence of a risk it did not assume. However, indemnification is generally subject to limitations on the minimum amount of damages required to make a claim (usually referred to as a 'deductible' or a 'basket' depending on its structure), the maximum liability of the paying party in connection with the transaction or, less commonly, each claim (usually referred to as a 'cap'), and the period of time after the closing during which indemnification claims can be made (usually referred to as the 'survival period'). The values of the deductible or basket, cap and the length of the survival period have an important effect on the overall allocation of risk between the parties and are usually the subject of heavy negotiation. Allocation of specific risks can be tailored with an individual deductible, basket, cap and/or survival period or by agreement that indemnification relating to a specific matter will not be subject to any limitation at all. In addition, special indemnification mechanics can be created for known risks to handle a claim in a way tailored to a party's exposure to the specific risk. For example, a special indemnification provision relating to an ongoing litigation matter of the target might provide that the seller will indemnify the buyer for 100 percent of the costs to the buyer of such litigation up to a fixed amount after which the buyer will be liable for 50 percent of any further costs. While certain studies suggest, and some practitioners will assert, that certain combinations of indemnification terms and limitations are 'market' for particular transactions, parties should resist relying on such a crutch and carefully consider indemnification terms in the context of the desired overall risk allocation.

As a practical matter, contractual indemnification or similar remedies are only as valuable as the ability of the obligated party to pay. In transactions where the obligated party will have deep pockets after the closing, satisfaction of a claim is not usually a problem. In situations where a party's ability to pay is less certain, various mechanics are available to protect the interests of the other parties including purchase price holdbacks (which provide a source of remedy for a buyer) or escrows (which can be used to protect a buyer or, less commonly, a seller). Terms for the release of funds from either of these payment mechanisms are also very flexible and can be tailored to fit into the overall transaction risk allocation.

Risk allocation in an M&A transaction is one of the driving forces behind the M&A process. Many tools are available to the practitioner to allocate transaction related risk between the parties. The key is to consider all of the tools available and to carefully tailor them in the context of the entire transaction to achieve the desired result.

Walt Lemanski is a partner and co-chair of the Securities and M&A practice at Patton Boggs LLP.

Directors' duties in M&A transactions

BY SHARDUL S. SHROFF

The Indian Companies Act is modelled on the Companies Act, 1948 of England. The directors of a company, as natural persons, are entrusted duties, functions and obligations to be discharged for the benefit of the company and its shareholders. A director in modern company law has duties of a fiduciary to the shareholders, but in times of adversity or impending insolvency, they have an obligation to act fairly and protect the interest of the secured creditors also. As directors, they have the duty to exercise reasonable skill and diligence expected of an ordinary person, in the carriage of the duties and functions owed to the company, other directors and shareholders.

In an M&A transaction, which concerns either a sale of shares, or a sale of undertaking or a takeover bid, or a related party transaction or stock options in the course of the M&A as consideration for directors, the duty of fairness, good faith and honesty is paramount. Indian law recognises that it is not merely pecuniary interest which determines the contours of conflicts of interest. Any angularity or skew brought to bear on matters of interest whether of a pecuniary nature or of relationships are also abhorrent. The directors have a duty to disclose their interest, the degree of relationships and their financial shareholding and stake in the company and in any transaction or transfer.

Under Indian law, any corporate transaction involving the sale or transfer of the whole or part of an undertaking of the company requires an ordinary resolution of the shareholders in general meeting. The law mandates that a complete disclosure is made in the Explanatory Statement accompanying the Notice for the meeting convened for approval of the proposed transfer. This position also inures in relation to a Scheme of Amalgamation, demerger, slump sale or exchange through courts or otherwise or when the undertaking is sold as a going concern. In the absence of full and fair disclosure in the Explanatory Statement indicating all nature of interest of the directors, an aggrieved shareholder could petition the company court or the Company Law Board (expected to be converted to a Company Law Tribunal) for action to set aside the decision and sue directors for misfeasance, malfeasance or nonfeasance, as the case may be.

Indian law does not recognise that a shareholder is conflicted in casting his vote in support of a corporate decision carried out through a vote. Thus though directors may be entrusted with a fiduciary duty and obligations of fairness, honesty and good faith, a shareholder can vote in its own interest.

The law recognises that a director with an interest has to recluse himself from the process of decision making at the level of the board or any committee of the board. This also holds true when takeover of management and control in a listed company is attempted and there are common directors of the transferor and transferee entities.

For independence in decision making, especially in listed company, a listing agreement has prescribed functions to be undertaken by an independent committee of directors or audit committee. Matters of valuation, post-merger concentration of promoter control, augmentation of such control, unfair treatment to minority are all matters to be considered by the audit committee. The independent directors have a duty to advise members of the public selling shares in a takeover offer between competing parties, of the merits or demerits of each proposal.

Insider trading and tipping of price sensitive information

There are significant issues of concern for a board of directors of a listed company, which is proposing to engage in mergers or acquisitions. At the preparatory stage, any information of a listed company, which is not in the public domain, and which has the effect of facilitating price discovery, could constitute insider information. The matters of business planning, pipeline discoveries in pharma companies, confidential information on risk management are not matters of public disclosure.

The directors of a company that is involved in an M&A transaction owe a duty to curb insider trading and should ensure that there is no abuse of inside information for any purpose not in the interest of the company and its shareholders. Further, it flows from the fiduciary nature of the obligations that a director should not exploit corporate opportunities for his own use. Therefore, directors cannot use price sensitive information for their own benefit, nor can they tip such information to an outsider. Any abuse of inside information by a director would invite liability under Securities Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992.

One of the ways around the sensitivities of sale of shares or a controlling interest is to offer the same amount of information to qualified bidders who passed the financial and technical tests for a relevant buyer of majority control in a listed company, but that is not a universal solution.

Requirements under the takeover code

In case of takeover or acquisition of a listed company, SEBI (Acquisition of Shares & Takeovers) Regulation, 1997 – or Code – lays down mandatory provisions governing the role and responsibility of directors of the target and acquirer company. For instance, in relation to the directors of a target company, the Code lays down that, from the date of public announcement of the offer, directors shall not enter into any material contract; shall ensure that a director who is also a director of an acquirer company does not participate in any matters in relation to the takeover; shall send their unbiased comments and recommendations on the offer to the shareholders, keeping in mind the fiduciary responsibility of the directors to the shareholders and for the purpose of seeking the opinion of an independent merchant banker or a committee of independent directors.

The Code also lists out the role and responsibility of the directors of the acquirer company. Though the Code does not expressly detail the responsibility of a director of an acquirer company, it does expressly lays down the role of an acquirer and a person acting in concert (defined to include directors of the acquirer company). The responsibility of a director in the instant case includes director responsibility statement in relation to all offers, brochures, circular, advertisement in relation to the offers; in the event the director of acquirer company is a director on the board of the target company, abstention from participation in any matters concerning the offer including preparatory steps leading to the offer; ensuring that firm financial arrangements have been made for fulfilling the obligations under the public offer and suitable disclosure in this regard.

Possible defences to a takeover

The duties of independent directors and interested directors in the case of a hostile bid differ. A director nominated or appointed with the support of the promoters, even without any shareholding, can work in tandem with an interested shareholder for developing defences such as poison pills, selling the crown jewels, golden parachutes and the white knight defence.

Conclusion

In India, the duties of directors in relation to M&A can be traced to the various provisions of the Companies Act, Code and judicial pronouncements. Though the present legal framework seems robust in relation to role and responsibility of directors in M&A transactions, law in India does require an in-depth scrutiny. For instance, directors' responsibilities are covered under various sections of the Companies Act; however, upon examination it is evident that all are mostly in the nature of activities that directors are required to perform merely to comply with the law. Clearly, there is absence of requirements which obligate directors to undertake affirmative action. This is in stark contrast to the recent amendment to the UK Companies Act, 1985 wherein directors have been given a positive duty to promote the success of the company, exercise independent judgement, exercise reasonable care, skill and diligence, avoid conflicts of interest, not accept benefits from third parties, etc. Further, in order to fortify the enforcement of law to ensure compliance of the new set of duties, it has been made easy for shareholders in the UK to sue directors on behalf of the company for a much wider range of deeds than are presently possible under common law. Similarly, unlike the UK Takeover Code, India's Code does not detail at length the precise role of directors through every stage of the transaction i.e., from inception, to execution and finally through integration. Even on the judicial front it is seldom argued that the common law principles of fiduciary duty and care are inadequate as they do not clearly lay down the scope, level and the ambit of such fiduciary duty and care.

Given that the Indian economy is one of the fastest growing economies in the world and in light of the increasing spate of M&A transactions in recent years, it is desirable to reconsider the present legal framework to ensure that the duties of directors involved in an M&A transaction are enunciated clearly and the risks associated with directorship are adequately appreciated.

Shardul S. Shroff is a partner at Amarchand & Mangaldas & Suresh A Shroff & Co.

M&A – an insurable risk?

BY SUSANNA NORELID AND CHRISTER A. HOLM

Despite the risks associated with M&A, the number of deals is increasing. The upturn in M&A activity has led to increased competition and higher prices on the market. Due diligence investigations made prior to the presentation of final bids increase costs for bidders who may not complete a deal. Due to the high competition, sellers are sometimes able to give away few or no warranties, which also increases the risks.

But is it possible to minimise financial risk? Is it possible to pass on that risk to an insurer? Is there an appropriate M&A-risk insurance product already available on the market – or is it an expensive, tailor-made solution only available at an unacceptably high premium?

The market for M&A insurance

The term 'M&A insurance' is not the formal name for a particular insurance product. Instead the term could be used as a name for an insurance covering several different parts of a transaction. Insurance can be agreed to cover all or some exposures and risks that arise in the context of an M&A transaction. It may include the seller's representations and warranties concerning the corporate, environmental liabilities, accrued balance-sheet liabilities and failure of tax treatment of the transaction. It could also cover certain guarantees regarding a minimum of income of a merger, or to cover the costs of a transaction which later fails.

Insurance could be useful both on the seller-side and the buyer-side of a prospective transaction. The premium cost could either be taken by one of the parties, or split between both parties. The fact that insurance is obtained could also simplify the process – questions might be settled easier and the parties could reach a closing more quickly.

Some years ago, M&A insurance was rare, at least in the Scandinavian market. Today the market has changed, due to the entrance of many foreign insurance companies on the Scandinavian insurance market, the increased competition between those companies, and of course due to the increased number of transactions. Insurance covering some or all parts of a transaction are increasingly popular.

However, it all comes with a price, and it is up to the parties to the insurance contract to agree upon the terms and conditions for specific insurance coverage. Furthermore, M&A insurance is not always trouble-free.

Different kinds of M&A insurance

Representation and warranty insurance (RWI) is the most common type of insurance associated with M&A. The buyer might need coverage in case the seller does not provide any warranties, or fewer warranties than desired. It is also useful when a buyer is uncertain about how to reinforce an indemnity. On the seller-side, RWI could be used to compensate a buyer that is claiming reimbursement for an inaccuracy in the warranties and indemnities made by the seller. This could be helpful when the seller needs to free itself of any claims for a period after a transaction, or when the seller needs the profit from a transaction to pay a debt. At the moment, buyers' RWI is dominant in the market.

In numerous transactions, tax treatment is a deciding factor in whether a deal is closed or not. Disputes concerning the responsibility of post-transaction tax liability risks can be avoided with appropriate insurance. Tax insurance could also cover unforeseen additional taxes owed after the transaction has completed.

Environmental liability issues can also get in the way of completing a deal. Insurance can cover situations where the cost of future cleanup procedures has not yet been estimated, or when the buyer does not want to be liable for pollution caused by a former owner.

Less common is credit enhancement insurance. This insurance guarantees a certain minimum income as a result of an acquisition. The insurance might cover situations in which a buyer's forecasted income does not materialise, which is practical when there is a need for a security to loan money.

Furthermore, so-called 'aborted bid' insurance is available, intended to cover the costs of corporate transactions which fail. Finally, there is also director and officer's liability insurance, frequently used to cover claims made against the directors of a company about the management of the corporate transaction.

The advantages of M&A insurance

The use of M&A insurance provides a possibility to pass on the risk of an M&A transaction to an insurer, allowing the parties to walk away after an agreement closes with no further entanglements. The seller has the possibility of a simple exit, and the buyer does not have to be concerned about potential future costs. M&A insurance also provides the security to create partner confidence, since it transfers the unpredictable liabilities to a third party. For example, a company that buys a producer of goods with a long lifetime might require M&A insurance because of the uncertainty of future liabilities.

Also, in situations where the parties are unable to agree on specific liability matters, insurance companies offer coverage targeted at facilitating the completion of the deal. Insurance companies might work as a third party setting a fixed present price on the deal, which might otherwise result in a large, unknown future cost for one of the parties.

Some negative aspects to take into consideration

Insurance is designed for a specific purpose. A provider of M&A insurance probably has a greater knowledge about transactions and consequently of this special insurance product than a traditional insurance provider. Since not all insurance companies offer this product, competition is not particularly high, which means premiums tend to be quite high.

Another negative aspect is that the insurance company might ask for a significant amount of information about the parties and the transaction before it can issue the insurance. Sometimes the parties would prefer to keep this information confidential.

M&A insurance demands that employees of the insurance companies have knowledge of the policyholder's business, and since M&A insurance is relatively new, this is quite rare. An inexperienced insurer will need quite some time to underwrite this type of risk, so the underwriting process might be time consuming and even delay the deal.

A further difficulty is the possibility of misusing the insurance. It may be exercised as a tool for manipulating and strengthening the policyholder's balance sheet, resulting in misrepresentation of the corporation's financial condition. Naturally this would not be appreciated by the investors and creditors.

Moreover, M&A insurance does not cover all losses from a merger or acquisition, but only those explicitly stated in the policy. Therefore it could be difficult to foresee all the situations that need to be insured, and to interpret the insurance agreement in the event of a dispute.

A buyer that has covered the risks with M&A insurance might also be concerned about the implied uncertainty surrounding the target, although this issue should decrease as M&A insurance becomes more widely accepted and dispersed.

Conclusion

The future of M&A insurance depends on many factors, such as premiums, one party's willingness to rely on warrants given by the other party, or the general trends of the M&A market. Problems associated with this insurance are likely to lessen as the coverage becomes more frequently underwritten, and insurance companies develop better knowledge about the market and are able to estimate the actual risks. Moreover, the high premiums should be viewed in light of the high risk that M&A transactions entail.

Susanna Norelid and Christer A. Holm are partners at Advokatfirman NorelidHolm.

Exploring the potential of joint ventures to create value as opposed to outright M&A

BY CHRISTOPH REIMNITZ

Whichever way you look at it, 2007 was a record year for M&A activity. While transactions tailed off towards the end of the year, sponsor and institutional acquisitions still reached unparalleled heights – with nearly $5 trillion worth of M&A deals announced, almost a trillion more than 2006. That is a huge level of investment by anyone's standards.

However, the outlook for 2008 paints a very different picture. M&A activity is already noticeably subdued by comparison to last year. While LBO deals are still taking place, the current market conditions are challenging, forcing sponsors and institutions to compete for a smaller pool of opportunities. Finding market depth for larger sponsor buyouts will be harder, paving the way for strategic M&A and – as an increasingly effective way of creating value – strategic alliances, partnerships and joint ventures.

The case for joint ventures

Like acquisitions, significant investment in planning, strategy and due diligence is required to maximise the chance of a successful joint venture alliance. There are many areas for consideration. The goal for a potential JV, such as business expansion, access to new distribution channels, new product development, technology sharing or entering new geographies, must stay at the forefront of the management team's mind throughout the whole start-up process. While joint ventures can be a cost-effective route to creating significant additional value for a business, particularly when compared to cost of M&A, they are not entirely cost or risk free. Entering a JV is a major business decision. This point is as critical as avoiding irrational exuberance when making acquisitions.

Businesses of all sizes can use JVs as a tool to create long-term relationships or deliver on short-term projects. Without exception, successful JVs make strategic business sense for all parties. Partnering with another business, whatever the size, can be time consuming and complex. It is important to have a complementary set of requirements, shared objectives and shared benefits. However, while it may seem counter-intuitive, it is as important to have clear ideas about the resolution and potential exit of the JV as the framework for a partnership is being created.

Partnership should be built on shared objectives and outcomes, while being similarly complementary to both parties. For example, a company may seek to widen its distribution channels in an overseas market by partnering with a strong and well-respected local company that is looking to expand its range of products. A successful joint venture could allow the company to grow strategically and cost effectively, increase its market penetration, grow the client base and build its reputation in a new market. At the same time, the local company may increase customer retention, gain new customers, generate increased profits from a new revenue stream, widen its product offering and have a joint stake in a growing product or area. Such criteria must be spelled out at the beginning of a relationship so that each party is comfortable and confident of the outcome. Fair sharing of the success, and risk, is essential to a joint venture.

Where parties have a common goal, a shared appetite for partnership with complementary capabilities and resources, this could be a promising starting point for JV discussions.

Joint ventures do not always have to be a 50:50 partnership or a typical JV format. Seeking a minority investment in an organisation, to create a mutually beneficial relationship, may also enable a business to achieve its objectives. For example, an established company from a mature market may take a minority stake in an emerging market company. This gives it a significant presence in a new and growing geography, while the strategic direction and decision-making processes in the business continue to be led by the local management team, which has proven market knowledge. Both parties can share expertise and best practice, while being open for joint investments in new product development, market entry and business growth. This is a win-win for both parties, as long as clearly defined benefits and risks are agreed at the outset.

How a JV is structured and approached is critical to success. Business cooperation in a limited and specific way can be an effective method for a small company with a new, unique product for example, that wants to sell via a larger partner's distribution network. In other circumstances, a separate JV business may be set up or even a new company formed where the partners own shares in the company and confirm how it should be managed.

Again, agreeing the structure, strategy, leadership, business plan and management of the JV with legally-binding commitment from both parties, maximises the effectiveness and success of the partnership. Transparency and trust are essential ingredients of a good marriage. While benefits must be agreed in advance, so too must the risks. It is important to outline the key performance indicators for the JV and set a clear process for dissolving the partnership, with defined roles and financial responsibilities, if results do not meet the JV performance criteria. Establishing these parameters in advance not only gives comfort to all parties, but also avoids potential confusion and unfair cost at the conclusion.

Stay strategic

As with all business ventures, success is in the planning. Companies should explore all opportunities to evaluate the risk versus benefits before making a commitment. Joint ventures are not a cure all, nor do they work in all circumstances. As discussed earlier, where parties have a common goal, a shared appetite for partnership with complementary capabilities and resources, this could be a promising starting point for JV discussions. Given the cost of customer acquisition and customer retention, or launching into a new market or geography, JVs or white-label initiatives can provide a cost-effective solution.

M&A and JV opportunities are an important method of supporting business growth. They can allow a company to do business with more customers and increase its penetration in the market to achieve core business growth. With economic conditions likely to remain challenging in 2008, JVs could create new growth opportunities for many businesses – as long as they stay strategic.

Christoph Reimnitz is head of business development for the European corporate finance unit of GE Commercial Finance.

CHAPTER SIX:

Accounting and financial challenges

Valuing assets in M&A under IFRS 3

BY PHIL ANTOON

Paramount to many acquisitions is the reaction shareholders, and the markets in general, have to the announcement of a transaction and the corresponding movement in the buyer's stock price. In previous years the focus was typically placed on the implied transaction multiple and the earnings per share effect. However, the implementation of International Financial Reporting Standard (IFRS) 3 has significantly increased the complexity of the projected earnings per share calculation due to the requirement to value and amortise acquired intangible and tangible assets. The following summarises IFRS 3 and outlines the various types of identifiable intangible assets and valuation methodologies. It also discusses how companies are reacting to IFRS 3, and the effect this standard can have on the acquisition decision making process.

IFRS 3 addresses financial reporting requirements pursuant to a business combination. Very similar to SFAS 141, the US GAAP standard addressing business combinations, IFRS 3, among other things: (i) requires that all business combinations be accounted for through the purchase method; (ii) prohibits the amortisation of goodwill acquired in a business combination and instead requires the goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with IAS 36 *Impairment of Assets*; (iii) requires that the company obtaining control be identified as the acquirer; (iv) specifies that the acquirer must measure the cost of a business combination as the aggregate of the fair values of the assets acquired, the liabilities assumed or incurred, any costs attributable to the combination, and equity instruments issued by the acquirer; (v) specifies that the acquirer must recognise the acquired company's identifiable assets, liabilities, and contingent liabilities, regardless of whether they had been previously recognised in the acquired company's financial statements; (vi) requires that the identifiable assets, liabilities, and contingent liabilities must be measured initially by the acquirer at their fair values at the acquisition date.

For many companies intangible assets comprise the majority of the firm's value. A quick comparison of the market capitalisation of a company based on the stock price value relative to the net tangible book value (tangible assets less liabilities) provides insight into the proportion of the value inherent in intangible assets. While many simply refer to this intangible asset value as 'goodwill', there are in fact any number of individual, identifiable intangible assets included in the 'goodwill' bucket.

Intangible assets that are commonly found in companies, depending on the nature of the operations and industry in which the company operates, may include: patented and unpatented technology; trademarks and trade names; trade secrets; customer relationships; proprietary know-how; software; regulatory rights; in-process research and development; non-compete agreements; databases; core deposits; mortgage servicing rights; copyrights; film, music libraries; licensing and royalty agreements; communications licenses; reserves; backlog; contracts; and leasehold Interests.

There are three generally accepted methodologies to estimate the value of intangible assets: the income approach, the market approach and the cost approach.

Income approach. This is typically the most applicable approach when valuing income-producing intangible assets, as value is measured by calculating the present value of future economic benefits to be derived by the asset. The two most frequently used variations of the income approach are the excess cash flow method and the royalty savings (or relief from royalty) approach.

The principle behind the excess cash flow method is that the fair value of an income-generating intangible asset is measured by the present value of its projected future cash flows, over its remaining useful life. To estimate excess cash flows, revenues attributable to the intangible asset are first projected over the remaining useful life of the asset. Next, expected costs, including cost of sales, operating expenses and income taxes, are deducted from projected revenues to arrive at after-tax cash flows. From after-tax cash flows, depreciation is added back and after-tax contributory charges (for the use of tangible and other intangible assets) are deducted to arrive at the excess cash flows specifically attributable to the intangible asset. These excess cash flows are then discounted to the present and summed to arrive at the fair value of the intangible asset.

Under the royalty savings (or relief from royalty) method, the value of an asset is reflected in the present value of after-tax royalties the owner of the asset avoids paying by owning the asset and not having to licence it from a third party.

Market approach. This measures the value of an asset through an analysis of recent sales or offerings of comparable assets. Sales and offering prices are adjusted for differences in location, time of sale, utility and the terms and conditions of sale between the asset being valued and the comparable assets. Due to the general lack of publicly available sale or transaction data regarding individual intangible assets (with the exception of communication licences, where auctions in Europe and individual licence sales and swaps in the US do provide some market data), a market approach is often not applicable in valuing intangible assets.

Cost approach. This measures the value of an intangible asset by the cost to replace it with another of like utility. The cost approach recognises that a prudent investor would not ordinarily pay more for an asset than the cost to replace it new. The cost approach is often most applicable when valuing intangible assets that are not income-generating, (e.g., internally developed software that is used for internal purposes and databases). For income-generating intangible assets, the cost approach is often not utilised because even if the development effort associated with the asset was distinguishable, the cost approach tends to understate the true value since the costs involved in developing the asset are typically not commensurate with the cash flow it may generate for the business.

The implementation of IFRS 3 can have a dramatic impact on how companies execute their acquisition process, as well as affect day-to-day operations, even post merger. Thus, all companies planning acquisitions should take steps to ensure they are well versed in the requirements and implementation of IFRS 3, as it will consume resources on a variety of levels. The acquirer's management must be able to articulate in the announcement of the transaction what the deal drivers are, with the understanding there will be an expectation from the auditors and regulatory authorities that those drivers (e.g., strong brand name, customer relationship) will be identified and valued as part of the IFRS 3 analysis. The group tasked with implementing the IFRS 3 accounting will likely need to identify and engage an independent valuation firm specialising in IFRS 3 valuation analyses (a company's auditors are precluded from providing this service to their audit clients due to independence restrictions), and they will spend significant amount of time complying with the required financial reporting. A number of individuals across the firm will likely be asked to participate in discussions with the valuation expert to better understand the nature, background, outlook, and specific details of the various intangible assets, all at a time when many resources are focused on their day-to-day tasks as along with the post merger integration. These are but a few of the strains that will be placed on the acquirer's resources and which should be considered in advance.

For companies that are sensitive to any potential negative movements in earnings per share (EPS), IFRS 3 can also have a significant impact on the decision to execute a transaction. This is simply because the requirement to identify, value and amortise intangible assets over their respective remaining useful lives (not to mention depreciate tangible assets) has a direct affect on the EPS of the deal. An acquisition that is EPS accretive – before consideration of intangible asset amortisation – could in fact become EPS dilutive once the amortisation is accounted for. Some companies may actually decide not to move forward with the transaction to avoid dilution to their EPS.

While the accounting treatment is required and thus avoidance of valuing and amortising assets is not possible, many companies will have an analysis conducted *prior* to the announcement and/or the close of the transaction in order to ensure that the markets are well aware of the potential EPS effect of the deal, including all intangible and tangible assets. While in many cases a full IFRS 3 valuation may not be practical on a pre-acquisition due to lack of available access to information, confidentiality, etc., it is possible to conduct a high level analysis. Although this approach will not allow for a formal opinion of the values of the identifiable assets of the target, it can provide important information regarding the potential range of EPS effects inclusive of the tangible and intangible assets.

Regardless of the size or complexity of a transaction, companies should ensure – early on in the acquisition process – that they have a firm understanding of the technical accounting requirements of IFRS 3, and that they have allocated appropriate resources, engaged an independent firm to execute the valuation, and can clearly and readily articulate the value drivers of the acquisition and relate those drivers to the IFRS 3 valuation and EPS effect.

Phil Antoon is global practice leader of the Valuation Services Practice at Kroll.

Growing influence of IFRS in M&A: why dealmakers should care

BY DENISE CUTRONE, RICHARD FUCHS AND WILL BRYAN

You are the CFO of a US company and are managing the divestiture of a profitable overseas operation. After months of due diligence, your prospective buyer backs out, citing that the acquisition would be dilutive to its earnings. How can that be? Your US GAAP (Generally Accepted Accounting Principles) carve-out financial statements show that the overseas division is profitable. As you investigate the situation, you find that the prospective buyer reports under International Financial Reporting Standards (IFRS). At present, you do not have the time, infrastructure or knowledge in place to understand how a set of accounting standards brought down a multi-million dollar deal.

With IFRS now in use in over 100 countries and the increasing globalisation of markets, the likelihood that US GAAP and IFRS will come face-to-face in M&A is real. Although accounting standards alone do not frequently dictate business decisions, they can be a key aspect of a prospective buyer's list of considerations. By being proactive in understanding the role IFRS could play in M&A decision-making, CFOs can position themselves to be better negotiators and avoid situations like the one described above.

IFRS: the global financial reporting language

Today, more than 12,000 public companies around the world use IFRS as their primary reporting framework. With markets such as Canada, South Korea and China committed to adopting IFRS, eventually all major territories and capital markets will require or permit IFRS as early as 2011.

Of the top 10 global capital markets (US, Japan, UK, France, Canada, Germany, Hong Kong, Spain, Switzerland and Australia) the majority already use IFRS while Canada and Switzerland are in the process of converging to IFRS, according to the Economist Intelligence Unit.

Even in the US, which uses US GAAP, the Securities and Exchange Commission (SEC) has recently eliminated the need for foreign private issuers to reconcile to US GAAP as long as they use IFRS as issued by the International Accounting Standards Board (IASB), the international standard setter. Many believe 2008 could bring an SEC proposal allowing the use of IFRS by US public companies. The SEC's actions have increased the urgency for companies to fully understand IFRS, the differences between IFRS and US GAAP, and how IFRS impacts their M&A endeavours.

Impact on M&A activity

IFRS has introduced a new set of challenges for dealmakers. As companies expand overseas through acquisitions or appeal to a broader group of buyers for a division they are divesting, they are likely to encounter IFRS and need to assess its impact on their transactions. The target may be located in a country that already embraces IFRS and, to get the highest price, sellers need to expand their buyer pool to include those who report under IFRS. The impact of IFRS is felt throughout the M&A cycle from pre- to post-acquisition. Knowing how IFRS can potentially affect a transaction enables dealmakers to be both prepared acquirers and sellers.

Pre-deal considerations. Structuring a deal under IFRS can be quite different from that under US GAAP. For example, certain items classified as equity under US GAAP may be classified as debt under IFRS, with associated payments treated as interest rather than dividends. This can limit an acquirer's ability to meet debt covenants and, in some jurisdictions, pay dividends. Failure to examine the potential impact of this accounting in the pre-acquisition phase can jeopardise the success of a deal – particularly one that is cross-border. Financial statements under IFRS will likely be required. Early in the process, companies should assess the impact IFRS will have on transaction multiples, hurdle rates and investment benchmarks.

Diligence considerations. IFRS principles may alter the timing of revenue and expense recognition, which can affect not only the price of a deal but also reported results, key performance indicators (e.g., EBITDA), loan covenants and balance sheet ratios. Companies well-versed in IFRS will find it easier to analyse and compare sales, net income and balance sheets of targets. The ability to adequately compare transaction multiples and other key benchmarking data will lead to a more effective diligence process.

Post-deal considerations. IFRS continues to play an important role after the successful closing of a deal. Companies with overseas parents may be required to report under IFRS or maintain both IFRS and US GAAP reporting. The conversion process may require expertise in legal, risk management, treasury, sales, tax, IT, human resources and investor relations. New financial reporting principles could impact almost every aspect of a company's operations – from customer and vendor contracts and employee compensation arrangements to income tax structures. Furthermore, a change in GAAP may require new or upgraded systems and controls and, often, multi-GAAP reporting capability. Companies may need to add resources to understand IFRS. All these issues make it complicated and costly for companies to report their financial results and communicate the impact of the acquisition or divestiture to the market and their stakeholders. Therefore, having a good grasp of IFRS and the difference between it and US GAAP is essential for multinational companies.

IFRS versus US GAAP: key differences

Although a number of countries have adopted IFRS as their local GAAP, the US continues its path of convergence by the FASB (Financial Accounting Standards Board) and the IASB. Their joint efforts are to produce similar but not necessarily identical standards, addressing key weaknesses in their respective accounting frameworks. The issuance of joint standards takes an extensive amount of time. As a result, in the six years since the convergence program began, the only joint standards issued to date revolve around business combinations – the newly issued FAS 141R (FASB) and IFRS 3R (IASB).

Should the US continue with the convergence program rather than adopting IFRS, the differences between US GAAP and IFRS will likely take a number of years to eliminate. CFOs and dealmakers should familiarise themselves with some of the key differences between US GAAP and IFRS since they impact financial reporting and M&A activity.

Asset write offs. Under IFRS, impairment assessment of long-lived assets is a one-step process based on discounted cash flows where no binding sale agreement or active market exists and, under certain circumstances, previously recognised impairments are reversed. Under US GAAP, impairment analysis is a two-step process based first on undiscounted cash flows for long lived assets. Reversal of impairments is prohibited under US GAAP. Impairment charges may be recognised in different periods and for different amounts under IFRS. Combine those factors with the ability to reverse impairments and the result is greater potential earnings volatility.

Fair value accounting. Under IFRS, greater use of fair value, and certain assets such as property, plant, and equipment; intangible assets; and investment property can be carried and remeasured to fair value each period. US GAAP, in contrast, requires historical cost valuation of such assets. The implications of this are different balance sheet amounts and depreciation, and a clearer view for investors of the unrealised appreciation in certain major asset categories under IFRS.

Development costs. Under IFRS, the development portion of research and development costs is capitalised if certain criteria are met. Development costs do not hit the bottom line immediately, but rather are expensed over an estimated life, typically as the associated revenues from the development activities are earned. Under US GAAP, both research and development costs other than software development costs are generally expensed.

Liability versus equity classification. Under IFRS, classification of an instrument as equity versus a financial liability is stricter and based on the substance of the instrument, rather than on its legal form. Compound instruments generally have to be bifurcated between the liability and equity components. Under US GAAP, instruments with both liability and equity characteristics can often qualify for treatment as mezzanine equity and are not marked to fair value. The result of IFRS is an increase in interest expense and greater volatility in the income statement, and less equity on the balance sheet than under US GAAP.

Conclusion

IFRS is gaining global acceptance and it is only a matter of time before it becomes the international reporting language. The prospect of IFRS impacting transactions is real and dealmakers need to be familiar with and understand the difference between IFRS and US GAAP to make informed business decisions. Not having a full grasp of IFRS could lead to a scenario described in the opening of the article where IFRS spoiled a multi-million dollar transaction.

Denise Cutrone, Richard Fuchs and Will Bryan are partners at PricewaterhouseCoopers.

Valuation and solvency analysis in failing firm claims

BY BORIS J. STEFFEN

For firms pursuing growth through M&A, regulatory constraints imposed by the antitrust laws may pose significant barriers. This is equally true for the strategic buyer pursuing a horizontal or vertical combination, a private equity firm executing an industry roll-up, or a control-oriented purchaser of the debt, or corporate assets, of a financially distressed company, within, or outside of, a formal plan of reorganisation. In cross-border transactions, government policies that differ with respect to consumer, industrial, or trade considerations may also exacerbate the obstacle posed by the concern that a transaction may have the potential to create or enhance market power. Notwithstanding, the US Department of Justice and Federal Trade Commission's 1992 'Merger Guidelines' provide a means of potentially resolving these obstacles using the tools of solvency and valuation analysis employed under the US Bankruptcy Code within the context of what has become known under the Guidelines as the 'failing company' and 'failing division' defence.

The failing company defence argues that a merger is not likely to create or enhance market power if the company: (i) is unable to meet its financial obligations when they fall due; (ii) is unable to reorganise under Chapter 11 of the Bankruptcy Code; (iii) is unable to attract an offer at a price above liquidation value from a competitively preferable buyer; and (iv) will exit the relevant market absent the transaction. The failing division defence posits similarly that a merger is not likely to pose competitive concerns if the division: (i) has negative operating cash flow after proper allocation of costs; (ii) has been unable to attract an offer from a competitively preferable buyer at a price above liquidation value; and (iii) would exit the relevant market if not sold.

Examining the Guidelines' tests within the bankruptcy context – that a company be unable to meet its financial obligations as they fall due – is consistent with the notion of insolvency in the equity sense. Further, the requirements that the company be unable to reorganise under Chapter 11, and unable to attract an offer exceeding liquidation value, are together suggestive of insolvency in the bankruptcy sense to the extent that they imply creditors would receive more if the company were liquidated than if it were restructured and valued as a going concern. Given these analogies, one possible approach to asserting a failing company defence in support of a merger is to employ the framework used to establish a fraudulent transfer under section 548 of the Bankruptcy Code.

Under section 548, a transfer of assets, or incurrence of an obligation, for less than equivalent value, may be deemed fraudulent, if as a consequence, the debtor (i) was or became insolvent, (ii) was left with unreasonably small capital, and (iii) incurred debts it could not pay at maturity. In practice, these conditions are assessed using the balance sheet test, adequate capital test, and cash flow, or ability-to-pay test. The balance sheet test examines whether the fair value of a firm's assets exceeds the face value of its liabilities; the adequate capital test looks at whether the company's capital is adequate to support its business activities; and the cash flow test asks if the firm can expect to pay its debts as they mature.

When adapting the balance sheet test to a failing company claim, a firm's balance sheet is only the starting point for the analysis as historical financial statements do not reflect fair market values, and may not include all assets and liabilities properly considered in determining solvency. Beyond this recognition, the first step is to determine an appropriate premise of value, whether going concern or liquidation. Generally, 'fair value' as used in the balance sheet test is interpreted to mean fair market value, and indicative of a going concern premise. For an inoperative company facing imminent demise, the liquidation premise may be relevant, however. The essential structural difference is that the going concern premise assumes the sale of an organised, functioning, interactive group of income-producing assets over a reasonable time period, while the liquidation premise assumes the debtor's assets are sold in a piecemeal fashion, either in an orderly or forced manner.

The valuation date selected in applying the balance sheet test to a failing firm should take into account as appropriate and feasible the circumstances of the failure. Changes in macroeconomic, firm-specific and industry conditions can alter the value of a company over time. Further, as in any business valuation, a valuation for solvency purposes should only consider data and information known or knowable as of a specific date. Consequently, the valuation date directly impacts what data and information can be relied on, as well as the related assumptions.

In performing the balance sheet test, the value of a company's liabilities is taken directly from the undiscounted face value of its debt, in recognition that insolvency would never occur if a company's debts were valued at market. In contrast, the fair market value of a company's assets is determined from the present value of its expected future cash flows, using either an income (discounted cash flow, capitalisation), market (comparable company or transaction), or cost (replacement, reproduction) approach. If the face value of the company's debts exceeds the fair market value of its assets, the company is deemed insolvent.

With respect to the ability-to-pay requirement of the failing company defence, a company will likely be able to pay its debts as they mature under the cash flow test if its capital is sufficient to support its operations over a range of economic and financial conditions pursuant to the adequate capital test. As might be expected given this symbiotic relationship, the steps required to perform the cash flow and adequate capital tests overlap. For example, both might start with the projection of expected future free cash flows as is used in a discounted cash flow valuation, with one scenario assuming management's best estimate, a second, with no changes in revenue or profitability variables, and a third, with adjustments to items that may affect and/or include revenue growth, gross margins, operating profit margins, depreciation, and capital expenditures, as appropriate and reasonable given the facts and circumstances.

To test the ability of the company to pay its debts as they mature, the firm's scheduled debt payments are matched with its balance of excess cash, free cash flow, and available credit under existing facilities at each payment date per the cash flow test. The process used to test the adequacy of the firm's capital then builds on the foundation of the cash flow test with analyses that compare the company's financial position and operating results over time on a standalone basis and in relation to others in its industry, assessments of the ability of the company to obtain additional or new debt and equity financing, and examination of the potential for the company to default under the provisions of its debt covenants.

A firm will fail the cash flow test if its scheduled debt payments exceed the corresponding sum of its excess cash, free cash flow, and available existing credit. A firm will also fail the adequate capital test if it can be demonstrated that its capital structure cannot withstand reasonable fluctuations in its business without triggering a default under its debt covenants. When using these tests in combination with the balance sheet test, however, it should be noted that the balance sheet test, being a valuation rather than a matching exercise, may suggest an alternative viewpoint due to its consideration of the time value and risk associated with a firm's cash flows.

In sum, though often used to assess solvency in fraudulent conveyance and preferential transfer disputes under the bankruptcy laws, the balance sheet, cash flow and adequate capital tests in part provide a relevant and reliable framework for use in addressing failing firm claims, the specifics of which are subject to interpretation under the Guidelines. Properly applied, the approach can assist acquirers in achieving antitrust clearance for a transaction that may otherwise be blocked, and avoid the costs of a broken transaction, which while likely significant in any event, are particularly prohibitive in today's environment of tightening credit markets, leveraged capital structures and economic uncertainty.

Boris J. Steffen is a partner at Bates White, LLC.

CHAPTER SEVEN:

Due diligence and integration

The evolution of diligence: how a multi-discipline approach gives buyers a competitive edge

BY GREG PETERSON AND MIKE BURWELL

Capturing value from a merger, acquisition or divestiture continues to be one of the most significant challenges dealmakers face. As companies become increasingly global and regulations evolve, diligence becomes more sophisticated and encompasses so much more than financial performance. Seasoned deal practitioners can attest, there are many factors impacting deal value and not all are attributable to financial statements. Financial diligence alone does not uncover the wide range of risks associated with a transaction; especially if it is a cross-border deal where foreign jurisdiction, culture, labour, transfer pricing, foreign market conditions and financial reporting come into play.

Many faces of diligence

Today, diligence covers the deal continuum to include commercial diligence which accesses the size of the market and critiques the target's business plan; total performance diligence which evaluates not only financial statements, accounting and tax but also operations, systems, governance, vendor relations, internal controls, management integrity, human resources and insurance; and sell-side diligence which helps sellers present the business to be sold from a buyer's perspective. To maximise deal and shareholder value, companies need to be aware of and anticipate deal risks while formulating an action plan to address them. Performing diligence on the entire operations of the target and its market strengths, weaknesses and risks will enable dealmakers to make informed business decisions.

Commercial diligence

Regardless if you are a buyer or seller or whether the transaction is domestic or foreign, early identification of potential deal issues leads to informed decisions and better financial modelling. As companies venture outsides their borders or expand into a new industry to drive growth, it is crucial to understand the market, the target's market position compared with industry peers, potential opportunities and alignment of opportunities to their business strategy. Commercial diligence enables companies to address the appropriate questions such as: What are the risks inherent in a business strategy? What strategic and market-related value creating opportunities exist? How sound are customer and supplier relationships? What is the sustainability of the company's competitive advantage? How big is the market?

Often transaction risk arises from inaccurately assessing market growth drivers, industry trends, competitive positioning and supplier relations. Deal value will diminish if the commercial viability of a deal cannot be supported. Commercial due diligence is best used when the buyer has reservations about key business plan assumptions. For example, a company recently needed to assess whether a telecom target's revenue and profit projections were achievable. Diligence revealed the target's market share and margin growth were unachievable since they implied the company would thrive in a price-driven, slow-growth market where its competitors enjoyed a competitive advantage. Gaining insights on unfamiliar areas gives dealmakers the confidence to make better business decisions.

Total performance diligence

Although understanding the financial and tax position of the target is important, they are only two of the many factors that could derail a transaction. Other factors impacting the value of a deal are often more important. Companies are increasingly becoming more global and diversified and have complex operational structures. When acquiring a multinational company with multiple businesses, it is beneficial for dealmakers to expand their diligence to include other areas of the business such as employee benefits, insurance, operations (including information technology), internal controls, governance, tax structuring, valuation and others.

Employee benefits. Compensation and retirement programs are getting more complex, and they become even more complicated when unions or country specific regulations are involved. Benefits issues could prevent a deal from closing. For example, a pension liability that is significantly underfunded may reduce the expected value of the transaction or the deal may be abandoned. Therefore, having a full grasp of the risks associated with unfunded pension liabilities, management compensation plans, employment and union agreements, equity compensation programs (existing programs as well as design and implementation of new programs), local regulatory approval processes and any obligations an acquirer will have once the deal closes can have a huge bearing on the deal.

Tax and structure. Tax diligence has evolved from the assessment of tax compliance issues to include the evaluation of potential deal structures and movement of cash. Considering how to structure a deal early in the process can often give buyers a competitive edge. For example, the benefits of acquiring the stock of a S Corporation by structuring the transaction as an asset deal through a Section 338(h)(10) election may add significant value – allowing the buyer to step up the tax basis of the acquired assets to fair market value, creating a benefit from higher tax deductions in the future. Other areas of taxation which may have an impact on deals include proposed restructurings and valuation of goodwill, know-how and other intangibles. Also, different states and countries have their own tax regime and understanding the tax implications on deals enables buyers to choose the right tax structure and move cash to the appropriate entity or territory to service debt as well as provide a tax efficient return to investors. Furthermore, should a dispute arise with the tax authorities, appropriate documentation of diligence performed and valuation issues encountered will facilitate a swift resolution.

Insurance. Companies face many risks, having an adequate insurance program is important to limiting their exposures. Dealmakers should expand their traditional diligence to include insurance to ensure the target has adequate self insurance reserves and coverage, and access the impact on the buyer's insurance programs in terms of change in control, insurance program structure, collateral and cost allocation.

Operations. Whether you are a corporate buyer looking to understand the potential operational synergies of a deal or a financial buyer assessing the standalone costs of a division of an entity, diligence on the target's operations will yield invaluable insights. Having insights on redundant functions and how the target fits into the parent company (or portfolio) enables acquirers to make swift decisions and implement the appropriate integration strategy to realise synergies sooner. Information technology is the cornerstone of most operations and understanding the adequacy of the application environment and expenditure required is vital. How often have you heard of companies that are unable to bill effectively because of system integration issues?

Valuation. Asset valuation and methodologies used can have a significant impact on deal value. The accounting principles used may also have a bearing on the perception of value of a business or an asset. In particular, identifying the differences between US GAAP (Generally Accepted Accounting Principles) and IFRS (International Financial Reporting Standards) is becoming more important as more countries adopt IFRS. A buyer needs to ensure its approach to valuation is the same as the seller's. If the approach differs, it is important to understand the differences and the effect they will have on purchase price. IFRS requires a wider range of assets to be valued and re-valued on an annual basis. If a buyer is not careful it can find itself paying for assets it has not anticipated.

Both commercial and total performance diligence continue to provide dealmakers value after the deal closes. Acquirers can use the industry and market information to increase their market position. Also, commercial diligence can provide additional insights and ammunition to help shape the acquirer's business strategy. Findings from total performance diligence enable acquirers to develop an integration plan to capture synergies by identifying and resolving issues early for a smoother transition.

Sell-side diligence

Normally when we think of diligence, we think of buy-side. However, when a division or business is being divested, it is equally important for sellers to undertake a sell-side diligence on the unit being sold to maximise value. This is especially important when the unit being divested is a carve-out of an existing business where no standalone financial information exists. It requires considerable judgement to apportion revenues and expenses to a specific unit or division when it involves shared corporate services such as finance, legal, marketing, pension, taxes, interest and insurance.

Even if a standalone business is being sold, it is necessary to adjust historical information to reflect the post-sale economics of the business which involves eliminating charges the buyer will not incur. Also, potential buyers may be foreign acquirers who have a different accounting reporting standard than the seller. To appeal to a wider pool of buyers, it is important to understand the differences between US GAAP and IFRS. Reconciliation between the two standards may be required.

Most importantly, supplying the information from a buyer's perspective limits the number of potential inquiries from acquirers so management can focus on running the business. Sell-side diligence enables sellers to identify and resolve information gaps as well as value detracting issues, and provides the right information to buyers for a smoother sales process.

Conclusion

As companies' transaction needs evolve to capture global opportunities, diligence also progresses to meet their growing complex transaction needs. Diligence has gone from solely financial diligence to encompass other business areas such as benefits, insurance, operations and others. Additionally, diligence expands to the commercial aspect when companies question the sustainability of a target's growth and sell-side diligence when dealmakers are ready to harvest their investments or part with non-core assets as their business strategy changes. Diligence enables dealmakers to make confident business decisions which may entail substantial reworking of a transaction prior to close.

Greg Peterson and Mike Burwell are partners at PricewaterhouseCoopers LLP.

Commercial due diligence and the nine levers of corporate growth

BY CHRISTOPHER 'KIT' LISLE

Consistently successful corporate growth is not the result of being in the right place at the right time. Nor is it attributable to the latest management craze. Some CEOs, regardless of industry or timing, are able to achieve lasting growth. Ongoing processes are used for discovering growth opportunities. Internal competencies, systems, people, and capital are developed to take advantage of those opportunities. And value propositions and brand promises are created to convey unique capabilities to the customers who value them. The result is predictable growth.

The complexities and challenges of international mergers and acquisitions raise the due diligence bar. Cross-border commercial due diligence (also known as business strategy due diligence) benefits from a systematic test of nine simple predictors of corporate growth.

When used in a commercial due diligence process, the 'nine levers of corporate growth' consist of nine assessments of acquisition targets – three tests of external strategic opportunities and the company's positioning relative to these opportunities, three tests of the company's internal capabilities to execute against these opportunities, and three tests of the acquisition target's strategic planning processes. The external tests involve competitor awareness, customer awareness, and market awareness. Internal tests include operational competencies, human capital and growth capital. The strategic or balancing tests include strategic planning, wild cards and value proposition. Without pulling the internal levers, and keeping them in balance, a company may be ineffectively executing a chosen strategy. Without pulling the external levers, and keeping them in balance, a company may be effectively executing the wrong strategy. The nine levers, or tests, facilitate diagnostic indication of growth potential and a quick understanding of organisation's weak links.

External tests

1. Competitive analysis can serve three distinct roles for buyers. First, assessing the capabilities and competencies of competitors. What are the competitors' strengths, relative to the acquisition target? Are they more efficient in production, do they have access to more resources or people skills, or do their competencies and brand promises better match customer needs, for example?

Second, understanding the intentions and future directions of competitors. Plotting the likely strategic paths of competitors against known customer needs and purchase decision criteria reveals that some competitors are heading in a very logical direction while others are driving off a cliff. The next step is to decide on the level of comfort with the strategic direction of the acquisition target, given the strategic direction of its competitors. Is it acceptable, for example, to try to compete head-to-head against a larger competitor with more resources and competencies?

Third, competitor due diligence can also be used to assess the broader competitive dynamics of the market. Michael Porter suggests evaluating the attractiveness of a market based partly on an assessment of the risks of new entrants, substitutes, competition from competitors, competition from suppliers, and the internal rivalry of market participants.

2. *Customer awareness* involves a disciplined, systematic process of gaining awareness of customer needs, interests, purchase decision behaviours, perceptions of suppliers, and the current state of relationships. Calls to customers may be the single most basic element of external due diligence. The calls are relatively easy, quick, and they can provide tremendous insights. Where most acquirers believe they are maintaining control, learning first-hand insights and saving money by conducting these calls internally, they fail to understand that outsourcing has tremendous benefits. Using a research-based consulting firm that makes the calls 'blind' (without revealing the name of the acquisition target or the true purpose of the call) ensures that the insights are objective. Research firms are also efficient, and produce reports which are not only full of quantitative and qualitative insights, but also analysis, options and recommendations. A good research firm will go well beyond the basics of how the customer chooses a supplier and how they rate and rank the various suppliers.

3. *Market knowledge* helps determine if the acquisition target is in the most attractive segments that it could be, given core competencies and the strategic direction of the company. Market due diligence is focused on answering two questions. First, how attractive is this market, from the standpoint of growth, profit potential, customer needs, competitor positioning, industry trends, opportunities and threats, critical success factors, etc? Second, how well positioned is the acquisition target in this market – is it competing in the most attractive segments or the least attractive segments? Conducting market due diligence in obscure, niche sectors means conducting primary research of customers, competitors, and third party industry experts.

Internal tests

4. *Core competencies and operational efficiency reviews* offer insight into potential competitive advantage (of an operational, cost, or service nature, for example) that may bring incremental value to the customer. Here, the due diligence focus is on identifying unique capabilities and operational efficiencies. These core capabilities may involve any operation or function of the business that contributes to the efficacy of the business model. Operational examples include procurement efficiency, internal communications between functional areas that contributes to operational efficiency, logistics and distribution efficiency, inventory efficiency, outsourcing utilisation and workflow process. The aim is to assess how unique and differentiated a company's operational processes are, relative to competitor capabilities.

5. *Human capital assessments* explore recruitment, selection, training and development, leadership development, culture, systems for performance management and feedback loops. In

due diligence it is important to examine the company's talent acquisition and retention success, check out training and development capabilities, look for cultural and ethical consistency, try to find compensation systems that reward behaviours that connect to the strategy and the corporate goal, and test for performance feedback programs. The result is an understanding of the relative strengths and weaknesses of the acquisition target, from a human capital perspective.

6. Growth capital analysis does not involve looking in the rear view mirror at financial performance. Financials are merely symptoms, not the core strength or weakness of the business. Due diligence should be used to investigate whether the company has the resources it needs to achieve the goals, objectives, strategies and tactics it has laid out for itself.

Strategic tests

7. Strategic planning assessments involve investigations into the direction the company is heading, the process utilised to arrive at this direction, and the company's perceived value of strategic planning as an ongoing process. Too many executives rely simply on an annual strategic planning meeting to make choices. They are destined to miss opportunities and unlikely to account for internal competencies, relative to their competitors. Conducting strategic planning as an event relies on the perceptions of managers, rather than on the facts and realities of the market, including the positioning of a company within the market. A never-ending planning process, on the other hand, forces executives to maintain an awareness of external opportunities and an appreciation of relative internal strengths, weaknesses and core competencies. With the input of external knowledge, decisions and choices are based on facts, not internal perceptions. Strategic planning is all about seeing options and then choosing a path which will most likely lead to accomplishment of corporate goals.

8. Wildcard analysis is about gaining an awareness of the potential for disruptive, disintermediating, playing-field-altering opportunities and threats. Technology, operational efficiencies, global supply chain management and channel strategy improvements, for example, have enabled some companies to fundamentally change traditional business models. Rapidly growing companies keep a constant lookout for ways to influence markets. Opportunities for growth are created that may not be visible to the casual participant – capitalising on inefficiencies many players assume to be 'givens'. It is a good idea to investigate the wildcards that may exist, and assess the company's ability to plan for the possible realisation of these wildcard events. Wild card analysis is partially dependant on external knowledge, but the ability to react to potential opportunities is a direct function of executing on the internal levers.

9. Value proposition and brand strategy assessments are used to determine if a company has a unique selling point, if that uniqueness is valued by target customers, and if those target customers are actually receiving the message that the company has the ability to offer that unique value. Brand strategy serves as the bridge that connects internal and external levers of corporate growth. Specifically, it connects internal competencies to awareness of customer opportunities through a discreet promise of value.

Without an effective brand strategy, the carefully developed core competency does not necessarily translate into growth because target customers may not believe, understand or realise this competency exists. And without a thorough understanding of customer needs, the communication may be promoting awareness of a service or product that is irrelevant to the target customer.

Conclusion

Every one of the 'nine levers' tests has the potential to 'kill' a deal, so they are all quite important. Utilising this model also helps management of the company determine where the weak links are post-closing, so that management and the new owners can agree on the initiatives that should be pursued in the first few months. Companies are more likely to see the appropriate opportunities to focus on for strategic planning. They will be more likely to have the requisite skills needed to execute their chosen strategy. Finally, their strategy should be continuously course-corrected, given the changing realities of their own company and their marketplace. Balancing internal realities and external opportunities not only facilitates improved strategic planning, it improves the odds of consistent revenue growth in the near term by focusing management's attention on the weakest link.

Christopher 'Kit' Lisle is managing partner at Acclaro Growth Partners.

Sell-side online datarooms

BY ANGUS BRADLEY

Online datarooms are finally being recognised as the best way to increase deal speed and reach more bidders, while saving money and travel time. Many large firms refuse to work any other way. Perhaps the days of paper-strewn rooms, coffee stained documents and flying a team to Frankfurt to visit a dataroom are drawing to a close. This article addresses issues around set up and choosing security levels, and also introduces important concepts like metadata cleansing and long term storage.

More paper, higher cost. Dataroom providers' costs vary, but they rise depending on the amount of data and number of reviewers. If most of the information required for due diligence is already available electronically ('soft copy'), then setting up an online dataroom is much easier. Documents can be uploaded directly and bidders invited to review them, with relatively low set up cost. On the other hand, if there are boxes of paper to be scanned, the costs of going online could be considerable. In cases involving large amounts of paperwork, and only a few reviewers, a conventional dataroom may be much cheaper.

Preparation is key. A better dataroom means a better transaction. Even though the dataroom is online, all the usual preparation work must still be done. The vendor should prioritise the collection of electronic and paper documents, and ensure its team understands exactly how the master index document will be constructed. All paper documents will need to be labelled meaningfully to make sure they can be scanned. Some documents may need to be redacted. This preparation phase is the most time consuming and error prone element of the process. The team should resist temptation to start and add content as it goes; far better to prepare well, and launch the room with most materials ready for review.

Scanning in-house or outsourcing? Most firms have some in-house scanning capability, so they may consider this is the best option to reduce costs. For cases involving a handful of documents, the in-house option is usually preferable, and an easy way to add new documents as the deal progresses. But when the pages number in the thousands, and time is tight, it may be wise to engage professionals to scan and index the documents. Of course, there is a risk that the originals may be lost in transit, so the vendor should send copies to be scanned, if possible.

To print or not to print? Reviewing documents on screen is tedious. Most reviewers will request print privileges. But the vendor should be aware that when it allows someone to print, that person can choose 'print to PDF' and make an electronic copy of the document. Even if the printout is watermarked, the vendor loses control and cannot later revoke this permission. It is prudent to allow print access to non-sensitive documents, restrict other documents to 'read onscreen only' and withhold extremely sensitive documents until later stages in the deal, when the vendor is more comfortable with a bidder's intentions.

For security, passwords may not be enough. Traditionally, reviewers use a username and password to access the dataroom. There is reliance on the terms of the deal, as well as ethics, to prevent the password from being shared with friends. Recently, stories have emerged of dataroom passwords being sent to competitors for their review. Even if ethics is not the issue, there have also been reports of keylogging on major deals, which means hackers log every key stroke from a computer and can obtain a password. Vendors should explore all available options for extra security, such as location-based restrictions in which users can only review from one office, or secure tokens.

Metadata – cleaning 'handwriting' from documents. When the British government published a report on Iraq's non compliance with weapons inspectors, hidden metadata in the document revealed that the report was plagiarised, and had been written three years previously by a US student. When SCO Group filed against Daimler Chrysler in 2004, a Microsoft Word copy of the suit had metadata which showed that the company had originally targeted Bank Of America instead. So how does this impact a deal? Upon completion, it is common to deliver the closing bible electronically, often with documents in formats like Microsoft Word. So to protect details like the author, version history, and other information that should remain undisclosed, vendors should strip documents of metadata by either printing them out or using a 'cleaner' before handing them over.

Excel documents are hard to secure. There are several document types that can be difficult to secure online, Excel is the most common. Most datarooms protect documents by converting them to an 'image' type format, which resembles a printout. Most financial Excel documents will secure easily, but some sheets, such as complex engineering sheets or those with interactive features, cannot be secured online if their function is to be maintained. There are options to resolve this, but a vendor should be prepared in some cases to share certain files without copy and print protection.

Storing closing bibles on CDs or DVDs may be unreliable. Post-deal, many people keep copies of the dataroom and audit trail on CD or DVD. Estimates for the lifespan of a DVD range widely from 30 to 100 years – but it is quite likely that someone will scratch or damage the disk when checking files. In either case, the 'dataroom master' disk may become unreadable. It is highly recommended that disc-based closing bibles are distributed to IT staff who can store them on servers – rather than kept exclusively on CD or DVD in a filing cabinet.

Angus Bradley is managing director at Projectfusion.

Utilising the extended customer chain to enhance due diligence

BY DAVID SOLEY AND MICHAEL SARLITTO

Investment professionals recognise and appreciate the legal practicality and protections offered by the safe harbour warning: past performance does not guarantee future results. Likewise, the universally time-honoured buyer beware dogma embraced by both financial and corporate strategic acquirers is of instructional value to new entrants and a useful reminder to even the most seasoned of dealmakers operating in an increasingly competitive M&A market. These generally accepted operating tenets are of particular interest to those dealmakers conducting transactions in high risk, rapidly changing or operationally complex industries, technologies and company frameworks.

How does a dealmaker, operating in today's fiercely competitive environment, conduct investment or M&A due diligence in a way that adapts and adjusts to a rapidly changing marketplace fraught with risk? Are there any enhanced due diligence methods or techniques better suited to quantify and qualify new and unanalysed transactional risks deemed 'material' to a proposed transaction? What value would an acquirer place on an analysis technique capable of identifying and quantifying latent, heretofore undiscovered opportunity to create business value associated with a pending investment or, as a minimum, result in a more competitive purchase offer / terms and conditions?

Extended Customer Chain (ECC) Analysis is rapidly emerging as an extremely efficient, methodical and repeatable technique designed to improve an acquirer's ability to quantify and qualify the future value of a target's products and services, markets, and revenue streams. This article introduces dealmakers to the ECC perspective in conducting due diligence and supplies a basic understanding of ECC methods and techniques used to analyse customer information, technologies, select business and work processes, key industry data, and internal and external resources in a way that cultivates discovery of previously undetected business value. When employed in conjunction with routine due diligence techniques, acquirers emerge better prepared to execute their deals with confidence, particularly those deals that are not simply exercises in financial reengineering and whose very success depends on the ability to create genuine business value. The practicality and value of ECC in shaping business transaction decision-making is demonstrated in a relevant case study based upon an application of the model and results achieved.

What is ECC?

Simply stated, ECC is a repeatable, predictable pre-deal analysis and modelling technique capable of exploring, leveraging, realigning and optimising the customer chain in which a target company operates. This analysis oftentimes yields undiscovered, sustainable, adaptable and incremental business value. While typical investment assessment analysis focuses to a great extent on identifying value chain improvements intended to deliver better margins or scouring revenue projections to come up with ideas designed to spur top line growth, ECC zeros in on the company's capability and capacity to service unique and rapidly changing customer requirements – whether direct or indirect, primary, secondary or tertiary.

Most traditional due diligence relies on a financial assessment and valuation of a target's management processes and the resources controlled by these processes (i.e., labour, material, machinery) in order to establish an initial company value. This exercise in number crunching is immediately followed by generous adjustments for yet-to-be-realised, self-identified business development opportunities, investment thesis conjecture, and non-repeatable artfully calculated synergistic benefits. ECC picks up where this financial and SWOT analysis leaves off in analysing sources of incremental business value. Its unique perspective views the target company's value proposition in the context of broader, interrelated customer relationships; relationships that when focused through a lens of change, innovation and integration, creates opportunities for new, unanalysed and previously undetected accretive company growth.

In addition, ECC applied during the early stages of transaction processing provides investment practitioners with critical, time-sensitive insight into the rationale for a target's claims to prospective revenue growth potential; validity of purported underlying root causes for a growing, stagnant or declining customer value proposition; and justification for continued optimism in the firm's ability to realise value from market development opportunities. In certain circumstances, ECC can help avoid wasted time and effort in pursuing permanently sub-optimised investment opportunities while in other instances, it can unearth previously undetected, less obvious, dealmaking value that turns a walk-away deal into a portfolio maker.

The building blocks of ECC

There are five building blocks comprising the economic instrument of the ECC model: market insights, data, process, relational capital and technology. While these key components, taken independently, are not and should not be new to dealmakers, their integrated use in analysing both the target and the target's direct and indirect customers is core to the ECC analysis technique. This simultaneous examination of the target, in conjunction with the target's customers, provides the core market structure context necessary to assess opportunity and to exploit new economic growth models.

Market insights give a transaction team a broader view into the trends, value drivers, market forces and industry dynamics necessary to formulate strategic solutions to a target's critical challenges, each of which constitutes a value creation opportunity. However, by also conducting a market assessment from a target's customer's perspective, the transaction team may discover new business opportunities, alternative commercial agreements, different business transaction models, and buying and consumption behaviours more indicative of the constantly changing and evolving marketplace.

These insights are a critical component of an ECC model and typically include the following six impact variables: (i) emerging technologies: understanding new technologies, their applications and how to effectively utilise them to increase the value of existing products or services; (ii) emerging markets: identifying new markets to sustain the core business or create an opportunity to offer new services to customers; (iii) industry challenges: recognising the issues that may impact future revenue performance and competitive position; those who can not identify trends, risk losing customers to firms that can adapt to dynamic environments; (iv) regulatory implications: government regulations and legislation often impact a target's efforts to conduct business and protect its competitive position; (v) industry event analysis: effectively identifying the competitive landscape and precipitating events are essential for effective business strategy formulation and execution; and (vi) regional focus: recognising local market activity and events, and micro-market variations in customer behaviour may provide practitioners with insights on which new markets to enter and how to do so.

Data is crucial to developing a meaningful understanding of a company's value proposition. In order to be useful in conducting valid ECC analysis, high quality data can be characterised as relevant, historically accurate, updated, retrievable, source-traceable and accessible. ECC data sources may include key information concerning all company inputs and outputs, selected processes and operations, and is particularly exhaustive in the areas of the company's products and services and end users or customers served. Data forms include referenced facts, individual and cumulative trends, and descriptions of qualitative and quantitative changes occurring within a target's extended environment.

Process frameworks internal to the company can provide useful information into understanding how well the company has defined, architected, managed and positioned existing products and services in the market-wide value chain. However, an acquirer's understanding of the 'as-found' strategic thinking displayed by company leadership may also provide valuable insight into how well they have, or will, embrace exploration into the broader customer environment to mine additional opportunities for supplying its products and services. In the context of ECC, the term 'process' collectively represents the steps involved in performing work, and specifically, how people, machines and resources are utilised in performing production tasks. ECC also provides a framework for examining how a target's core business and its products and services interface with customers and partners.

Relational capital represents current and potential capital resources (i.e., financial, human, intellectual) embedded within existing or future relationships with business partners and customers. Relational capital is categorised and aligned by company product or service in order to gain maximum leverage in the company's aggregate value proposition. Relational capital may also include indirect sources, such as ongoing collegial relationships with consultants and publishers who in turn possess significant business relationships with key contacts within a certain company's target market. These relationships oftentimes yield valuable influence in sourcing new business and can also contribute to successfully entering new markets.

Technology can be a key enabler to innovatively enhancing the value of a company's product and service offering, naturally broadening its value proposition. Technology is often used to effectively expand the relevancy of a given product or service resulting in a more comprehensive connection to adjacent products, processes, people and organisations. Technology plays a critical part in achieving scale objectives by enabling simultaneous delivery of value added services for multiple customers, whether part of the same customer or value chain or not. Finally, advancements in technology-enabled processes can provide a rapid and responsive means for managing and executing new product and service development initiatives.

In the context of M&A due diligence, the ECC perspective extends conventional due diligence beyond a targets' core business and into its customer's customers and consumers. This broader, holistic approach into understanding a company's position in the extended customer chain helps to cast a wider relationship-driven net across organisations that may offer product, services, IP, or relational capital resources that would otherwise remain off an investor's radar. The inclusion of an ECC perspective in conducting due diligence may be the first time an organisation is exposed to this broader perspective. In these cases, the acquirer would be well advised to pay particular attention to results that, when properly bundled, create considerable negotiation leverage. While implementation of ECC may challenge the company's basic assumptions and conventions about how business value is created, customers are serviced and new markets are defined, the results realised will quickly demonstrate a return on the assessment effort.

Case study: consumer goods manufacturer

A financial sponsor was performing due diligence as part of a plan to determine if continued investment or extension of an existing product/service was viable. The target had recently introduced a new wireless communication product to the consumer market place. The product's original platform was designed to allow its customers to contact a centralised call centre to alert service representatives of particular issues concerning product applications. Customer Service would direct immediate and geographically dispersed responders to correct the customer's situation. Though the customer problem resolution function was of particular importance to its customers, there was a sense that new market applications were not being pursued and as a result, the company was interested in taking action to pre-empt entrance of potential competitors.

Facing continued pressure to reduce competition and increase market share, the financial sponsor was also searching for opportunities to increase business value, rationalise a higher valuation and multiple, and differentiate the company's product within a crowded asset class. To better understand and develop actionable solutions and define a new product or services model, the transaction team utilised ECC.

In defining the market context for applying ECC, external industry and customer analysis was conducted and revealed market gaps, new market segments, the linkage opportunities between unique market segments, market incongruities, revenue streams, and unmet market needs. Customer and product application data was abstracted from this analysis and then broken down into key components using system analysis methodologies. These components derived from analysis were then utilised to build new product models and identify related external market entities and technologies, adding a further dimension to a qualified and quantified strategic plan for a more expansive product platform.

The improved product platform productised information, captured and modelled customer information, and functioned as a wireless platform model for enabling customers to acquire new products and services in near real time from remote locations. The wireless communication model created new market space, services, business intelligence and integration opportunities with retail, services, media, and hospitality markets. The new product platform would also be linked to other business models, allowing the products vendor to analyse customer behaviour in near real time.

Based on the ECC analysis, previously unknown and undetected business value was discovered and quantified. The financial sponsor was able to commit the significant capital investment necessary to continue market expansion and systematically implemented the ECC due diligence recommendations. The company enjoyed rapid market growth acceleration with product sales increasing over 800 percent during the five year investment horizon time period. As a result, ECC meaningfully contributed to creating a product to market success story enabling for better than average investor return.

Conclusion

ECC provides financial and strategic acquirers with a means for defining and establishing new market positions, business models and strategies. Due diligence that utilises ECC is enabling more insightful and competitive decision-making. The value that ECC delivers to investors is becoming of critical importance as growing volatility in the economic and national political climates, increasing competitive dynamics, weakening capital and liquidity markets, and tighter valuations continues to impact deals of all sizes and across all industry sectors.

David Soley is a senior consultant and Michael Sarlitto is managing partner at SummitPoint Management.

Due diligence trends in Europe – commercial, operational and cultural twists

BY C. SCHINDLER

Subprime's tightening of credit markets has ushered in a new phase of European M&A. Gone are the days of quick, financial investor-led deal flow with ever-rising multiples. Process and scrutiny have replaced arbitrage in driving transactions. As value creation becomes the new buzzword, due diligence methods need to respond.

The primary focus for change resides in commercial, operational and cultural due diligence, as these are the areas of value creation and not just risk assessment. Knowing what can be done and how to go about it separates the men from the boys in this roll-up-your-sleeves market environment. Forget 'defining the equity story'. It's now all about managing the value equation, which in Europe means taking a professional look at commercial, operational and cultural issues prior to the transaction.

Commercial becomes the band leader

With private equity retrenching and strategic buyer coffers filled with recent profit gains, European buyers are taking a harder look at their targets, thereby softening once rigid auction processes. This means more access to the company and a heightened awareness of commercial issues. In Europe, where management controls and systems are often less advanced than in the Anglo-Saxon world, commercial due diligence needs to be more creative in identifying key value drivers and gathering the data that leads to sound conclusions.

In such cases the due diligence team must be highly effective in managing hypotheses testing starting from a broader, less transparent base. Missing the key message or getting off on the wrong tangent leads to inaccurate assessment of the opportunity and to a flawed transaction.

European due diligence teams, therefore, have to be creative, disciplined and focused to drive toward the right results. Experience is more important than following a cookbook, and the right message capsulated in 10 pages is far superior to a 100-page fact cemetery.

Operational – do as I do, not just as I say

It is harder to drive ROI these days just on market growth and buy-and-build strategies. Even healthy targets can be optimised, while weaker candidates need restructuring. The substance in a transaction, therefore, is often found on the shop floor. If an acquirer wants to find the value prior to purchase, they need to do more than just kick the tires on a few machines. They need an expert, in-depth look into the risks and opportunities.

Whether healthy or distressed, most European targets today are in the midst of some growth, market, technology, or regional transition that, depending on how it is managed, will either make or break future performance. Modern operational methods such as Value Stream Mapping, Six Sigma, 5S or Lean have a lot to offer in creating success stories. For due diligence, the team needs to have experience with such tools and how they are applied. Many times, the effectiveness of these measures is determined by not only how the methods are deployed but also how effectively organisational and cultural nuances are addressed. This is a key factor in Europe, where each country has its own language, culture and mindset.

Automotive is one of the most challenging manufacturing environments around. It is important to recognise causes and effects early in a due diligence and make experience-based assessments of what can be accomplished at what expense. During the evaluation phase, this often requires mapping to industry benchmarks and calculating the resulting ROIs in financial terms that can flow into a valuation model.

Correct identification and assessment of improvement areas are not enough though. They need to be implemented to be worth something. Words need to turn into actions. A common flaw in operational due diligence procedures is that the team assessing the potential is no longer available or desired in post-acquisition implementation. This may result from an organisational lapse or, as is often the case, from the fact that many consultants like to write reports but don't want to get their hands dirty.

At the end it's all cultural

The backbone of Continental Europe's corporate infrastructure is represented by privately held, technocratic family businesses. In Germany, for instance, a country whose commercial law prescribes a two-tiered management structure, the managing director of a mid-sized company will think very differently than his Anglo-Saxon counterpart. As an example, one should not assume that a German manager is looking to do an MBO, which is still seen by many as a minor form of blasphemy in the church of shareholder loyalty. Of course, some do cosy up to the idea of sweet equity over time, but only if the concept is introduced with proper timing and discretion. The better short term hook to get a manager on board is to appeal to his need for continuity and new challenges. Devotion to duty and company will lead most managers to talking about the many strengths and weaknesses they see – invaluable in due diligence.

Shareholders in Europe think differently too. On the surface, many are less infatuated with the prospect of cashing out than one might expect, a by-product of less value other cultures place on conspicuous consumption. In order to open the doors for a transparent transaction, the initial appeal needs to be to other values – assuring the continuity of the legacy through new (wise) ownership, recognition of the moral obligation to employees, etc. Playing the human piano well can make all the difference between getting comfortable with a deal and not having one at all.

Shifting markets imply increased emphasis on commercial, operational and cultural elements of due diligence. Winning the race is all about knowing where the currents are and applying the right strokes – especially in Europe.

Christoph M. Schindler is a managing director and European Practice lead at BBK.

Due diligence and integration planning in cross-border transactions

BY MARK THOMPSON

Due diligence is undoubtedly one of the most critical steps in the acquisition process. Used properly, diligence is an effective tool to enable decision makers to evaluate the risks and benefits of a potential transaction. The advantages of a properly constructed due diligence process, however, do not end simply at the completion of a transaction. The due diligence process and integration planning should go hand in hand to ensure a successful acquisition.

The rise of due diligence

Due diligence has grown in importance in recent years. Although some would argue this is due to the influence of the US style of transactions, there are, in fact, several more important contributing factors. As evidence has shown, many acquisitions have had a negative impact on the financial position of an acquiring company. There is concern by several constituencies about companies making hasty decisions to grow in size or prestige without truly understanding exactly what it is that they are buying. Consequently, increased scrutiny on companies making acquisitions by shareholders, governmental entities and creditors is a major factor in the importance of due diligence.

This issue is magnified by the ever increasing liabilities associated with acquisitions. In many cases, the target company's past problems can result in significant ongoing liabilities. As regulations are increasingly expanded to include successor liability in areas such as environmental, employment / benefits, money laundering, and international trade issues, acquisitive companies have been forced to examine their targets more closely.

The dominance of private equity funds as both buyers and sellers has also created a larger role for the due diligence process. As a buyer, a private equity fund needs to be aware of every issue that can affect cash flow in order to be able to service any acquisition financing and provide a return to their investors. Since the liquidity of a fund is limited, when making an acquisition, there is scarce room for costly liabilities. Further, as a seller, private equity funds frequently provide very limited claims protection to potential buyers. Funds often try to structure their sell-side transactions to mimic a public transaction where there are no surviving warranties or indemnities. Consequently, buyers must seek protection through diligence, as claims protection will be limited.

Team coordination

A thorough diligence investigation requires input from a number of different sources. Due diligence is typically divided by business function – usually financial, legal, accounting and tax – and shared between the advisers and the acquiring company. On large cross-border transactions, and even on smaller deals, dozens of people and a handful of different outside firms and sub-specialists can become involved. Coordination of these functions is therefore crucial from the outset, particularly in terms of putting together a due diligence plan and protocols that establish the working relationships among participants.

The first step in creating such a plan is to determine the goals and objectives of the investigation – essentially, what information will help the decision makers determine whether to proceed with the transaction and at what value? Each acquirer will have different sensitivities about this – for example, some companies are particularly concerned with employment issues, while others may focus more on potential environmental liabilities. It is important to sit down with the decision makers from the beginning to develop a plan focused on their concerns. Surprisingly, this step is often overlooked as advisers frequently charge forward with a so-called standard due diligence investigation without taking into consideration what the acquirer really needs.

As a general matter, one of the most important things to recognise is the difference in approach to due diligence between strategic buyers and private equity funds. The short term approach to an investment typically taken by funds (generally three to five years) means their financial models may not tolerate much of a cushion to cover potential liabilities, even if they are ultimately indemnified down the road. Therefore, it is important that they are aware before execution of an agreement of any issues that could impact cash flow. Although strategic buyers are also concerned with immediate financial returns, they are typically more focused on identifying issues that may stall the integration process and create costs or liabilities for the combined companies further down the line.

Once the goals and objectives of the due diligence investigation have been established, it is equally important to be sure that there is an organised chain of command when it comes to reporting the findings. If the results of the diligence do not reach the appropriate decision makers, the entire effort will have been wasted. A protocol must be devised from the outset which establishes not only the reporting chain, but also the timing and format of the reports. In addition, a process should be set up to flag significant issues to the decision makers immediately.

It is also useful to work closely with the integration team leaders to create a product that can be used for integration planning pre- and post-completion. If the diligence and integration are not done hand in hand, the diligence frequently will be duplicated later and valuable time will be lost. Of course, this sounds easier than it actually is in practice, and while some companies are very good at integration on their own, the vast majority will or should look to their advisers for assistance.

Indemnity protection and warranties

It is often asked whether the need for due diligence can be eliminated by protecting the acquirer with warranties or indemnity protection. While there is great appeal in taking that approach as it saves the upfront diligence costs, it is a very risky alternative. Fundamentally, due diligence could turn up potential liabilities or business issues that would cause the acquirer to walk away from the deal, or at least adjust the pricing. Furthermore, often the most important representations, warranties and indemnities in a transaction are specifically crafted to deal with issues identified during the due diligence. Simply stated, if a company does not know what is out there, it is hard to protect itself adequately.

In addition, there are certain liabilities where indemnification cannot provide adequate remedies, particularly if common caps and limitations are applied. For example, when a US company is the acquirer, liabilities raised due to violations of the Foreign Corrupt Practices Act by the target company, or parties contracting with the target company, may pass through to the acquiring company, even if post completion such illegal activities are halted. In addition, liabilities relating to issues such as environmental, money laundering, and employment / pensions raise significant successor liability issues that should be identified in diligence pre-completion.

A further risk is the credit-worthiness of the party providing the coverage. Frequently, protections gained in a purchase agreement are neutralised because the party providing the protection is effectively judgement proof, particularly if the vendor in the transaction is an individual. In addition, even if the acquirer is able to obtain a judgement, resolution of such matters can take significant time and expense.

Simply stated, diligence provides the acquirer with the opportunity to learn everything there is to know about the target's business before being bound to the transaction. That way, whether the target is a stand alone acquisition or will be integrated into a larger organisation, the acquirer can determine whether it wants to proceed and at what price and knows what to expect post completion, allowing it to get the business running more quickly.

It is frequently debated whether warranty insurance can be useful in mitigating these types of risks. In many cases, insurance is extremely helpful, particularly if there is a gap between the acquirer and vendor in the cap on claims protection. Insurance, however, is not a substitute for due diligence. In fact, the insurer will review the acquirer's diligence report and often will want to conduct its own diligence investigation. Furthermore, it is important when using insurance in a transaction to review the exclusions to the policy very carefully as key risks will often be excluded from the policy. In practice, insurance is most effective when purchased in order to bring a transaction together when it covers specific risks uncovered in due diligence.

Whether the acquirer is gaining protection through representations, warranties, indemnities or insurance it is important that the decision makers know the results of the diligence investigation and all of the data provided by the vendor has been thoroughly analysed. Contractual protections in a purchase agreement can be voided if the acquiring company learns about a problem or a breach of a warranty before the execution of the purchase agreement or, in some cases, before completion. Further, in some jurisdictions, courts will not allow a recovery for damages if the acquirer should have known about a breach or a problem based on the information provided by the other side. Consequently, it is important for acquirers to include language in the purchase agreement that limits its knowledge in some manner or identifies the universe of information about which it will be accountable.

At one end of the spectrum, the purchase agreement can contain a provision that all information learned during diligence is held against the acquirer. Often referred to as an 'anti-sandbagging' provision, such provision provides that anything the acquirer learned prior to signing cannot be used as the subject of a claim or to prevent completion. At the other end of the spectrum, some purchase agreements state that the only knowledge an acquirer is deemed to have is included in the purchase agreement itself and its schedules. A compromise position often seen limits the universe of information about which the acquirer is accountable, but also requires the acquirer to state that it has no knowledge of facts that amount to a breach of warranty or create a claim.

Even when the purchase agreement is crafted appropriately, unless known problems are specifically addressed in an indemnity, many courts have held that knowledge of a potential liability prior to execution of the purchase agreement can prevent a successful claim if such liability turns out to be a breach of a warranty. Consequently, it is important for the diligence team to be in contact with the negotiating team to be sure there is a proper understanding of the consequences of the diligence investigation and how it relates to the overall agreement.

Due diligence is an integral component of the acquisition and integration process. Although often complicated, expensive and time-consuming, it is extremely important for acquirers to conduct an organised and thorough investigation in order to complete transactions successfully and ultimately integrate the target efficiently.

Mark Thompson is a partner at King & Spalding International LLP.

Breakthrough value creation in M&A

BY VIKRAM CHAKRAVARTY AND NAVIN NATHANI

Mergers and acquisitions often fail. Studies have shown that close to half of all mergers failed to create any value and perhaps only a few of them outperformed their industry benchmarks. However this has not diminished the appetite for M&A. Indeed with private equity funds in the mix, the quantum of merger activity has hit record highs. With astronomical prices the onus on generating value is even higher than before.

Studies often point to the poor process of bringing the firms together and organisation disruption as the root causes of failure. We believe that the typical process of merger integration – which merely drives towards standardising processes and practices – is inadequate. It is important for firms to use the 'event' as a catalyst for step change and to embark on a program of significant transformation.

Background

M&A deals are complex undertakings that take centre-stage in the lives of the parties involved for a significant period of time, well before the actual deal. This pre-deal phase can range from months to years, during which the parties engage in planning for the deal – selecting a viable target, running strategic, commercial, operational and legal due diligence, developing a valuation range, and starting the negotiation process.

In some well planned mergers there is growing emphasis on chalking up 100-days plans, value-extraction plans, synergy calculation plans and so on. However, these plans remain relatively high level, partly due to legal barriers but mostly since there is uncertainty about whether the deal will go through.

A bulk of activities in the pre-deal phase remains linked to getting the deal through. Anyone who has been in the midst of a negotiation process can testify to the highly charged atmosphere and the driving rationale that without the deal there really would be no ability to create value. So it is not surprising that the task of thinking through how the deal will create value is often neglected and the plans remain rudimentary.

Our experience suggests that typical management objectives after the merger process focus on: (i) getting a budget done and ensuring decent allocation of resources (capital, labour, research, training); (ii) a desire to stabilise the firm; (iii) reducing disruption; (iv) imposing a consistent firm culture; (v) ensuring that the 'right' people are in the right roles; and (vi) starting the value creating process by activating some initiatives (typically the low hanging fruit).

The trouble is that this is a relatively timid approach focused on incremental changes. A merger offers the chance to 'change the rules of the game'. The merged entity is encouraged to re-think its strategy and positioning based upon its new position, and should implement a process of transforming its organisation to 'best in class'.

Value creation – planning the post-deal phase early

Since there are very few good bargains around to justify a deal on the back of 'simple' financial reengineering, acquiring or merging entities are clearly forced to focus on post-deal value creation.

Synergy extraction is often spoken about but not typically understood or planned for. Most mergers have synergy calculations done at a very high level in the pre-deal phase with little emphasis on exactly how they plan to extract the value. The realisation of this synergy will likely occur after stabilisation of the new entity, but often the extraction rate slows down after a while or disappears altogether. Our research shows that mergers generate a certain momentum, and unless synergies are extracted within the first 12 months they are unlikely to be extracted at all.

The pre-deal phase is usually passive with primary objectives such as assessment, identification and planning. Couple this with access hurdles for regulatory or confidentiality reasons, and the value-creation opportunities that arise out of this stage are neither concrete nor easily realised. In comparison, after the completion of the deal, the single emerging entity will be able to make plans from a better vantage point, as well as make plans that are likely to yield tangible benefits. But pre-deal planning is still important and must be attempted as much as possible within existing limitations.

In summary, we have found that industry consolidation trends and financial opportunities (low prices or cheap debt) are often the triggers for initiating a takeover bid. But true value creation lies in the mundane world of improving the organisation and its operations. Therefore the merger event is a time to push through significant change that will set the merged entity on a significantly different course. This is equally true for strategic buyers as well as buyout funds.

Lessons from successful merger transformations

During merger activities it is prudent to spend a lot of time getting the basics right. Standard hygiene factors for planning a merger integration include: (i) establishing clear goals, managing expectations and communicating openly; (ii) selecting the leadership quickly; (iii) focusing on customers; (iv) establishing a strong integration structure; (v) proactively addressing cultural issues; and (vi) creating an internal sense of urgency. But companies are also urged to consider radical solutions to the age old problem of value creation through M&A, as outlined below.

Setting new ambitions. Shift the mindset of the senior management from attempting to just get the best of the two firms, with minimal disruptions, to attempting to shift to a higher level of productivity. In general, this notion is met with scepticism as the merger process is cumbersome and there is a fear of 'biting off more that we can chew'. However M&A events tend to loosen age old corporate thinking and make radical change possible. In recent mergers we have seen firms shaken out of their standard ways of doing things and setting new goals to become the best player in their industry. The stock market has rewarded these efforts and the companies are on their way to becoming global industry champions.

'Jump-start' the clean room. For too long the clean room has become a dumping ground for data with managers rarely having good access to it to ensure detailed study. Data must be kept confidential but consultants also need to have access to both data and people to start the planning process. Multiple teams may need to work on multiple functions simultaneously, to plan for the merger in great detail before the actual closing of the deal, including joint studies. The planning stages should be carefully calibrated with the approval process, with more detail and access provided after each acquisition hurdle is crossed.

Detailed planning / responsibility allocation. Ensure that there are detailed execution plans with people allocations and KPIs completed and ready for execution on 'Day 1'. Short term plans, like 100-days plans, are critical for setting a sense of urgency and demonstrating the possibility of working together to generate positive results.

Selecting / moving to best practice. For processes and practices, be open about challenging the current status quo and pick a path to achieve the best in class. Benchmarking, all too often an ignored aspect of setting strategy, can be a powerful tool for forcing a re-think or encouraging out of the box thinking.

Avoid short termism. It is sometimes imperative to produce short term gains to show immediate results in order to pacify the investing public, creditors to the deal, regulators and others. Sadly, this is often achieved by cost cutting key functions which might hinder later stages of transformation. Although cost cutting is necessary, if the objectives of the merger become a transformation drive, then the areas of cost cutting migrate from SG&A toward marginal plants, improving procurement and logistics improvement, complexity reduction, manufacturing optimisation and the like.

Carrots and sticks. Detailed planning and responsibility allocation needs to be reinforced with a clear performance management system. This sharply allocates responsibilities, sets measurable KPIs and tracks performance. The system should have a strong incentive structure to ensure that individuals and teams are motivated. There should also be some 'headline punishment' events to let the employees know that slack will not be tolerated.

Discrete value creation opportunities exist at every juncture. Mastering the integration process is a critical success factor in capturing merger value, as most mergers and acquisitions typically fail due to a few consistent factors that relate to poor execution rather than strategic rationale. Fundamentally, mergers are a useful and valuable option for improving the fortunes of a firm. But the root cause of failure of M&A goes beyond weak execution of plans – often companies are not aggressive enough in their ambitions. Indeed, firms fail because they set their sights too low on incremental improvements and not on 'jumping the queue' to best in class.

Vikram Chakravarty is a principal and Navin Nathani is a consultant at A.T. Kearney. *The authors would also like to thank Phil Dunne, a partner at A.T. Kearney, for his support and advice.*

Cross-border M&A: downstream implications

BY DAVID EATON

Mergers and acquisitions have dominated the global stage for many years, cycling up and down based on market conditions, yet always serving as an accelerant of profitable growth, and ultimately, enabling globalisation. Worldwide M&A reached record levels in 2007, with $4.83 trillion worth of announced deals, according to Dealogic.

But, as previous statistical summaries have indicated, the M&A failure rate continues to range between 60 and 75 percent. Why do three-quarters of all M&A deals fail to deliver the intended benefits? The following example illustrates some underlying issues.

For global executive Hans Kommer, trying to focus his EMEA manufacturing team on getting this international acquisition back on track was proving to be more challenging than he had anticipated. Based on early scope and due diligence assessment, it appeared fairly straightforward. The deal made sense; bolting on a mid-market manufacturing operation in Eastern Europe to his company's global manufacturing footprint should have mapped beautifully. The target was already on board with the principles of Lean Manufacturing and Six Sigma, based on a previous joint venture with another competitor of Hans' firm. Even geographical synergy should have been easy, since the company was less than a 1000km from its headquarters in The Netherlands. So why was everything falling apart?

As Hans sat on the two-hour flight back from Bucharest, he thought about his latest meeting with the local team that had been assigned to him by the Integration Management Office (IMO) to integrate the manufacturing process. No one could explain why scrap rate and slow cycle times on the production line continued to escalate; customer deliveries were now a significant worry, and the sales team was climbing all over his back for delays in order delivery. The merit-based incentive system which was used successfully for years in Europe and North America was having little or no effect with these new employees in Romania. Hans' ability to gather high quality data on this last trip was limited; every question he asked seemed to generate confusion and mountains of excuses for why that information was not available. There seemed to be so many layers added to the decision making process, with a hierarchical, power hungry reaction from some folks, while others hung back and seemed to avoid the conversation. It also seemed to be difficult for some members of the new management to accept their fate, to understand they needed to join the European manufacturing team and demonstrate ownership of the integration strategy laid out by senior leadership at headquarters in Europe.

Hans has the challenging task of successfully integrating this acquisition into his global functional responsibilities, while achieving the ROI predicted and communicated to shareholders and the board. Cost savings and supply chain synergies based on supposed geographical advantage would not pan out as the corporate development team had expected unless he got his act together quickly.

It's all about integration

There are five misconceptions that continue to plague cross-border deals in particular, even those consummated by the most brilliant officers of corporate development or M&A, and talented integration teams assembled from some of the strongest talent within each function of both companies.

First, functional integration. "Manufacturing is manufacturing, IT is IT, and finance is finance." While some functions do share common terminology and professional training around the globe, in the post-acquisition period standard practices for developing prototypes or deploying the IT function may not be so compatible.

Second, geographical integration. "Geographies will meld together. My Western European headquarters will have no issues of compatibility with its new Eastern European colleagues." Even in an era of transnational management, many employees are still very much culturally conditioned by their national backgrounds, and may leave a post-integration entity if their legacy culture is not incorporated into the new operating environment.

Third, customer integration. "Customers who previously used one supplier from their home market will be fine receiving shipments from the other side of EMEA. Our customer support centre now based in North Africa will serve our EMEA customers just as well." Customers tend to have their own way of looking at the world, and may not see the new set-up as a plus from their standpoint.

Fourth, manufacturing and supply chain integration. "Closing redundant plants and merging supply chains into one robust system will be a relatively straightforward consolidation exercise." In many regions of the world, personal ties to employees and long time suppliers, along with deep-rooted organisational systems, can lead to highly charged debates that make supply chain rationalisation surprisingly difficult to achieve.

Finally, human integration. "Our corporate cultures seem to be pretty compatible." Acquiring companies consistently underestimate the challenges of post-merger integration of human capital. Often the most critical success factor in making a deal work is not the financial projections, the strategic plan, or the organisation chart, but the ability of the principals to mesh as a new team. Different personal styles, thought processes and informal patterns of communication shaped by both organisational and national cultures can all make human integration a challenge.

Building a third culture

Come on, we're all smart people, we've read the articles, we know we need to concentrate on these issues as we contemplate a joint venture, a merger or the acquisition of another organisation. So why do these issues continue to challenge us? Why can't we anticipate these challenges and develop a plan to minimise the 'noise in the system'?

It is quite common for employees from an acquiring organisation or a new partner to think "For years we have been successful with our methods of manufacturing, financial reporting, and staff training. If the other organisation's ways were so superior, wouldn't they be in better financial shape?"

The challenge lies not so much in whether one way is more right than the other. The challenge is creating a mutually-respectful environment where exchanging ideas and explaining processes creates the opportunity to build an even better post-M&A culture without 'giving up' the asset value of the target or the non-negotiables of the acquiring company.

Experience suggests that one good way out of this perpetual hurricane is to build a 'third culture', or a third way of operating, which rises above either party's traditional methods.

It has been said many times that the whole is greater than the sum of its parts. But the whole is not simply gathering all components to make a big heap in the center of the warehouse floor. The whole is actually the cumulative effect of the best ideas derived from the individuals, teams and organisations involved, as well as the contribution of new, innovative thinking arising from the synergies of the acquisition.

In other words, the best success stories begin when a topic is placed in the centre of the table. All the best minds available gather to discuss and brainstorm great ideas and innovative solutions, and if an element from a previous system or organisation should contribute to the final solution mix, fantastic.

Building a third culture requires humility, open mindedness, flexibility, creativity and comfort with risk. It also depends on the ability of group members to value other opinions, fresh thinking and the potential to create something original. But most of all, the team, or pair of individuals, can only achieve third way solutions if they are in a place where they can successfully navigate stylistic differences.

Follow the rapids

To minimise the costs inherent in unsuccessful cross-border M&A and joint venture activity (longer cycle times, opportunity costs, and even business failure), Hans could consider the following seven steps to successfully navigate the rapids and resolve his current predicament in the downstream integration phase.

Scope the activity. Hans needs to be very focused on the problem he is trying to solve. For example, what will be the key initiatives he needs to implement to get the manufacturing streamlined and realise the savings for the region promised by the acquisition, what systems need to be built or installed, or which components need to be integrated? In other words, how does this acquisition impact his overall strategy in EMEA, and the roll-up to the company's global requirements?

Metrics that move. If he achieves a successful outcome as a result of bringing key individuals or teams together, what metrics will move as a result? Examples of ROI include improved cycle times, cost reductions, increased sales, customer or employee retention, one fully integrated key account or reward system moving forward, and so on.

Human interaction touch points. Who needs to be invited to the party? Hans must identify key stakeholders per category, and involve them in the process by which a creative, innovative solution will be developed to achieve the desired state. This could be called a 'human interaction across cultures' audit. In essence, it means looking for the places within the newly combined organisation where two or more people will interact across multiple definitions of 'culture' – company, national, functional, geographical, industry, headquarters versus subsidiary, etc. – in a way that impacts the challenges, and the expected synergies.

Personal styles inventory. Each individual arrives at the incubator table with his or her own styles of 'human interaction'. It is vital to understand their 'pile of styles', the hard wiring they have received that shapes their behaviours. Team members must achieve a level of acceptance/respect, to gain awareness of each other's styles, and to understand the 'why' behind their behaviour, so they can appreciate each individual's starting point.

Building team systems. Before it is possible to navigate the business issues that need to be solved, we must create a 'human operating system' that will drive a team's interaction going forward. The team must define a shared vision of what goals it seeks to achieve, the key business problems it must address, and individual roles and responsibilities. In addition, the team needs to co-author a number of key shared systems, the components of which tend to vary widely according to national and organisational cultural norms: decision-making system; project management; communications (virtual and face-to-face); meeting management; conflict resolution; and other group norms (email, conference calls, agenda setting, relationship building, etc.). Out of the array of individual styles present at the table, team members need to create the most appropriate team culture to achieve a successful outcome.

Solve the problem. A business work-out can be accelerated in the initial stages by an internal or external facilitator who can not only guide the team through the process of developing an innovative solution to the business challenge, but also serve as a process coach. The facilitator helps to enforce, and reinforce, the newly-created team culture, ensuring that team members stick to their agreements and utilise shared processes to drive problem resolution.

Loop back around. All good processes contain an element of self-reflection and evaluation. Companies should undertake a process of review against the previously mentioned 'metrics that move'. Measuring progress toward stated goals and experiencing improved results is a powerful elixir with which to motivate any individual, team or organisation.

Summary

Successful mergers, acquisitions and joint ventures depend on the eventual integration of two or more organisations. The net deliverable of the seven steps described above is nothing less than the creation of a third culture within the newly combined organisation. An acquirer is ultimately judged on how well it achieves the stated objective: to buy, merge or collaborate with another entity – sooner, faster, cheaper, better. When bringing together diverse colleagues and cultures, and merging systems, processes and procedures into one organisation, specific steps can be taken to enable these teams to rise above their competing styles and develop a third culture – one that can fuel integration and superior business performance.

David Eaton is a managing director and founder of Aperian Global.

Integration – the key to a successful merger

BY RICHARD LIEBERMAN

No buyer acquires another company anticipating the transaction will fail. Nevertheless, a surprising number of mergers and acquisitions yield results far below projections. Many acquired companies are later resold to new buyers or spun-off within a few years, allegedly because the new business was not a 'strategic fit'. Regardless of the reasons given, many of those transactions underperform because the buyer did not devote sufficient attention to the integration of the businesses.

Ideally, a successful integration permits the combined enterprise to operate as a synthesised unit on the closing date, with minimal disruption to customers, personnel, productivity and operations. Employees are motivated and cross-trained on the products and services of the combined enterprise. Employees can communicate with each other, customers and vendors through compatible systems in the appropriate languages. Policies and procedures are synthesised and incorporate best practices. Compensation and benefit programs recognise and reward retained personnel in effective ways. Disruptions from the elimination of redundant positions are minimised and consummated promptly. Service levels to customers equal or exceed prior levels. Financial results improve and continue over a sustained period.

The danger of delay

Due to its critical importance to the success of the transaction, buyers should commence integration preparations as far in advance of the transaction as possible. Many purchasers delay integration planning until just before the closing, to save effort and expense. Their limited staff resources are often otherwise engaged. Confidentiality considerations may limit the ability to introduce necessary personnel to the potential transaction. Similar reasons are offered for why the integration efforts are postponed.

Delay, though, can exacerbate the difficulties in achieving a smooth and prompt synthesis of the companies. Frustration caused by the disruption in the integration can result in loss of key employees, customers and good will. Failure to properly assess the impact of disparate methods of operation could result in delays in production or delivery of services. Ignoring the impact of foreign laws could result in false starts in implementing new procedures or wasteful litigation, leading to further delay and expense.

Buyers can commence integration planning early, without undue expense, and focus additional resources as the transaction progresses. Purchasers should seek relevant information during negotiation and due diligence to assess integration aspects needing attention. A cohesive acquisition and integration plan should be seamless. Buyers that have never acquired another company should commence the process earlier than those who have completed the process multiple times, to provide sufficient time to develop an approach to each issue. Nevertheless, every transaction will have its own particular aspects that warrant attention, even for experienced buyers.

The integration team

The integration team should have the capacity to effectively identify and develop solutions to the integration issues. Often, the acquisition team will contain many of the personnel qualified to analyse those aspects: executives, attorneys, human resources, accountants and tax professionals, operations experts, information technology personnel, and others. If in-house expertise does not exist, or confidentiality or other reasons prevent including those personnel in the early analysis, outside consultants can be engaged on a confidential basis.

Care should be taken to be sure that the integration team evaluates the ability to achieve projected results on the anticipated timetable. The acquisition team may have incorporated assumptions into the projections that are not achievable due to delays caused by the integration process.

As noted below, if the acquisition team will be diverted to other transactions shortly following the closing, buyers might consider designating one or more persons responsible for the integration who will continue to focus on those efforts after the closing.

Aspects of integration

Proper integration planning should review all aspects of the business, focusing on implementing the best employee, administrative, operational, and marketing programs available to the combined enterprise. Additional integration planning is appropriate for transactions between companies in different industries or with foreign operations.

Employees. Perhaps the hardest but most important aspect of integration planning is determining the compatibility of employee cultures. Some employers have prospered with results-oriented 'survival of the fittest' systems, while others foster more collaborative, nurturing environment. Buyers may mistakenly assume that the same incentives for their employees will also motivate the new workforce. Compensation works for some, while recognition and intellectual challenge are necessary components for others. Proper assessment of employee cultures can help buyers implement effective programs. Employee training will also help to educate new workers on accepted methods of operation and expected performance levels.

Compensation and benefit programs of the target company should be evaluated to determine which model should survive and for how long. Buyers should not assume that their existing programs are necessarily the best, and should consider adopting the best practices of each group.

Buyers should also evaluate the impact of the transaction structure and terms on executive and employee motivation. For example, if earn-out performance targets are difficult to achieve, the sellers may have little incentive to help drive performance as planned. Buyers may achieve better long term results by offering the seller's executives a significant incentive to help achieve maximum performance, rather than trying to keep the purchase price to a minimum.

Administration and operations. Communication, accounting and information technology systems will need to sync as soon and seamlessly as possible. Those issues may be particularly difficult to achieve if the companies operate in different countries and in different languages. Converting the accounting, tax and information technology systems into a cohesive, technologically compatible system may involve significant time and expense. Meanwhile, an effective interim solution will need to function before a more permanent solution can be implemented.

Policies and procedures of the enterprise should be introduced to the employees with proper training. If the business combination brings the enterprise into a new jurisdiction, the new policies and procedures should be reviewed for legal compliance as well as their conformity to local customs and methods of operation. Personnel from the seller's operations can help identify potential roadblocks and solutions.

Significant time may be required to obtain required licences and permits necessary for the purchaser to operate the business. The parties can often structure the transaction to minimise the impact of the delay.

Customer and vendor relations. Proper integration planning will enable the company to communicate with its customers and critical vendors promptly following the first public announcement of the transaction. Customers should be educated on new products and services available to them. Vendors will seek assurance that their receivables will be paid and will want to know the impact of the transaction on their relationship with the company. Although many issues may not be known, buyers are well advised to prepare answers to as many of the anticipated questions as possible. Similarly, they may want to develop a small team prepared to respond to unanticipated issues, to help maintain consistency in approach.

Sustained efforts help generate success

Integration efforts should continue well beyond the consummation of the transaction, to help assure that the two companies are merged in more than name and financial results. The integration of employees and cultures takes time. Too often, companies focus on the next transaction and fail to complete integration of prior deals. Executives may leave integration to their operations personnel, who may have different incentives in making integration decisions. For example, administrators may make personnel decisions favouring co-workers whose skills are known to them, rather than to thoroughly evaluate all qualified candidates from both organisations.

Integration efforts should continue well beyond the consummation of the transaction, to help assure that the two companies are merged in more than name and financial results.

Companies can facilitate the integration process in a variety of ways. They might designate a liaison who offices at the seller's location. The liaison could be responsible for the successful integration of the two businesses and be given appropriate authority to help facilitate the combination. He or she can serve as a resource for the employees of the acquired business and help instil in them the new cultural values of the buyer, while advocating for the new employees and their needs, as appropriate.

Devoting time and resources to allow key executives and employees to meet personally and to see the operations of the other can help strengthen intercompany relationships. Buyers have often met with success by conducting strategic meetings with the seller's personnel at all levels of the organisation, listening to their suggestions, concerns and aspirations.

Regardless of the methods undertaken, buyers who devote attention to integration early in the process, and who sustain a focused effort on it, can greatly enhance the prospects for success in their acquisitions. Moreover, the efforts expended should result in improved results and more satisfied customers and employees.

Richard Lieberman is chairman of the Corporate, Securities and Finance Department of Jennings, Strouss & Salmon, PLC.

Protecting your cultural assets through an integration

BY KATE LYE

If you are looking for clues to the likely success of a particular merger or acquisition, then take a look at the integration plan. Research has shown time and time again that the quality of the integration planning, particularly around the softer cultural issues, is a reliable predictor of future shareholder value.

Ironically the M&A process tends to be weighted towards the front end; think of all the energy and attention that goes into target identification, due diligence and the actual deal negotiations. Post-deal planning; by contrast, can seem like a secondary consideration.

Certainly, organisations are quick to execute the basic operational, financial, people or market changes that are necessary to unite two once separate businesses. But many seem content to rely on unsupported assurances of 'cultural fit' or hope they can deal reactively with the thornier questions of cultural integration. This is foolhardy given the wealth of data that highlights the integration period as the point at which shareholder value is most likely to be destroyed. The soft integration issues are where merging organisations are most likely flounder. This failure to manage cultural contention can transform a once market focused business into one that becomes internally obsessed and on a slide towards mediocrity.

Leaving aside the technical integration issues, for which there tend to be more tried and tested solutions, there are six questions any integration plan needs to answer if it is to address the cultural integration conundrum, as outlined below.

1. What is the strategic value we believe we can create through this deal? Few mergers or acquisitions are undertaken without a clear vision of business outcomes that become possible through a deal but that neither party could achieve independently. These may be to deliver new products or services, to benefit from economies of scale, to rejuvenate a mature company by injecting new thinking or talent, to increase market share or rapidly access foreign markets. Whatever the original strategic rationale for the deal, this needs to be the focal point for all subsequent integration decisions and plans. M&A stalwarts rightly judge that 60-80 percent of a deal's value is won or lost in the first 12 months. In the many cases where the shareholder return is a loss, businesses have often lost sight of the underlying strategic rationale in all the upheaval and discord of the integration.

2. What are the true measures of success for this integration? So be sure you have a clear statement of the ultimate strategic value that the merged organisation needs to deliver and make this the bottom line for the integration team and executive team.

Another recommendation is to determine some distinct operational, customer, people, cultural and financial metrics to focus the integration plan. It is possible to track many integration aspects such as operating efficiencies, productivity, customer retention, service disruption, talent retention, employee trust, speed of implementation and brand loyalty. The key is to identify those that are most closely tied to the strategic rationale and devise an integration scorecard that keeps the new organisation on track.

3. What form of integration approach will best deliver these outcomes? Integration can be compared to organisational surgery; painful, unpredictable and not to be undertaken unless absolutely necessary. Integration teams must draw distinct boundaries around how and where the two organisations need to come together and where there is benefit in remaining apart. Integrate only where it serves to add value or reduce friction. The assumption that the full integration (i.e., integrating all the processes, teams, locations cultures and structures is always better) is a common mistake. A more studied approach is to consider the different forms and levels of integration possible, the pros and cons of each and how they support the deal rationale. It is more helpful to think of integration choices in terms of a gradient and the varying integration activities required for each level: (i) minimal integration; (ii) partial integration; (iii) full integration into the acquiring business; and (iv) co-creation of a new business.

There may be real benefit, for example, in maintaining a standalone entity and brand, if the acquiring partner is unknown in the target's market. In this the integration may be limited to joint financial and legal reporting structures. Other situations can call for a partial integration around a particular function or operating process. When full integration is the appropriate option, be clear about who is leading the process and who is integrating into whom. For the sake of appearances, leaders can fall into the trap of giving false assurances about the integration being an opportunity to co-create entirely new working practices and take the 'best from both'. In practice, it is hard to dispassionately judge whose processes or people are best. The reality is often that the acquiring company's norms and practices will be the blueprint for the new organisation. While the organisation should take the opportunity to learn and improve from their new colleagues, few businesses want to start again with a blank piece of paper.

4. What cultural assets and risks do you need to manage to safeguard the post-deal strategic value? The due diligence process can be woefully deficient in identifying those softer assets the buyer hopes to acquire or create through the deal. This is a serious oversight. Integration teams need to be rigorous in assessing what cultural, people or reputational assets they must preserve, sustain and build into the new organisation. Many an acquirer has discovered to their cost that cultural assets they believed to be integral to the value of the target organisation can quickly diminish if not identified and managed from the start. This is especially true when large mature organisations use their financial muscle to buy an edgier market brand or an alternative talent pool. Once again, being clear about the strategic rationale for the deal helps an integration team to focus on the cultural assets or risks they need to manage from day one.

5. What plans and resources do we have for shaping the culture the new business needs? There will be cultural surprises at many points in the integration process. Experienced integration teams recognise this, but also know the importance of going into play with a clear point of view about the type of culture the new business needs to thrive and a working plan to put this into place. Being ready and able to move quickly on cultural issues is important because an organisation, like nature, abhors a vacuum. In the absence of the new cultural direction a 'de facto culture' can emerge. This may have been shaped by early integration decisions, unplanned events, key individuals or third parties and can prove difficult to override.

There are any number of models and tools on the market for assessing the current cultures and helping create some shared expectations and language about the cultural differences. However, there is no 'silver bullet' cultural methodology. The real value is in how the integration team uses the data to plan and manage the softer integration issues. Even using a straightforward model such as Johnson and Scholes, to map the current and future culture, provides integration teams with a framework for understanding where the two existing cultures are naturally aligned and where there is likely to be conflict.

The team can then develop a systemic approach that combines hard tactics (organisation structure, compensation incentives, and a shared decision-making system) and soft tactics (symbolic actions, leadership communication, employee involvement, people development) to demonstrate to employees what the expected behaviours, assumptions and values are of the joint organisation and then to reinforce and embed them over time. It is also possible to track cultural alignment over time and pinpoint problem areas that need more support.

6. Where does the buck stop for making our culture work for the business, its employees and shareholders? The best laid integration plan will not be effective if it is working without the full support and cooperation of the senior leaders in the business. Leadership behaviour is the single most powerful and visible force for shaping the culture of a business. In the heightened environment that follows a deal, what leaders pay attention to, reward and role model is disproportionately important, as well as how they react to critical decisions or events.

One misplaced comment or action from a leader can send a contradictory cultural message that will reverberate around the business. Senior leaders must recognise that they are a key ingredient to the future culture and be guided by their integration team on how they can support the cultural integration process.

Conclusion

Anyone who doubts whether 'culture' exists or matters need only take a ring-side seat at a poorly orchestrated integration to see the cost cultural problems can inflict on a business. Culture can work as an asset or liability for any organisation, but during integration, managing softer business assets is critical to delivering the strategic rationale and enhanced shareholder value.

Kate Lye is an independent integration consultant.

Human resources – a fundamental part of the planning phase

BY SEAN WELLS AND SAMANTHA BARKLAM

Although recent surveys show an encouraging trend towards HR involvement at an early stage in M&A there is still more to do. Some businesses do not involve HR quickly enough – perhaps due to a heavy focus on commercials or a low regard for HR's capability. A strong HR presence at board level helps, but is not the panacea. Successful M&A transactions use HR to help shape some of the major decisions and ensure big cost items can be budgeted, such as pensions and restructuring. But these are not the only factors to consider.

Culture. Culture can be viewed as the internal brand of an organisation; how people feel about the company and the principles used to address issues. Culture is such an integral (albeit subtle) part of an organisation that common sense suggests it should be a fundamental consideration. So why is it often overlooked? Among the reasons cited are that culture is too difficult to analyse and there is no tangible return on investment for doing so. Neither of these assumptions is correct.

Cultural differences can arise in many areas, including: companies placing greater emphasis on employees than shareholders; retaining control rather than delegating autonomy; operating a lean, rather than large employee-driven operational centre; or being cost, rather than employee-driven. The risks associated with these differences include: different interpretations of company strategy from board-level downwards, dividing leadership; poor external branding, caused by weak messages coming from employees of the merged entity; slower communication and consultation processes; and employees remaining mentally tied to their pre-deal company, rather than working together for the merged organisation.

A company can take steps to mitigate these issues. It should invest time to understand both companies' views of the world, measure culture at the start, analyse where the merged company needs to be and how to get there, implement regular cultural temperature checks, respond quickly to any concerns raised, and set clear links to the return on investment (which really is possible). It is hard to imagine an area within M&A that is not affected by culture, so it is crucial to address this early on.

Communication and buy-in. Human nature can lean towards voicing negative, rather than positive thoughts. It is therefore imperative that communication with employees is not left to chance, to avoid unhelpful messaging. The aim should be to take employees through the engagement steps of awareness, understanding, buy-in and then ownership of the changes. At the start of discussions, a clear, structured communication plan should be in place which covers identification of stakeholder groups, positive communication ambassadors, appropriate communication channels and estimated communication dates. Getting business buy-in is vital, particularly given the sensitive nature of HR changes. Aside from employee communication, roles and responsibilities across the integration team should be clearly defined, to eliminate cross-over or gaps.

Linked to culture again, two merging companies can place different levels of importance on communication. For example, one may have 90 percent of its communications focused externally while the other has 90 percent focused internally. This indicates opposing views of the importance of employees versus market views, and appreciating such differences is key.

To harmonise or not? Some terms lend themselves easily to harmonisation while others do not, so a hybrid of the two approaches is often sought. However, companies may have the required systems to enable them to take on a large number of different terms without the need for change. It depends on the business model. Considerations include the financial costs of harmonisation; whether current HR Information Systems (HRIS) are able to handle a variety of legacy terms; whether current processes lend themselves easily to harmonisation; and whether employees are used to change or likely to have an adverse reaction that outweighs any gains of harmonisation.

Reward / retention. A common mistake when devising retention strategies is to focus solely on financial rewards. This can backfire, with employees viewing bonuses as a 'given' rather than something that really addresses their concerns, such as recognition from management, better communication or personal development. A poorly considered retention plan can result in greediness, little improvement in performance and a focus on resignations surreptitiously geared to pay-out dates. All in all, this is not a sure-fire way to improve morale, and definitely not a time to take a broad-brush approach. The company should ask itself what the new entity wants from its employees. It should decide whether its employees are central or peripheral to the organisation's goals. If the former, an employee retention strategy is a must. Even if the latter is the case, the company should make a conscious decision to let employees resign, rather than leave attrition to chance. Finally, the company should identify the major concerns employees have and how it can help to resolve them.

Other issues. There are too many additional HR issues to detail here, but three others are worth noting. Legal issues: it is important to ensure both parties have a common understanding of legal implications and timeframes, and that HR is used to provide a balanced, rather than purely legal, view. A common viewpoint should be sought. Change fatigue: a company should be mindful of people's workloads and know when to bring in external support to ease the strain. If people strategies are at the heart of the business, the warning signs are more apparent. Project management skills: this includes understanding costs, benefits, milestones, risks, issues, dependencies, resource planning and stakeholder buy-in. The same rigorous standards should be applied regardless of whether the company is being acquired or vice versa.

Are people strategies the responsibility of HR or the business?

The answer is both – most companies speak about the need for HR to act as a 'business partner'. The reality is that few organisations achieve this, either because the HR team is not ready to take on this role, or the business has not bought into the concept. While time is spent debating this model, is the business receiving the support it really needs?

Putting the HR business partner model to one side, the key questions for HR are quite simple. Are you close enough to the business to understand its drivers, peaks and troughs? Are you helping the business achieve its goals? Are your business relationships formed out of a defined structure, or an ability to proactively engage with people, regardless of a prescribed role?

A 'good' HR approach is about more than dealing with legal issues. It is about all parties thinking commercially enough to actively support the business strategy. By thinking in these terms, the implementation of people strategies becomes a combined effort between the business and HR, rather than a painful afterthought.

Although the financials may be the primary drivers for mergers and acquisitions, the people are the fuel. By forgetting to address people-related issues at an early stage, a company is forgetting to fill the tank up with petrol before it starts a long, and often arduous, journey.

Sean Wells is a partner and Samantha Barklam is HR M&A lead in the Financial Services Practice at Atos Consulting.

Maximising deal value through the human side of M&A integration

BY TIMOTHY GALPIN

After the downsizing and cutbacks of 2002 and early 2003, M&A activity now rivals the dealmaking pace of the late 1990s. Executives who were part of that earlier M&A period may believe they know how to execute a successful merger or acquisition, but M&A deals often do not achieve the strategic objectives trumpeted in their initial announcements. Indeed, numerous deals result in a net loss of value, from Quaker's ill-fated acquisition of Snapple to the failed DaimlerChrysler merger that dominated recent headlines. But why?

Although subpar M&A results can be attributed to several factors, from too high an acquisition price to a bad strategic fit, the central problem is poor integration, particularly on the organisation and people aspects of the deal. Integrating one business with another is highly complex, even for the most experienced acquirers, and companies must manage the process exceedingly well to succeed. Unfortunately, in the University of Dallas Graduate School Of Management's recent M&A survey (including 124 executives and managers from 21 different industries), 63 percent of the respondents rated their company's integration efforts 'average or below average'. Equally troubling, two-thirds of the executives said their newly merged company took at least one year and in some cases three to five years or longer to achieve full integration, during which time employee anxieties and misaligned cultures damaged productivity, performance, and customer relationships.

Among the most critical, but under-managed aspects of integration, are: (i) development of an effective Newco culture based on the integrated company's strategy; (ii) the retention and 're-recruitment' of key talent; and (iii) communication about integration progress.

A vivid example of culture issues hindering deal performance is the 2000 AOL-Time Warner merger, which has yet to add shareholder value in large part because of a culture clash between the two companies. Given the key role cultural integration plays in the overall success of an M&A deal, executives must achieve better performance in this critical area. The merging of two cultures depends first and foremost on a clear articulation of the Newco's strategic goals. Once those goals are set, they provide the foundation for the Newco culture. For instance, a company with a strategy focused on service excellence will want its employee and management behaviours to consistently reinforce that commitment.

Shaping organisational culture, however, can seem like a frustratingly vague task. To reshape culture in order to serve a Newco's strategic goals, management can employ an operational description of culture that segments it into 10 key elements: organisational structure, staffing and selection, communications, training, goals and measures, rewards and recognition, rules and policies, ceremonies and events, decision making, and the physical environment. A focus on integrating these 10 cultural components, as well as on the more informal aspects of culture (e.g., executive teaming and social networks), provides management with a tangible and comprehensive approach to moulding the culture of the Newco.

In addition to the cultural issues that are created by mergers and acquisitions, when a company announces a deal, the ensuing turmoil leads managers and employees alike to turn inward. They focus far less on their job responsibilities and customers than on their 'me issues' (Will I have a job? What about my pay and benefits? Who will my boss be? What about my location?). In this uncertain environment, headhunters seize the opportunity to lure away key talent. And even if good performers stay, their emotional commitment to the organisation often fades, which can be as devastating on Newco performance as actual departures. Therefore, management needs to make retention and 're-recruitment' (emotional re-engagement) of top performers a central priority during mergers or acquisitions. A five-part retention and rerecruitment approach is critical: (i) identify key people; (ii) quantify what the impact of their departure would mean (e.g., a loss of key clients or knowledge about a core product); (iii) identify their needs; (iv) develop and act on a plan to meet those needs; and (v) draft a contingency plan in case key people do leave.

Too often the easy answer to retention and re-recruitment is a 'stay bonus'. But the process cannot end there, as key talent have other needs that may go overlooked, leading to frustration and resentment. Beyond stay bonuses, key people want to feel included and know what is going on during integration. To maintain their engagement, the company should keep key people in the loop by involving them in the integration process. Moreover, employers make a big mistake when they do not share information just because some integration decisions have not yet been made. Accordingly, frequent updates on the integration process and progress can go a long way toward retaining and re-recruiting key talent. Finally, people need to feel both pride in their day-to-day work and satisfaction in playing an important role in the Newco's success, making it critical to recognise significant employee contributions to tough integration tasks.

An excellent example of retention and re-recruitment results that can be achieved comes from the integration of two major software firms. Silicon Valley-based Macrovision set a target of 80 percent for employee retention during its acquisition of Chicago-based InstallShield. Using the retention and re-recruitment approach, Macrovision actually achieved a retention rate of over 95 percent – a remarkable figure that accelerated integration and saved the company considerable expenditures.

Finally, when it comes to deal communications, management must first be aware of the 'killer phrases' frequently used during M&A. Unfortunately, these phrases are voiced time and again from management about the deals they are doing. The most common killer phrases – and the realities behind them – are identified below. Any of these statements alone can be a value killer. Two or more of these statements together are a quick and powerful route to destroying deal value. As soon as one or more of these phrases is uttered by anyone who has a direct impact on the success of a deal, a caution flag should go up:

(i) "This is a merger of equals." – There is no such thing.
(ii) "It is too early in the deal to begin planning for integration." – It is never too early.
(iii) "We don't need to tell the employees anything until there is something to tell." – There is always something to tell, if not decisions, at least integration progress along the way.
(iv) "We'll freeze the organisation for at least a year, and once things settle down we'll start integrating." Or, "We'll ease the changes in." – Slow integration only elongates the inevitable productivity drop.
(v) "Now that the transaction is complete, the deal is done." – Nothing is further from the truth. In fact, the real deal is just beginning.

In any merger or acquisition, it is virtually impossible to be seen by everyone involved as being totally fair. The difficult issues that must be dealt with during integration include making and communicating key decisions about: organisational structure, reporting channels, spans of control, roles and responsibilities, as well as the selection of people, processes, and systems. There are hardly ever straightforward answers to these and other integration decisions. But senior management must make decisions quickly (with 'prudent speed'), communicate those decisions, and stand behind them. Otherwise, employees, investors and customers get the message that top management is disorganised and indecisive, and that the merger lacks leadership. Even if key decisions have not yet been made, communicating progress provides people with a sense that management has the integration effort under control.

In order to get the most value out of deals, the mandate is successful integration of a target's operations, systems and people. The key risk is that the organisations fall apart rather than join together – destroying value. And, the market is unforgiving. Given the resurgence of M&A activity today and the high volume of deal activity expected in the future, organisations must reassess both their existing M&A integration capabilities and future plans to include the people matters. Companies' deal processes cannot simply be limited to assessing and integrating the financial, operational and technological aspects of targets. Companies must also be able to conduct thorough cultural due diligence and integration. Likewise, companies must possess the ability to quickly and effectively develop and execute M&A retention and re-recruitment plans that fully account for the needs and concerns of key talent, enabling them to keep the best people on board. Moreover, management must frequently communicate integration progress or risk the rumour mill taking over and distorting the information that employees, customers and shareholders receive. Building strength in these areas paves the way for faster, more effective integration, and better overall Newco performance, ultimately maximising deal value.

Timothy Galpin is an associate professor at the University of Dallas Graduate School of Management and a senior fellow at Katzenbach Partners, LCC.

Post-deal soft skills in emerging markets

BY NICK HOOD

Contemplating a knock out acquisition in a gloriously tempting market in a growth economy in Eastern Europe, Asia or Africa? Salivating at a non-price sensitive commercial environment, where there is no pressure on margins and where the competition is either non-existent or totally disorganised? Dreaming of a world where there is no ridiculously employee-friendly legislation and where money-laundering or antitrust rules are not even a twinkle in the eye of the local politicians?

Doing the due diligence and closing deals in emerging markets can be tough – but the upside is the endless high returns and interesting places to make business trips. Isn't it?

Actually, the most important and really challenging part is: making it work. And the questions are endless.

How far should the foreign acquirer try to integrate its new toy? Imposing its standard of financial and commercial reporting is one thing (and not an easy one), but what about IT, HR and all the other elements of how the mothership is run?

IT and communications dominate business life in all developed jurisdictions, but even in these sophisticated days, replicating the instant access and hyper-speed interaction we all take for granted will be difficult. The more complex or modern an acquirer's systems are, the greater the risk they cannot be introduced easily or effectively in the new location. First, the acquirer must question the ability of its IT department or support function to carry out this task. It needs to be honest about their skills, if there are any doubts, turn to outside specialists who can demonstrate a track record.

Most of all, the acquirer should be gentle with the staff in its new acquisition, who may not be comfortable in cyberspace or even Excel. Not everyone checks their emails constantly and understands why their acquiring firm might be impatient at the slightest delay in replying to questions. They are also highly unlikely to understand the intricate politics and protocols of email circulation lists and blind copying.

IT is only the start of the communications agenda. How will the acquirer keep in touch with the management of its far-flung acquisition? The one absolute rule is that somebody has to go somewhere, because a strategy of video- or tele-conferencing can only send one message: that the acquirer does not believe its new colleagues are sufficiently important to see face to face, or their market isn't worth keeping in touch with first hand.

The next issue is whether the acquirer will go there regularly or decide to disrupt local management by asking them to visit instead. Psychological common sense suggests that the constructive thing is to give the subsidiary the advantage of home turf, if only because it will be more at ease and the acquirer will gain huge insight from seeing them operate in their own environment. It is also extremely important to avoid the 'seagull' management technique: flying in briefly and dumping toxic management waste from a great height.

Language is a key issue. Using English as an example, even if local staff can speak it well, there will be subtle differences in the use and meaning of words, which takes time to understand and may cause major misunderstandings. No one likes using interpreters, but there are times when it is more sensible than forcing local staff to struggle along in their third or fourth language.

Corporate governance norms need to be reviewed in the context of local best practice.

Corporate governance norms need to be reviewed in the context of local best practice. An acquirer may not like what it sees – especially how the wheels of business relationships are lubricated – but a knee-jerk rejection of 'commission' arrangements will be highly counter-productive. The acquirer should try to understand the true nature of these practices and judge them against the market in which they operate. Are they out of line? How they would be perceived if they reached the public domain in a media-unfriendly way? An uncomfortable acquirer should facilitate open discussion with local management and try to find another way of preserving key relationships, or toning down the worst excesses. Sometimes local management share these concerns and may welcome assistance in changing things.

Management structures can be puzzling. The tendency is for quite flat hierarchies, with many people apparently reporting to one or a small number of decision makers. Simplistic reviews of job specifications can be wildly misleading. An acquirer must not accept what it is told initially at face value; it must dig deeper and find out what is really going on. There will be community and family considerations, many of them unstated. In one example, the key individual in a vital section of a textile mill was not the foreman, but the cleaner, who was more senior in the relevant religious community.

Many such acquisitions falter because buyers fail to transfer their skills. In emerging markets, this is a strange oversight, which condemns the local management to frustration and the acquirer to endless disappointment at ongoing underperformance. So creating a workable program for training and upgrading local staff is a must. This does not require the involvement of a large number of people if key individuals are identified who can pass on what they learn, preferably down through a number of management generations. Short or medium term staff secondments back to the buyer's home base can be particularly effective.

An acquirer has a serious decision to make about whether it is going to deploy a 'spy in the cab', possibly by sending one of its own people to work in the local structure.

Alternatively, it can hire an independent local. If it decides to use this technique, the individual will have to be a special animal with an unusually well-developed ability to empathise with local concerns while remaining objective.

If the acquirer opts for an outsider, it should think twice about choosing a classic 'ex pat' who originates from its home jurisdiction. Some are very good and provide the ideal mix of understanding both environments and acting as mediator over the inevitable disputes. But far more are past their sell-by dates and have a distinctly short shelf life on any particular assignment. Far better to use a good, independent local executive.

The pace of integration needs careful consideration. Two instincts predominate. The first is to throw all the balls in the air at once, like some sort of demented management juggler. Dictats and policy pronouncements rain down indiscriminately from head office, usually causing panic and confusion.

Other acquirers seem dazzled by the thrill of the chase and paralysed at the moment of capture. The gruelling due diligence process and interminable price and contract negotiations are followed by… very little. Days stretch into weeks and then months, with local management wondering what to expect and not knowing whether they should be doing something different.

The sensible strategy lies somewhere in the middle. A pre-deal dialogue is necessary to explore what needs to be done quickly, what is a medium term objective and what is pie-in-the-sky fantasy. They may not agree with everything that an acquirer wants to do, and these objections should not be accepted at face value, but if local management feel a genuine part of the process, their active and positive participation is much more likely.

The motivation and behaviour of staff are at the root of all business success. If this is true, then how much more important it must be to get the human side of an acquisition right in the emerging market context.

The first concern that local staff will have is whether their jobs are safe and if their pay will change. Next come the usual rush of questions about changes in the management and reporting structures, whether they will be expected to learn another language, and so on. These are the easy issues.

Many emerging jurisdictions have delicate community and family structures, entrenched concepts of honour and face, fundamental religious principles and impenetrable local political considerations.

Much more complex is what the acquirer is not asked or told. Many emerging jurisdictions have delicate community and family structures, entrenched concepts of honour and face, fundamental religious principles and impenetrable local political considerations. These are just as important in business as they are in local micro-economies in the developed world, where a major enterprise can dominate a village or a small town, or indeed a major city like Detroit with its auto industry culture.

These considerations are why using experienced but independent local business people and professionals as intermediaries can be essential and why rushing into decisions affecting local staff is often so unwise. Time must be invested in understanding these aspects and being seen to respect cultural imperatives, while still making sensible decisions. But be firm as well as reasonable, because weakness will not be respected.

The final recommendation to buyers is to start the planning for the implementation phase as early as possible and to take it seriously. Experienced players say that they allocate as much time to planning the post-deal phase as they do to the due diligence and contract negotiation processes combined. They also believe that implementation is a phase which never ends, it just changes as familiarity with the acquisition increases.

An acquirer should remember that it is not just buying a business and a bag of assets and liabilities. It is investing in people and the success or failure of the deal will depend on how it treats them. It will also dictate how stressful the stewardship will be. Investing time and quality resource in pre-planning and implementation, will allow the acquirer to earn a considerable return, not just in financial terms but by avoiding damaging management distraction.

Nick Hood is executive chairman at Begbies Global Network.

IT integration challenges in M&A

BY GRAHAM SMITH

In 2007 over US$4 trillion was spent on M&A activity across the EMEA region and the US alone, according to Dealogic. Alongside the expertise, synergies and economies of scale driving M&A deals, hidden risks lie just beneath the surface. Failure to address these risks before committing to a merger can see companies waving business benefits goodbye and being left holding a poisoned chalice.

Business reports estimate that between 50-70 percent of transactions fail, with two problems cited most frequently. First, cultural disparities and an inability to integrate different working styles. Second, the post-merger integration of IT systems.

The integration of IT systems is a tough challenge; three-quarters of companies involved in M&A report problems. IT is central to the business function, supporting both operational and ancillary activities. Lost revenue resulting from a poorly executed IT integration strategy and subsequent non-functioning systems can be huge – up to $10m a day for some organisations. Industries solely reliant on IT businesses can come to a complete standstill.

The main issues that organisations face when merging their IT systems include maintaining continuity, data migration and compliance (including the related security and political implications). Merger ROI is of the utmost importance, so the integration simply has to succeed; pressure deadlines and quality expectations therefore weigh heavily from the top down.

M&A is often highly visible and failures are well documented. This holds both positives and negatives for the implementation of IT systems. Making sure IT systems go live at the date stipulated is vital to avoid media criticism. However, this can mean that time allocated for testing is reduced, which may lead to the deployment of systems that are fraught with problems. The negative impact of failure can be catastrophic. This prospect is usually enough to deter companies from allowing such an outcome and, more often than not, testing is undertaken. But what are the key areas to address?

Organisations often encounter problems maintaining business continuity and reducing disruption throughout the transition period. Irreparable reputation damage can be done as customers suffer from using unsteady, inefficient applications that are the result of poor integration.

The situation is exacerbated by the fact that new users may be using unfamiliar systems and further slowing down transactions. Sufficient staff training is required to overcome this and manage consumer delays. Having new users on a system that is under the strain of redevelopment must be managed in a structured way or the business will suffer. This can be compounded by additional 'defects' being reported that are, in fact, modifications to the systems. Furthermore, additional staff put an increased load on systems, which may cause them to crash under the weight. Sufficient load and performance testing ensures that systems are equipped to cope with unexpected numbers of users. Without it, hidden problems may be uncovered when it is too late.

The operational change that must occur during or after an acquisition involves significant data migration, whether to an existing or entirely new system. The information will consist of sensitive corporate and customer details, the integrity of which is of the utmost importance. When integrating systems there is potential to lose data upon transfer and organisations should do everything in their power to ensure this does not happen to avoid negative repercussions.

Loss of data can occur due to incompatibilities in the way in which different systems store information. Data must be converted into a format which will be recognised by both systems and usable when necessary. Ensuring the systems are capable of achieving this requires careful definition of requirements and a structured data migration process. Testing at each stage of the program highlights problems and helps to protect against data corruption and subsequent loss of crucial information.

Another concern in migration projects is the security vulnerabilities that can be created when developing new systems. This is especially pertinent to financial service organisations due to their copious amounts of sensitive personal information. Migration of data must therefore be carefully executed in order to maintain integrity and ensure security weaknesses do not occur. To achieve this, security testing must be a key component of the testing phase.

Protecting consumer data goes further than retaining customer satisfaction – it is also a legal requirement. Adhering to mandatory regulations is becoming increasingly important as more domestic, European and global legislature must be adhered to. The Markets in Financial Instruments Directive (MiFID) and Sarbanes-Oxley are just two financial examples, while the Payment Card Industry Data Security Standard (PCI DSS) is central to retail payment security. Management must also be aware of laws in place which govern any markets it may be acquiring in. It is the organisation's responsibility to enforce these regulations by having systems which enable compliance. The integration process must therefore take into account mandatory legal requirements and build them into development or modification of the systems.

Protecting consumer data goes further than retaining customer satisfaction – it is also a legal requirement.

The desired result of an integration program is to have an IT operation that is effective for both internal users and external customers. Usability, functionality and providing the required data output are vital elements of the IT systems. Assuring quality is essential to meeting this target and must be conducted continually, lest problems go undetected and cost substantially more to rectify at a later date.

Involving the Chief Information Officer as early as possible in M&A deals ensures that decision makers are fully informed about technological requirements.

In past mergers, up to 50 percent of integration costs have been incurred by IT, massively impacting returns generated by the deal. As such, the realisation of benefits post-merger can largely be attributed to the successful management of IT integration. Companies need a thorough implementation plan to ensure that IT is a central consideration in the M&A process and it is communicated efficiently.

Top-level management of a merger or acquisition is very stressful, involving due diligence, integrating corporate cultures and defining the future direction the new company. Outsourcing the IT integration is one way of alleviating the pressure and providing objectivity. Whatever the decision, acquirers should take time to fully consider what is required from an IT standpoint, as this can mean the difference between success and failure.

Graham Smith is European head of client engagement at AppLabs.

CHAPTER EIGHT:

Environmental issues

Climate change and the cost of carbon: incorporation into M&A deals

BY WILLIAM BUTTERWORTH AND JAIDEEP DAS

While global markets remain uncertain, there seems little doubt that the need for long term carbon reductions and a more robust management of climate change issues in general is now firmly entrenched on political agendas. This was evidenced by the run up to the United National Climate Change Conference in Bali and in the constraints which emissions trading schemes and other measures are starting to impose on different business sectors.

A key question for investors is how might new, post Bali carbon reduction measures, impact on target businesses. This is most notable in the US, where the political climate looks certain to change on this issue, but in other parts of the world the pressure to take action also continues to grow. It has been estimated that, globally, it would cost about US$1.6 trillion a year to reduce carbon emissions by 50 percent by 2050.

Perhaps not surprisingly, given the above, the due diligence process surrounding M&A can be an important catalyst for screening the potential impact and cost of climate change issues on different facilities as well as the scope for achieving new efficiencies going forward. Purchasers and vendors will increasingly find themselves taking account of energy and climate change risks which were previously deemed either not relevant or material in the context of a successful transaction. As such, they may have to make assumptions about the impact, for example, of tough new emissions trading regimes in Europe and in the US.

Inevitably this conjecture, alongside existing carbon constraints, is starting to have an impact. In our experience, climate change is a material issue in around one in five deals. A variety of approaches can be used to address climate change risk, not only in the most energy intensive sectors such as power generation, metal and cement manufacturing but across a whole swathe of other businesses, which both consume large amounts of energy and have a pronounced carbon footprint. Questions may cover anything from the potential cost of emissions trading for US power generators to the impact of flooding from storm events in China.

A growing number of deals now include at least an element of carbon and climate change risk screening. Initially this screening revolves around asking questions to determine the importance of energy use and carbon emissions as well as evaluating the wider potential physical impacts of climate on the business. Flood, sea level rises and drought, for example, are all relevant in this context. Where issues look material a more detailed analysis with projected costings is likely to follow.

The initial screening will depend on the nature of the business and will consider energy and climate change risks alongside a range of others. In the case of a power utility or energy intensive manufacturing company, for example, the introduction or tightening of emissions trading could have a significant impact on the business plan. If a company is not currently subject to a trading scheme this may become the case in the future, for example with the UK's carbon reduction commitment and similar schemes in other countries.

The cost of carbon regulation takes on an even greater significance in the face of rising energy costs. A business which effectively manages the former is likely to have an influence on the latter with a growing number of companies asking for advice in this direction as part of the M&A process. In one example, an energy price trend analysis recently looked at what a company's current annual energy bill of approximately US$50m would look like in the face of projected increases over the next few years. The analysis was relevant not only to the transaction value of the business but also to the consideration of future investment decisions to achieve greater energy efficiency and carbon compliance. Where energy may once have simply been a line item on the balance sheet, there is now a fundamental need to understand where it is coming from, future costs and sources, how it is being used and what alternatives and new risk mitigation approaches could be introduced going forward.

Insurance costs may also become an issue as part of this climate change screening process. Premiums may be affected not only by serious climate risks – for example a facility's location in or near a flood plain – but also by the risk of serious business interruption. Another recent M&A project related to an oil refinery which relied on its local river as a primary means of transporting raw materials and products. After two consecutive summers of very low water levels in the river, the business was facing material additional distribution costs and potential delays using alternative road and rail links. These issues were factored in as part of the transaction.

In summary, climate change issues are now relevant to the M&A process across a range of business sectors. If political intent is turned into genuine action there will inevitably be a cost to business as well as opportunities for those who plan for, and where appropriate invest in, a future carbon constrained economy.

William Butterworth is a partner and Jaideep Das is a senior consultant in the Corporate Risk Team at ERM.

Identifying opportunity in the carbon era

BY TIM CLARE

As recent renewable energy acquisitions show, there is opportunity and not just liability in the challenge of tackling climate change and implementing strict new waste and chemicals legislation. Environmental due diligence in the future will extend to become part of the target selection and business plan appraisal process.

Scottish & Southern Energy plc's acquisitions last year of the Irish wind farm developer Airtricity and Segro's Slough Heat & Power, made it the British Isle's biggest renewables generator. It demonstrated the increasing value seen in the 'green' power sector and the fact that it now forms a key part of the strategies of the tradition power generating companies. Indeed it was a sign of it now being mainstream.

Prior to this, Terra Firma's development of the Infinis business for example, showed that many foresaw a significant area of opportunity. In 2003 it acquired the Waste Recycling Group and a year later Shanks' landfill and power generating arm. To many this appeared to be primarily the creation of a significant waste management business, but the sale of the waste recycling operations to Spanish construction company FCC for £1.4bn, showed that in fact Terra Firma had created a renewables business just as market demand was growing. Flotation is now likely to reveal the true value of the investment.

This is not to say that waste management does not still represent an attractive investment opportunity as shown by, for example, Montagu Private Equity's involvement in Cory Environmental and now in Biffa. The waste management industry has the enviable position of being able to capitalise on increasing strictly levels of legislation that are forcing both households and businesses to recycle more. However, whereas with waste the legislation is currently forcing greater levels of recycling than public or business participation would do on its own, the explosion of interest in 'carbon' over the last two years as individuals and business seek to reduce or neutralise their carbon footprints has fuelled the market for renewable energy beyond the level which current legislation or policy would trigger alone.

The above, and the development of specific energy saving equipment, are among some of the more obvious areas of opportunity. The investor will still find opportunities here, ranging from lower risk investment in the ever increasing number of specialist funds (although some have recently experienced some falls) to higher risk provision of venture capital to new, untested technologies. With the latter some are drawing parallels with the dotcom era as more opportunities are being sold at the idea or concept phase. The green pound will provide many strategic opportunities over the next decade. But spotting them requires a clear framework and also a great understanding of both sustainability and the market as well.

Do not think carbon is gone. Maybe some of the opportunities for renewables seem less attractive today. But low carbon products provide a great opportunity and the opportunities for innovation and different brand proposition are huge. Reducing carbon emissions by 60 percent in the UK by 2050 is so radical that many struggle to conceive what this will require. But those who can think differently and beyond the immediate day to day pressures will create strategic value in spades. In the commercial property sector, Energy Performance Certificates will provide a consistent rating scheme across the industry. How long before rateable values are based on the EPC? In the electronics sector, creating innovative end to end carbon stories for products will demonstrate real leadership and new markets. And how much opportunity exists for the firms to commercialise robust carbon capture, zero emission vehicles, and the next generation of IT that reduces the need for travel.

Carbon is the game in town today, but there will be other drivers. The UK launched its water strategy in March. The Code for Sustainable Homes which all new developments will need to follow will require radical low water products as well as low carbon. With the UK forecast to become much drier in summer, how will this provide opportunities for low water consuming equipment and for companies that can produce products using low water techniques?

In chemicals, the EU's REACh regulations provide the most substantial changes to chemicals legislation seen in the last 50 years. REACh creates opportunities for the manufacturers of safer chemicals. It also provides strategic opportunities for firms who can eliminate likely 'substances of very high concern' from the supply chain today – and tell customers about it.

Perhaps the optimum scenario is spotting an existing business with existing products that have the potential to see significantly increased demand due to climate change. Again the greatest rewards should go to those who react quickest, be it to modify their product or simply communicate its environmental credentials. Suppliers of heating, ventilation and air conditioning equipment who have been quick to market more efficient products are currently seeing dividends as legislation and market demand (what you might call the Marks & Spencer (M&S) factor) have together forced the design of increasingly efficient commercial buildings. Those who have invested in LED lighting systems are enjoying a particularly positive period. The technology is now in vogue as suppliers extol the twin benefits of low energy demand and low production of latent heat, meaning that less cooling is also required in those buildings in which it is installed.

In searching for the next areas of opportunity, investors also need to consider which businesses will benefit from the environmental and societal changes that climate change will bring, rather than simply focusing on the technologies being developed to reduce carbon, waste and other pollutants. At the extremes, dependant on geographical location, flooding or water shortages (or both) will require major expenditure on infrastructure. At a general level, milder and shorter winters in temperate climates may, for example, increase productive time for the construction industry but reduce the need for specialist winter equipment. The possible individual results and opportunities of climate change are potentially endless and will require a significant amount of future gazing. Crucially, it will be essential to ensure that 'good science' forms the basis of that analysis to ensure that only viable opportunities are pursued.

Beyond the specific search for direct carbon related opportunities, the analysis of any target business should now involve an assessment of its vulnerability to and awareness of environmental issues, and carbon in particular, at the earliest stage. While the legislative drivers, although spreading in coverage, are not yet directly affecting significant elements of the economy, the potential impacts on demand caused by the changing environmental conditions described above, have the potential to affect all. A truly forward thinking management team should have looked at climate change and asked the question as to whether it provides an area of opportunity or more crucially, a threat to its current markets and therefore its business plan.

Traditional environmental due diligence, primarily focused on site based contamination and end-of-pipe compliance issues, usually occurs at a late stage of the transaction and only rarely extends into an assessment of the business' strategy. Environmental due diligence in the future will also form an element of the initial appraisal of a business and focus on strategy rather than facilities. In the last 18 months a number of household names, most notably M&S, have seemed to seize and driven forward the agenda. But there are vast differences between the ground occupied by the likes of Marks & Spencer, who have developed a proactive strategy based on good science and the chasing pack for which many buying carbon neutrality via offsets has effectively been done as a defensive strategy. Not every company can or indeed should embrace environmental issues in the way that M&S has; but it will be crucial that an investor becomes comfortable that a target has undertaken that risk analysis and that the value judgements it has ultimately made are robust and leaves the company fit for the future.

Tim Clare is technical director, Environmental Due Diligence, at WSP Environment & Energy.

The affect of market turmoil on the treatment of environmental liabilities in transactions

BY JOHN SIMONSON

Although private equity deals may have slowed down given the recent credit squeeze, corporates have remained remarkably active; not only as acquirers in current transactions but also as would-be vendors which are preparing for a return to normal business in 2008.

While the market is clearly more cautious, there is little sign of stagnation. Rather, in certain areas there is a change in emphasis and new concentrations of activity. Mega private equity deals, for example, may have disappeared, but clients are retaining a sharp mid cap focus and paying attention to key issues which will ultimately provide them with a successful exit when the time is ripe.

Trade buyers are doing deals in a less competitive environment. There is a growing trend among corporates, most notably in Europe, to seek advice on issues prior to a sale, in expectation of a market upturn in 2008. By ensuring that facilities are compliant, and making themselves aware of EHS and climate change issues that could become material, vendors are seeking to ensure full control of a future sale once the process is underway.

Focus on assurance

Companies are taking a longer, harder look at environmental issues. Rather than simply ticking off compliance items, there is a growing desire to look behind the scenes at EHS assurance systems and processes which support compliance – not to mention the staff and resources that may be needed now and in the future. This is true for facilities in a whole range of sectors, from power generation to food manufacture.

New players are coming into the market, notably from BRIC countries (Brazil, Russia, India and China) and from the Middle East. Companies from these countries, including those backed by state-owned sovereign funds, are well financed but need to address EHS regulatory and reputational pressures in different parts of the world. Understanding the timing of EHS costs and the assurance systems which need to be put in place has become an important part of the process.

In our experience, around one in five deals now have material climate change issues and this trend is expected to continue whatever the fluctuations of the market. Issues can range from energy use and tighter emissions regulations to the location of facilities. The challenge for investors is to factor in climate change as part of the overall investment. A company may need to look at holistic regional or country climate change risks, particularly companies in extractive industries which are under pressure to meet the demand for scarce resources. New approaches and screening tools are being developed to mitigate these risks. As markets tighten there is a greater onus on cash flows with EHS costs and future requirements are receiving more scrutiny.

Another upshot of the credit squeeze is that some private equity houses are feel more exposed on EHS liabilities because they are investing more of their own money. This in turn is starting to have an impact on the way they look at EHS issues – again with attention to the timing of individual cost items and assurance issues.

In fact, the market slowdown offers the opportunity to look in more detail at how a business could benefit from a more strategic EHS focus. This can cover resource-related issues such as energy use, waste and emissions to wider, areas such as trading carbon credits and the geographical location of key facilities. Concern over climate change and particularly (too much or too little) water, are helping, for example, to bring the last of these issues sharply into focus.

In short, the market as a whole is taking stock and buyers are paying close attention to the timing of individual costs and assurance issues in a whole range of areas. Furthermore, new players are coming into the market, all of whom must at least take EHS and climate change issues on board as part of the dealmaking process.

John Simonson is the global director of M&A at ERM.

CHAPTER NINE:

Sector analysis

Trends in independent oil company M&A

BY TERRY A. NEWENDORP AND NICOLE WEYGANDT

Following a strong year for oil and gas M&A in 2006, last year saw the aggregate value of deals remain steady, rising only 0.4 percent to reach US$292.2bn, while the number of deals dropped by 2 percent to 893, according to PricewaterhouseCoopers' 'Oil & Gas Deals Annual Review 2007'. Although these figures suggest little change in the industry over the past year, the dynamics in the oil and gas sub-sectors have changed significantly.

In 2007, the refining and marketing – or downstream – sector witnessed average deal values grow by 120 percent, led by the largest M&A deal of 2007, the $20.1bn leveraged buyout of Lyondell Chemical Company by Basell. In contrast, the average deal value in the exploration & production (E&P) – or upstream – segment fell by 27 percent, according to PricewaterhouseCoopers. Although this difference can be partially attributed to the lack of mega deals on the scale of the $32.2bn Statoil-Hydro merger in 2006, the overall decline in deal value in 2007 also reflects a shift away from industry majors towards greater M&A activity among independents – non-integrated oil and gas companies that receive nearly all of their revenues from production at the wellhead.

Even among high-priced deals, independents are playing a significant role. Anadarko's acquisitions of Kerr-McGee and Western Gas Resources each ranked among the 10 largest oil and gas M&A deals of 2006, totalling $25bn. With a premium of 40 percent, the $19.6bn Kerr-McGee acquisition was notable for being financed in part by concomitant divestitures of Anadarko assets in Canada for $4bn. Upon completion of the deals, Anadarko not only increased its proved oil reserves by 32 percent and its proved natural gas reserves by 45 percent, but also more than tripled its undeveloped acreage. The company is now a leading producer in the Rockies and the deepwater Gulf of Mexico, with share prices reportedly rising nearly $10 to over $60 since the acquisition was announced.

Developments on AIM

In contrast to Anadarko, the 109 oil and gas producers listed on the Alternative Investment Market (AIM) of the London Stock Exchange are exclusively small- and mid-cap independents operating early stage upstream assets, with an average market capitalisation of £94m ($184m). This places these companies squarely into the range of the fastest-growing segment of the oil and gas M&A market – the deal range below $250m accounts for nearly 80 percent of all oil and gas M&A deals, with 25 percent year-on-year growth in the value of deals. M&A among these companies is motivated both by financing needs and the desire to develop economies of scale.

With upstream development costs having nearly doubled since 2005, according to the IHS/CERA Upstream Capital Cost Index, the smaller independents with limited cash reserves are having greater difficulty developing their acreage and establishing positive cash flow. The global credit crunch has greatly reduced access to capital from debt markets, while poor shares performance of the AIM-listed oil and gas companies makes it difficult to raise capital from new issuances. Ernst & Young reports that, as of the third quarter of 2007, nearly 50 percent of AIM-listed E&P companies are trading below their initial listing price. Combined with the fact that, at the same time, nearly 65 percent of AIM-listed E&P companies hold less than £10m ($19.4m) in cash, the small- and mid-cap independents – particularly those with low capitalisation and no producing assets – are highly vulnerable to takeover.

Demonstrating this vulnerability, Wham Energy was acquired within two years of listing on the AIM after share prices dropped to half of their initial listing price after the company's first well came up dry. With insufficient capitalisation to absorb this loss, the company was purchased by Venture Production PLC, a better-capitalised firm with its own production, in August 2007. Tristone Capital Ltd. predicts that nearly two-thirds of AIM-listed oil and gas companies will disappear from the market over the next two years as a result of their financial weakness.

Not only are AIM-listed companies potential targets of larger independents and integrated companies, but there have also been a number of corporate acquisitions within the AIM, with AIM-listed companies acting as aggressive buyers. In early 2007, for instance, Encore Oil acquired four E&P companies (AIM-listed subsidiary of Grove Energy, privately held Virgo Oil & Gas and Virgo Energy Ltd., and the UK subsidiary of Nido Petroleum) for a total of £8.6m ($16.9m), thereby quadrupling the number of exploration blocks it holds in the UK offshore, according to Reuters. Encore Oil has already expressed is intention to continue to expand via both corporate and asset M&A in 2008.

Market opportunity for NOCs

In addition to the growing number of M&A transactions between independents, both corporates and assets are also proving to be attractive acquisition targets for national oil companies (NOCs) – oil and gas companies fully or majority owned by state governments. Although NOC activity dropped off somewhat in 2007, NOCs spent over $55bn in 2006, or nearly 35 percent of global oil and gas M&A spending.

This drive to acquire – particularly among Asian NOCs – reflects the strategic advantages M&A can provide to less efficient or inexperienced NOC buyers. Apart from enabling geographic diversification and entry into new asset classes such as unconventional oil and gas, corporate acquisitions allow NOCs to bring in experienced personnel and gain access to new technologies. Additionally, the acquisition of existing assets can allow NOCs to develop international operating experience, enabling them to compete effectively in bids for exploration blocks. Finally, by taking over existing assets, particularly in the downstream sector, NOCs can gain access to infrastructure and potential customers, allowing them to more rapidly expand in new markets.

Despite the reduced level of overall NOC M&A spending, some state-owned energy investors remained highly active in 2007. TAQA, an energy investment company that is majority-owned by the government of Abu Dhabi, spent over $10bn on seven transactions in 2007. These deals expanded the company's presence internationally into Canada, Germany, India, Morocco, Saudi Arabia, Ghana, and the UK, while also increasing the company's role in conventional upstream oil and gas, Canadian oil sands, and power generation. The company has indicated that it intends to increase its assets to $60bn by 2012, up from $21bn at present, as part of its long-term growth strategy.

Most notable among TAQA's deals are the Canadian corporate acquisitions, which not only introduced the company into Canadian oil sands – a source of unconventional oil production – but also brought with it the technology and experienced personnel to operate these types of projects. As a result, TAQA has become a leading player in Canadian oil sands, becoming one of the top 10 companies in Canada in terms of proven natural gas reserves and one of the top 12 companies in terms of oil and gas production. It has also enabled the company to pursue an aggressive reserve replacement level of approximately 140 percent – well above the levels many majors have been able to achieve.

Refining sector opportunities

M&A in oil refining and marketing is undergoing rapid expansion in the wake of strong refining margins, supported by a tight capacity-demand balance and escalating capital costs, which reached record highs in the third quarter of 2007, according to the IHS/CERA Downstream Capital Cost Index. As a result of these dynamics, purchasing and upgrading existing plants has in many cases become cheaper than greenfield development. As majors divest of their refining assets and optimise their portfolios at a time of high prices, independents and NOCs are taking the opportunity to integrate their operations.

The urge to integrate appears particularly strong in North America, where operators of Canadian oil sands projects are seeking to secure capacity in complex refineries capable of processing their crude. These transactions take the form not only of outright acquisition of refineries, but can also involve capacity purchases or exchanges of shares. In the case of Husky Energy, the company not only made a full acquisition of a 165,000 barrels-per-day refinery for $1.9bn plus net working capital, but also purchased a half-share in a BP refinery while granting BP a stake in its Canadian upstream operations.

M&A in oil refining and marketing is undergoing rapid expansion in the wake of strong refining margins, supported by a tight capacity-demand balance, and escalating capital costs.

In Western Europe, independent refiners have been taking advantage of integrated oil companies' divestures to increase their scale and geographic diversification. Petroplus Holdings AG, for example, has purchased 521,000 barrels per day of additional refining capacity from ExxonMobil, BP, and Shell over the past year, becoming the largest independent refiner in Europe with total nameplate capacity of 864,000 barrels per day, as reported by Fitch Ratings. In contrast, Central European refining M&A has been led primarily by large regional players such as Austria's OMV and Hungary's MOL, which seek opportunities in the less competitive Eastern markets. Apart from lower competition, these markets have the additional advantage of offering higher profits from price differentials between Brent and Urals crude oil. Privatisations and westward expansion of Russian and Kazakh oil and gas firms are adding additional momentum to the European M&A markets.

Conclusions

M&A in the oil and gas industry entered a growth phase in 2005, when upstream transaction value more than doubled from the previous year. Figures from John S. Herold Inc. show that activity in 2006 reached new records, with asset transactions topping $60bn along with corporate transactions of approximately $100bn. Although aggregate M&A figures have not changed significantly, there has been a dramatic shift towards lower-value transactions involving independent oil companies – both as buyers and targets – as global credit markets and escalating capital costs push the industry towards greater consolidation.

Terry A. Newendorp is chairman and CEO, and Nicole Weygandt is an analyst at Taylor-DeJongh.

European airline industry: value creation through M&A

BY DR. JÜRGEN RINGBECK

With long term market growth forecasted at 5 to 6 percent and benefits accrued from globalisation, it seems that the European airline industry should be highly profitable. However, the intra-European airline market deregulation in the early 1990s brought a wave of competition, and even with an infusion of private capital, the sector's financial results are not up to par. Over the past decade, the European airline association (AEA) members (mainly flag carriers) have seen net losses on average, and thereby have been unable to recoup their expenditure. Even in 2007, which was very successful, all AEA members will not earn more than an estimated operating profit of €3bn, which is only about 4 percent of revenues (on average) and far below the 7 to 8 percent typically required to cover the cost of capital. This is too little to satisfy future investors.

In any other sector, market consolidation would have occurred long ago. In the European aviation industry, however, the number of airlines grew steadily between the time the intra-European market opened for EC carriers in the 1990s until 2002. Despite the fact that low-cost carriers, such as Ryanair, have entered the European market successfully and captured more than 30 percent market share on intra-European routes, only some consolidation has occurred. Due to ongoing heavy regulation (e.g., intercontinental traffic rights) and state subsidies, weak carriers (e.g., Alitalia and Olympic Airlines) have been prevented from exiting. The recent acquisitions by Air France, which took over KLM, and Lufthansa, which acquired Swiss, were not significant enough to change the overall picture: M&A activity in the European airline industry has been relatively weak during the last 10 years.

However, over the coming years, that picture might change. With further liberalisation and deregulation of the European airline industry we might soon face a significant wave of consolidation. In this article, we highlight the major industry trends and drivers of a potential consolidation scenario and take a deeper look at how value might be created by M&A in the European airline market. For this purpose, we will use the Lufthansa / Swiss merger to highlight the key factors that drive the success of cross-country airline mergers in Europe.

Clearing the way for further consolidation

There are three major trends that could be the driving factors of a wave of consolidation in the European airline market.

The next downturn of the industry cycle. It is becoming more apparent that such a downturn is on the horizon. IATA, the global airline association, corrected its profitability outlook for its members three times between June 2007 and December 2007, for a total decrease of around 50 percent. The credit crisis in the US and increased fuel prices also drive up the risk of an industry downturn after a strong 2007. The major flag carriers might be the potential winners in such a downturn, thanks to their long-term development of economies of scale and marketing in hub-and-spoke systems. By shaping their global alliances in the 1990s and making more recent acquisitions, the three leading European airlines – British Airways, AirFrance/KLM and Lufthansa/Swiss – have captured a market share of 47 percent of passengers carried by European flag carriers.

New emerging competitive dynamics in the intercontinental business. This business has traditionally been a goldmine for the European network airlines. Fuelled by globalisation and resulting increased travel, especially in Asia, these markets have experienced high growth rates. Regulation, including restricted traffic and ownership rights, has also benefited European flag carriers, as has the comparative weakness of players in the emerging markets and the US, whose carriers even today are still suffering from the effects of September 11. However, we expect that European flag carriers' dominant position in this sector will change soon.

The major US flag carriers are currently seriously discussing how to consolidate the intra-US industry, driven by early merger negotiations between Delta and Northwest or United and Continental, and thereby strengthen their competitive position in the transatlantic business. In addition to this development, strong new players are emerging in Asia and the Middle East: Emirates is desperately trying to get more traffic rights in Europe, and even Air China is planning to expand its European network quickly, seeking 12 new connections to the US and Europe in 2008 and 2009.

On top of these market shifts, regulatory issues are coming into play: competitive dynamics on transatlantic routes are fuelled by a new Open Skies Agreement between the US and the European Union that will come into effect in April through June, 2008. This agreement allows every EU and US carrier to fly to any destination in either region. The upcoming opening of the EU-US air market will kick start a new game – making transatlantic cross-border deals even more compelling. For example, European carriers might consider opening up their own US feeder service in a major US hub. Lufthansa has just bought a 19 percent ownership in the New York-based carrier JetBlue Airways, which has a strong intra-US network out of John F. Kennedy Airport, which may serve as feeder system for Lufthansa in that market. As airlines introduce the Airbus A380, they will need to ensure that they have sufficient hub feeds to keep aircraft seat load factors high. Moreover, Air France/KLM now has strong incentives to build up an intercontinental business out of London Heathrow in joint partnership with Delta. They have even signed a specific joint venture agreement to share revenues and costs on their transatlantic routes. A consolidation of the US carriers might give these types of JVs a larger role; it could even result in minority ownerships of European carriers in the emerging US mega carriers.

Continued growth from European low-cost carriers. We expect LCCs to continue expanding their role in the intra-European market and thereby drive up further competition. Realistically, LCCs could gain around 40 percent market share in continental passengers by 2012. These private carriers have a significant opportunity if they quickly consolidate their own market segment and thereby capture economies of scales in their business to strengthen their competitive positioning against the major flag carriers. These economies will be increasingly necessary: Fuel price, even today, constitutes more than 30 percent of the total costs; price elasticity is high; and there is almost no room left to drive down margins through operational cost improvements alone.

The shape of what's to come

All three of these trends will clearly create a difficult burden for the many smaller players in the European airline market.

Several of the European LCC niche players, such as SkyEurope, are at risk of becoming takeover candidates or being washed out of the market. Moreover, most of the smaller European flag carriers, which are mostly unprofitable and undercapitalised, are burdened by suboptimal networks and the legacy cost structures of a traditional flag carrier. Therefore, they too are clear candidates for further intra-European consolidation; these include Alitalia, Iberia, and LOT. Many of these carriers and their owners are considering privatisation now and are looking for private investors.

The three major flag carriers are the obvious candidates to drive this next consolidation round of smaller flag carriers. Air France is interested in acquiring Alitalia, British Airways may expand its minority stake in Iberia, and Lufthansa would most likely be open for discussions with its STAR members.

Likewise, the three major LCCs – Ryanair, Easyjet and Air Berlin – will probably drive consolidation in their sector, as they currently offer more than 60 percent of the seats available in the European market. However, the upcoming consolidation game might become even more complex and allow convergence of the two European industry segments: the intercontinental network carriers and the low cost carriers. The current talks between TUI and Lufthansa about a merger of their LCC/charter businesses (Hapag-Lloyd and German Wings, respectively) might result in a fourth significant low cost player under Lufthansa´s leadership. Air Berlin has acquired the long haul charter carrier LTU and is in the process of acquiring Condor, with the hope of creating an international network out of Germany that combines its strong European network with a growing number of intercontinental destinations. Finally, other private carriers – like AirOne in Italy or Ryanair, which took shares in Air Lingus – are amenable to looking beyond their narrow business segment. The upcoming wave of consolidation may therefore not only drive consolidation in the old business segment; it might stimulate the emergence of innovative hybrid business models with an even higher rate of return.

The face of successful European consolidation: Lufthansa/Swiss

What are the drivers of a successful cross-border merger? How can the synergies be captured best? What are the real levers of value creation for cross-border M&A deals in the airline industry? The best way to study these questions is to take a closer look at perhaps the most successful cross-border merger to date: the Lufthansa-Swiss merger.

One of the prerequisites for its success was a great cultural fit between the players; another was the positive motivation of the Swiss management and employees to cooperate in the takeover: Swiss had always considered itself a premium carrier in Europe, with several customer awards thanks to its extreme customer focus and commitment. But after the bankruptcy of Swissair at the end of 2001, the company went through a deep painful restructuring in its battle for survival as newly founded Swiss. This difficult period opened the company to the idea of a win-win opportunity through a merger with a larger player. Former emotional and political doubts became less and less important when Lufthansa started the negotiations again in 2005.

At the beginning, the deal did not focus on expanding the airlines' network, rather than on operational integration and cost synergies. However, it was clearly crafted around 'win-win' opportunities, as Stephan Gemkow, the CFO of Lufthansa Group, emphasised in a discussion with us. It allowed Swiss to keep its brand and its intercontinental hub in Zurich, and expand its business as part of a comprehensive Lufthansa multi-hub network. The continental traffic as well as intercontinental traffic has been aligned carefully and Swiss customers quickly took advantage of their broader choices in flying with Swiss or Lufthansa to international destinations (via Zurich, Frankfurt, or Munich). Customers also enjoyed the rapid improvement of ground services and the investment in a new three-class intercontinental product with modern equipment. The fact that the airline now has one of the world's largest frequent-flyer programs ('miles and more') is another compelling benefit to the customer.

As a consequence, Swiss was able to expand its revenues from CHF 3.6bn in 2004 to an estimated CHF 4.4bn in 2007. It also transformed its losses of CHF 140m in 2004 to an estimated profit of more than CHF 500m in 2007.

As a result of this deal, Lufthansa and Swiss have significantly extended their market and customer coverage.

As of September 2007, Lufthansa and Swiss have realised more than €420m in financial synergies thanks to this merger; more than €230m of these savings were realised in the first 18 months after the deal. More than 60 percent of the synergies are based on revenues. Nearly 60 percent of the synergies have been realised at Swiss and therefore directly contributed to its financial turnaround.

As a result of this deal, Lufthansa and Swiss have significantly extended their market and customer coverage. However, while a lot of value has been created in the short term by integrated network planning and sales and marketing, there are significant other levers that have not been exploited fully until now. The merger clearly offers the opportunity for further functional consolidation in areas including aircraft maintenance or IT. If the time is right to pull these levers in the interest of both companies, these areas will be addressed as well.

Conclusion

The consolidation wave in the European airline landscape has just started, and the urge to merge will probably become stronger. With market power and scale being the major drivers of future survival, M&A will be an important weapon in winning the battle for profitability and growth in the European airline industry. In an industry in which organic growth is difficult to achieve, acquisitions and financial stakes in smaller industry players – including smart integration strategies – will differentiate the winners and losers of tomorrow.

In the highly political flag carrier environment, public pride about a country's flag carrier and government interest in controlling air capacity and air service have created large hurdles to takeovers. But the Lufthansa-Swiss case shows that even a merger with an international partner can be a real win-win opportunity for everyone. A merger may create value for all stakeholders: the financial shareholders, the employees, and the customers. There is no longer any reason to dismiss consolidation as the next move for a number of European carriers.

Dr. Jürgen Ringbeck is a senior vice president at Booz Allen Hamilton. *The author would like to thank Mr. Stephan Gemkow, CFO of the Lufthansa Group, for his willingness to share his personal insights on the value drivers of the Lufthansa–Swiss merger. Many thanks to Dr. Stephan Gross, Senior Associate at Booz Allen Hamilton, for supporting the author with research and insights on the European airline market.*

M&A boom in the CEE telecommunications market

BY DR. KARIM TAGA, OLIVER LUX, CHRISTIAN NIEGEL AND EVGENY SHIBANOV

Strategic and financial acquirers have driven intense M&A activity in Central & Eastern European telecommunications markets. We have observed 10 major transactions with a total value of €3.9bn. Strategic investors were buyers in four of these transactions with a total value of €1.9bn while financial investors dominated slightly with six acquisitions totalling €2bn.

Transactions are driven by growth perspectives and a desire for ongoing empire building by strategic buyers. Financial investors seek short to mid term value creation potential. Three trends should lead to increased M&A activity in CEE in the mid to long term.

Strategic buyers

Strategic buyers from Western Europe are heading east in search of growth. For example, Vodafone's CEE footprint includes operations in Hungary, Albania, Czech Republic, Romania and Turkey. France Telecom has subsidiaries in Poland, Moldova, Romania and Slovakia. Telefonica/O2 has a presence in Czech Republic and Slovakia, while Deutsche Telekom holds subsidiaries in Hungary, Slovakia, Croatia, Macedonia and Montenegro. Telenor has expanded its Nordic roots by moving into Hungary, Montenegro and Ukraine and it holds a significant stake in one of Russia's mobile operators.

While Vodafone, France Telecom, Telefonica/O2 and Telenor did not expand their empires further in 2007, Telekom Austria/mobilkom was active. It already held operations in Slovenia, Croatia, Serbia, Macedonia and Bulgaria. To expand that footprint further, Telekom Austria/mobilkom secured the second largest CEE telecom deal by acquiring 70 percent in Cypriot SB Telecom Limited. CB Telecom owns Belarus mobile operator MDC which operates under the Velcom brand in Belorussia.

The acquisition market is further fuelled by CEE and Middle Eastern operators. In early 2007, the Serbian incumbent Telekom Srbija snatched 65 percent of the shares of Telekom Srpske for €646m. A consortium including Turk Telekom acquired a controlling stake in the Albanian incumbent Albtelecom for €145m. Hungary's Telephone and Cable Corp. bought 100 percent of the Hungarian fixed line operator Invitel from Mid Europa Partners for €470m, with multiples of 1.4x revenue and 3.9x EBITDA. Saudi Oger, based in the United Arab Emirates, also moved into CEE when it bought Turk Telekom for €5.5bn in 2005 and a 45.8 percent stake in Romanian specialised mobile operator Zapp for an undisclosed amount.

Financial buyers

The largest telecommunications transaction in 2007 was conducted by AIG Capital, which acquired 65 percent of the Bulgarian incumbent BTC for €1.1bn, taking it over from another financial investor. AIG also acquired SC Digital Cable systems in Romania for €45m. Mid Europa Partners acquired the Baltic mobile operator Bite for €450m from TDC and also acquired the leading Serbian cable and broadband provider SBB for €200m. Providence Equity Partners took over the Ukrainian cable company Volia Cable for €200m. GML has announced its intention to sell 100 percent of the shares in GTS CE to a consortium of private equity funds, led by Columbia Capital. GTS CE operates a group of alternative telecom service providers in Czech Republic, Poland, Hungary, Romania and Slovakia.

The activity of financial investors proves they expect to be able to create substantial value through a future exit. Their focus is no longer solely on telecommunications operators but also includes cable operators.

Future trends

The slowing growth rate in many CEE markets suggests saturation. The number of 'obvious' acquisition targets is declining, which may lead to a slowdown in M&A activities by strategic investors. The financial crisis, which has made financing for financial acquirers more difficult, may also reduce their activity. However, the potential for value creation through consolidation prospects, operating cost reductions and remaining growth areas should continue to drive the interest of financial investors in CEE telecommunications assets.

Overall, three fundamental trends should drive mid-term M&A aspects in the telecommunications sector in CEE:

Privatisation. Privatisation is driving three long awaited exemplary transactions which should take place in 2008. First, the sale of 49.13 percent of Telekom Slovenije to either of two remaining bidders in the bid process: Iceland telecom incumbent Skipti or the private equity consortium led by Bain Capital even though the process was recently halted by the Slovenian government and therefore will be delayed. This project is at risk as recently the Slovenian government threatened to withdraw the process. Second, the privatisation or IPO of Lattlecom in Latvia. Third, the potential sale of a share in the Ukrainian incumbent Ukrtelecom.

Licence issuance. Investors acquiring new licenses will set-up businesses which may be involved in future M&A activity. CEE regulators continue to issue a number of licences. For example, a number of CDMA licences have been awarded, some of which led to the establishment of new, specialised operators. Recent examples include the fourth mobile licence in Bulgaria which has been awarded to CDMA-Operator RCE. In Czech Republic, Mobilkom, a startup set-up by Czech based private equity house Penta Investments and not related to mobilkom Austria, launched a CDMA network branded U:fon. Also, in Poland, Nordisk mobiltelefon, a Finish mobile operator, recently received a CDMA licence. Warsaw based Sferia also owns a nationwide CDMA licence.

In mid-March, Romania's national regulatory authority launched a draft decision on the procedure for granting a licence allowing the provision of mobile services in the 410-415/420-25MHz bands. The tender will only be open to bidders that do not currently hold an GSM, UMTS or CDMA license in the country. This might be quite attractive for investors searching for greenfield operations in the region and will further increase competition.

Greenfield opportunities. Companies do not require a huge excess of cash in order to swim with the big fish. There are vast opportunities for those with a smaller pocket and an innovative spirit. Companies can team up with other small players and create broadband accesses either in new buildings or to cover whole city districts. In the Czech Republic, for example, there were 800 Wi-Fi ISPs offering services to over 350,000 subscribers in early 2007. We expect to see some consolidation among these ISPs. There is a similar situation in Bulgaria, where many small LAN operators have emerged and successfully attracted 60 percent of the fixed line broadband market.

New businesses addressing these broadband opportunities as greenfield start-ups are likely to become the object of future M&A activity. Airbites, a Swisscom-backed ISP, is one strategic investor waiting to pick up successful start-ups. It specialises in acquiring local ISP operations in CEE countries, especially small, LAN/Ethernet based neighbourhood networks.

We expect M&A activity in the CEE telecommunications markets to continue in 2008 and 2009. But the merger and acquisition process has become more challenging. As the number of obvious opportunities has declined, competition for high-value transactions, such as in privatisations, is particularly intense. A buyer therefore needs to be fast, well-prepared and take into account the dynamics of competing bids to determine the amount it is prepared to pay. Bids for future licences may also decline since the markets are relatively saturated and future licences will mainly address niche areas such as CDMA. Acquisitions of specialised greenfield start-ups certainly require a thorough technology understanding. The transaction process is further complicated by the current situation in global financial markets, which are certainly affecting financial buyers.

Dr. Karim Taga, Oliver Lux, Christian Niegel and Evgeny Shibanov are consultants at Arthur D. Little.

CHAPTER TEN:

Regional view – The Americas

The M&A world comes to the United States

BY JOHN BRANTLEY AND MARTIN HUNT

The United States has become a focus of merger and acquisition activity for companies and investors from around the world. Of the $1.5 trillion in US M&A transactions during 2007, as measured by Thomson Financial, non-US acquirers made nearly one-quarter of the total – a percentage double that of 2006. Sovereign wealth funds in Southeast Asia and especially in the Middle East (the latter with investment assets estimated at more than $2 trillion) received the biggest headlines in this 'buy American' boom, but European based companies drove the majority of inbound business purchases and combinations. These companies were spurred by solid business fundamentals: favourable exchange rates from the falling dollar, favourable company valuations from lower equity prices, and favourable opportunities in a country with the best growth opportunity in markets as varied as technology, energy and consumer goods.

The inbound acquisition surge is not without its concerns for offshore purchasers. From the litigious nature of doing business in the US, to a variety of heightened regulatory concerns, investment in the US can involve a wide range of special considerations. Non-US companies need proper due diligence and planning when structuring their deals, to help ensure that a potentially profitable deal does not turn into a costly mistake.

CFIUS national security review

The Foreign Investment and National Security Act of 2007 adds a new element of political exposure to foreign direct investment transactions. While the American economy remains largely open to foreign investment, the new law increases the risk that domestic political considerations will influence the approval or rejection of a foreign bid to acquire an American company. The Act revises the process by which the Committee on Foreign Investment in the United States (CFIUS), an executive branch body, reviews foreign direct investment in the US for national security concerns. In so doing it allows members of Congress, competing bidders for targets, labour unions and advocacy groups to shape, delay or prevent proposed acquisitions.

The increased role of politics in the CFIUS process is apparent from the expanded number of ways that a review or investigation may be triggered. The Act requires a CFIUS review of any foreign government-controlled covered transaction. Parties to a covered transaction must certify that the information they provide is correct, and CFIUS may negotiate any provision or even create new terms of a covered transaction in order to mitigate a national security threat. A covered transaction may not be exempted from further review and investigation until the report and findings are approved by a majority of CFIUS members and signed by the secretaries of Treasury, Homeland Security, and Commerce. Most importantly, the results of CFIUS standard and national security reviews must be provided to the appropriate House and Senate committees for their own review and assessment. The likely result will be public hearings at which any economic or political interests can oppose a given acquisition.

Recognising the importance of foreign investment in the US, Congress and the Administration have emphasised that their intent is not to allow the new law to disrupt or block routine foreign investments and acquisitions. The new law will, however, raise the cost and lower the chance for approval of some acquisitions by foreign investors and could discourage or defeat some investments. Foreign investors should exercise all necessary caution regarding the political ramifications of their proposed US acquisitions. Although a CFIUS application for review remains mostly voluntary, failure to seek a CFIUS review may leave a transaction open to future scrutiny and even to dissolution. The decision to seek a review should be part of transactional due diligence, particularly in industries with national security implications. However, the serious nature of the remedies available under the law will cause most foreign acquirers to file, even for transactions with only tangential national security implications. Acquirers also should build legal strategies and structures to support the deal – such as management techniques to minimise the effect of foreign ownership, control and influence. Proactive strategic communications to educate stakeholders, frame debate and influence policymakers is crucial in major acquisitions. Taking these steps and developing a general appreciation of the heightened US sensitivities to foreign direct investment transactions are practical ways to facilitate successful approval and consummation of inbound investment deals under the new CFIUS rules.

Foreign Corrupt Practices Act

That US companies must comply with the Foreign Corrupt Practices Act of 1977 (FCPA) is sometimes overlooked by inbound acquirers. US regulators and prosecutors are aggressively enforcing FCPA financial reporting requirements and prohibitions on payments to foreign officials, but many other countries have also stepped up anti-bribery enforcement on their corporate nationals. Anti-corruption compliance programs are now a virtually global requirement for multinationals, and compliance officials in most OECD countries share both a similar understanding of what constitutes corporate criminal conduct and the legal infrastructure to detect, report and prosecute it. Rigorous anti-corruption due diligence (particularly on offshore distribution arrangements and financial reporting) can reveal problems early in the acquisition process so that remedial action can be taken prior to closing.

Litigation risk

FCPA compliance and the possibility of regulatory action and shareholder lawsuits over noncompliance is just one form of US litigation risk that inbound acquirers often find troubling. US companies and their officers and directors have much greater liability in both federal and state courts than foreign acquirers are accustomed to in their own countries. For example, a director of a Delaware company living anywhere in the world can be sued in Delaware, and the CEO of a corporate entity based offshore can be subpoenaed to appear in any state court hearing a product liability or negligence lawsuit (a risk that BP's chairman faced in litigation over that company's Texas refinery fire). Enforceability of non-compete and confidentiality agreements is also a major concern for non-US acquirers. There is no overall solution to litigation risk – acquirers must rely on due diligence and advice of US counsel to manage it.

Competition enforcement

Despite increased public and political concern over foreign acquisitions of US businesses, national security concerns are largely separate from competition enforcement as a regulatory factor for inbound acquisitions. Although acquisitions that meet certain thresholds are subject to antitrust reporting requirements under the Hart-Scott-Rodino Act, the vast majority of reportable transactions faces no hurdles after the parties report the transaction. The FTC and DOJ do not typically take steps to stop non-US acquirers from acquiring US companies unless there is some significant evidence that the transaction will have a substantial negative impact on competition. Similarly, informal and non-reportable business combinations generally are not challenged by the US government without some evidence of an illegal purpose or conspiracy.

Public policy advocacy

Acquirers must often combine regulatory insight with public policy advocacy to gain approval for complex investment and business combination transactions. For example, if a foreign company faces shareholder, regulatory and political opposition in the US over a proposed major investment, it may be prudent to commission an independent assessment of its proposed transaction. If the report concludes that the parties have fully and completely complied with all laws, rules and regulations applicable to the transaction, the SEC and other regulatory bodies may give the report considerable weight in approving the transaction. Such an innovative advocacy strategy shows the preparation that future major inbound acquisitions may need.

Despite increased public and political concern over foreign acquisitions of US businesses, national security concerns are largely separate from competition enforcement as a regulatory factor for inbound acquisitions.

Unique financial and operating concerns

Beyond the courts, Congress and the regulators, inbound acquirers face a variety of unique financial and operating concerns when they acquire US companies. None of these are typically dealbreakers, but all should be considered as part of due diligence review: (i) the heightened government scrutiny of immigration and expatriate employment, particularly in light of complex visa restrictions for expatriate executives and their families; (ii) the prevalence of employee stock ownership plans and equity incentive compensation plans for executives, and how an acquirer not traded on a US exchange must deal with them; (iii) the more extensive regulation (from the SEC to the Sarbanes-Oxley Act) and shareholder rights issues that publicly owned US companies must contend with; a complication that leads many foreign acquirers to rely more heavily on debt rather than equity financing; (iv) compliance with the double tax treaty network that the US has with many countries, thereby ensuring efficient cross-border flow of capital, earnings and dividends; and (v) the importance of local economic and political considerations as they translate into extensive media attention that could delay or derail a deal (as in the concerns of the 12,000 Hershey, Pennsylvania residents over the company's potential purchase by Cadbury).

Final thoughts

Despite all the cautions and potential problems, inbound acquirers should continue to find in the US an open and accepting environment for business purchases. The country's balance of payments situation virtually requires inflows of offshore capital, and the recognition of that fact means that there is no substantial public policy bias against foreign investors. With proper due diligence on each transaction, adequate preparation to deal with potential problems, and a close working relationship with US counsel to navigate the legal and regulatory complexities, acquiring companies based outside the US have every reason to continue and expand their efforts to exploit market opportunities and capital market advantages through the purchase of US business assets.

John Brantley and Martin Hunt are partners at Bracewell & Giuliani.

Taking advantage of the weak US dollar

BY GARY W. MARSH, MICHAEL J. COCHRAN AND ANN-MARIE MCGAUGHEY

'America is on sale' is a common sentiment expressed by bankers, investors and commentators these days. The relative weakness of the US dollar undoubtedly will attract the capital of not only US buyers, but also non-US buyers in search of possible investment opportunities in the US. One such area of opportunity, particularly with the current state of US credit markets, is the market for distressed companies.

The acquisition of distressed companies in the US involves aspects that are unique from transactions involving financially healthy businesses. Below are some of those issues and the ways in which a buyer may resolve them.

The value of rigorous due diligence

A critical component of any transaction is the need for comprehensive due diligence on the business, even more so when evaluating a distressed business. Determining the underlying causes of the insolvency is vital to understanding the viability of the business going forward. A potential buyer should focus its attention on the seller's key consituents: (i) customers – distressed businesses may have delivery or quality problems in their product areas. Key customers may find alternative suppliers and the seller's business may be substantially eroded; (ii) vendors – distressed businesses may create short term financing by stretching the terms of their trade payables. Following the sale, existing vendors may be unwilling to extend terms or may require significant monetary or other assurances to continue supply; and (iii) employees – distressed businesses risk losing key employees because of the pressure surrounding a troubled company. Business culture also may be damaged due to attempts to achieve short term liquidity at the expense of good business practices.

Buying assets from a US company in bankruptcy

Both buyers and sellers may prefer for the sale of business to occur in a court-supervised bankruptcy process (as opposed to outside of the bankruptcy process, discussed below). Typically, asset sales under Section 363 of the US Bankruptcy Code involve a Chapter 11 debtor-seller and a prospective buyer presenting a fully negotiated asset purchase agreement to the Bankruptcy Court for approval. The drawback being that Section 363 sales are then subject to a court-supervised auction process where additional buyers may bid for the business. Other potential acquisition methods include a friendly foreclosure, a sale by a state court appointed receiver, an assignment for the benefit of creditors and a Chapter 7 Trustee liquidation sale.

There are several benefits to purchasing a distressed business in a bankruptcy context. First, a buyer of assets from a seller in bankruptcy eliminates fraudulent conveyance risk that might otherwise exist in a purchase prior to bankruptcy. Second, the transfer of assets through a Section

363 sale is typically free and clear of all liens, claims and interests and eliminates successor liability. The ability to be relieved of all future claims is more uncertain and depends upon the facts and circumstances. Third, the sale of assets pursuant to Section 363 to a good faith purchaser for value cannot be set aside, modified or reversed. Fourth, a seller is required to file, under penalty of perjury, detailed schedules of all of its assets and liabilities, a detailed statement of its financial affairs and periodic monthly detailed operating reports. Finally, a seller may reject burdensome contracts and may assign contracts and leases to a buyer without the consent of the non-debtor party to such agreement and notwithstanding anti-assignment provisions.

However, there are two principal disadvantages to a buyer in a bankruptcy context. First, the Bankruptcy Court will require an auction sale of the debtor seller's assets to ensure that the seller is realising the highest price possible. Thus, the buyer has the unavoidable risk that it might be outbid in the auction process. Second, the assets usually will be sold 'as is, where is' with few representations and warranties, leaving the buyer with minimal recourse.

With respect to the auction issue, the initial buyer can attempt to negotiate a break-up fee (usually 1-5 percent of the purchase price) as compensation in the event that it is not the high bidder and can request expense reimbursement up to a cap. The Bankruptcy Court does not have to allow these protections.

As for the condition of the business, the buyer can attempt to negotiate a 'hold back' of a portion of the purchase price to secure certain limited representations and warranties or to negotiate a purchase price based, in part, upon post-acquisition metrics. These mechanisms must be approved by the Bankruptcy Court.

Buying 'distressed' assets in a non-bankruptcy context

Buyers of troubled companies outside of the bankruptcy process face two major risks: successor liability and fraudulent conveyance.

Successor liability

Most buyers of troubled businesses structure their transaction as an asset purchase, thereby attempting to avoid assuming liabilities of the troubled business. However, there are some important exceptions to consider. First, the buyer will have successor liability if it expressly or implicitly agrees to assume the liabilities of a seller. The purchase and sale agreement should establish excluded and assumed liabilities. Second, a buyer has successor liability if the buyer is deemed to have engaged in a 'de facto merger' with the seller. While this doctrine is a creature of state law, the risk is generally the highest if there is a continuity of shareholders such that the shareholders of the seller become shareholders of the buyer. Third, a bulk transfer generally involves a sale, not in the ordinary course of business, of a substantial portion of the inventory of the seller. Compliance with these statutes requires notice to all of the seller's creditors and other specified procedures. Failure to comply with these statutes generally permits the seller's creditors to sue the buyer for a period of up to 6-12 months following the transaction. Finally, certain federal and state statutes may create successor liability, including federal labour and employment claims, environmental claims and/or product liability tort claims. These claims may have their own 'successor' standard to which a buyer may become subject.

Fraudulent conveyance

The doctrine of fraudulent conveyance may be applied to impose liability on buyers. Generally, there are two types of fraudulent transactions: (i) actual fraud, in which there is an actual intent to hinder, delay and defraud creditors; and (ii) 'failure of due consideration', in which the buyer does not receive fair consideration from the insolvent seller. A successful fraudulent transfer claimant may, among other things, set aside the transfer or obligation to the extent necessary to satisfy such creditor's claims.

There are several ways of structuring transactions to mitigate fraudulent conveyance risk. Care must be taken to ensure that the surviving entity has reasonable expectations of meeting its fixed obligations following the transaction. Generally, transactions will not be fraudulent conveyances if some of the following elements are present: (i) no prejudice to existing creditors; (ii) the seller was solvent following the transaction and had adequate capital; or (iii) the transaction involved adequate consideration. Good faith also may be a defence.

In sum, those buyers seeking to take advantage of the current market conditions in the US will have an advantage if they understand and appreciate the dynamics of acquiring a business in financial trouble.

Gary W. Marsh, Michael J. Cochran and Ann-Marie McGaughey are partners at McKenna Long & Aldridge LLP.

Deal or no deal

BY FRANK A. MCGREW IV AND DUNN MILEHAM

As investment bankers focused on the middle market, this past year provided plenty of drama both here in the US and around the world. The stock market entered 2007 a bit sluggish, but by March all three primary stock indices seemed to hit all-time high levels on a weekly basis. Following on the heels of what was then the largest leveraged buyout in history (Blackstone Group's $39bn buyout of real estate investment trust Equity Office Properties in early February), the first half of 2007 included the announcement of several notable M&A transactions: a consortium of financial buyers purchased TXU Corp. for $44.5bn in the largest LBO in history, First Data Corp. was purchased by KKR for nearly $29bn and a Goldman Sachs-led group purchased Alltel Corp. for $28bn. As the second quarter ended, it appeared that 2007 would be a record breaking year by all standpoints – the stock market was up 7 percent, ample capital (both equity and debt) was available to consummate transactions at increasingly higher valuations and the economy appeared to be on solid footing. Private equity firms were even talking about the prospects of a $100bn buyout transaction.

However, the balance of the year was quite different, beginning with the mortgage and related credit turmoil in July that put the brakes on a rising stock market, reduced transactions by financial buyers and lowered overall acquisition multiples. Numerous M&A transactions have been shelved or delayed, including those being pursued by strategic buyers. Where have all the good times gone?

After three strong years, the US economy has clearly slowed, and there is an overriding fear of a recession due to housing and mortgage turmoil, rising oil prices and overall anxiety by both consumers and businesses. The impact of a series of interest rate cuts by the Fed and a falling dollar have proved to be only somewhat effective in strengthening consumer confidence and boosting exports. All this uncertainty on the eve of one of the most important presidential elections in recent history. Financial markets hate uncertainty, and nothing appears certain today.

Market pundits argue that Wall Street runs in cycles and this period is no different than past bubbles with the pendulum having swung toward fear rather than greed. Robust fundraising efforts by private equity funds over the past five years led to over $500bn being raised due to large alternative investment allocations by pension funds and other wealthy investors. The insatiable deal appetite displayed by financial buyers led to an explosion of liquidity in the leverage finance markets – low default rates and confidence that equity sponsors could write cheques to support disproportionately high leverage caused traditional diligence and underwriting practices to fall by the wayside.

Owners of both public and closely held

businesses who witnessed peak valuations being paid for competing companies now wonder if liquidity options still exist. Large banks (and investment banks) have been forced to lay off employees in the wake of ill-fated trading and fixed-income operations and deteriorating profits. The consumer has shown initial stages of hibernation given continued uncertainty surrounding the economy, falling consumer confidence related to the subprime mortgage debacle and curtailed discretionary spending. Furthermore, the continued erosion of the US dollar, renewed concerns regarding budget and trade deficits and the upcoming election loom large.

Private equity transactions will slow but not cease in 2008 – there is just too much money to be invested and managers run the risk of forfeiting management and transaction fees.

If there is a bright spot, the middle market, defined as transactions less than $1bn, has been somewhat more resilient due to typically lower leverage and transactions at relatively reasonable multiples.

What might this wave of uncertainty mean for the transaction environment in 2008 and beyond?

As private equity buyers will be forced to contribute more equity and rely less on 'excessive' leverage, strategic buyers (particularly those outside the US) will re-emerge as victors in competitive auctions. After years of strong financial performance, cash-rich strategic buyers can use cash on hand or public stock (which allows sellers to participate in future upside) as currency. Sellers will be appreciative of more conservative leverage multiples and a greater certainty of closure due to less reliance on finicky debt markets.

Private equity transactions will slow but not cease in 2008 – there is just too much money to be invested and managers run the risk of forfeiting management and transaction fees. After years of strong returns, pension funds, endowments and other institutional investors have allocated large portions of their capital to alternative investments, such as private equity. Until the returns on this asset class experience a significant fall, managers will continue to allocate funds. Sound deals will continue to get done; however, leverage to finance these transactions will be based upon how much debt a company can reasonably handle, not how much an underwriter can sell in syndication.

Competing with financial buyers for deals will be Special Purpose Acquisition Companies (SPACs), which are public shells of 'blind pool' capital designed to acquire or merge with an operating business. SPACs currently have over $18bn of capital available for acquisition deployment with an additional $12bn in registration. Similar to private equity funds, these pools of capital have a set time horizon in which a transaction must be consummated, otherwise, funds held in trust are returned to the investors.

Foreign investors will be able to use their stronger currencies to make aggressive and opportunistic acquisitions in the US market

– particularly related to divestitures of non-core or underperforming assets by public companies. Against a basket of foreign currencies (including the euro, the Japanese yen, the British pound, the Canadian dollar and others), the US dollar is down in excess of 20 percent versus five years ago.

The market will remain active although highly volatile in the days and months ahead. Both buyers and sellers will be forced to demonstrate their skills in a competitive international environment. Corporate boards and management teams should review the state of their M&A preparedness and should attempt to capitalise on M&A opportunistically. Strategic options should be evaluated, and regulatory and governance affairs (SEC filings) should be current in order to quickly raise capital to take advantage of transaction opportunities. Importantly, companies should raise funds when market conditions permit, not when funds are needed. Lastly, companies and executives should exercise discipline and patience, as transactions will take longer to negotiate, finance and close.

Frank A. McGrew IV is a managing director and Dunn Mileham is a vice president at Morgan Joseph & Co. Inc.

A brief glossary of US M&A terms

BY RICHARD LIEBERMAN

Mergers and acquisitions involve complex business and legal transactions, which carry an entire lexicon that may be unfamiliar to buyers and sellers, particularly parties from other jurisdictions. The following glossary includes terms commonly used in US acquisition transactions. The descriptions are intended to be descriptive, rather than to constitute legal definitions. Because similar terms may carry different connotations in other countries, it is advisable to check with experienced professionals on proper usage in the relevant jurisdictions.

Accretion / Dilution. An *accretive* acquisition increases earnings per share. Conversely, a *dilutive* one decreases earnings.

Baskets and Caps. In negotiating indemnity provisions, the parties sometimes agree that a party need not indemnify the other unless the damages exceed a minimum amount, called a '*basket*.' Sometimes baskets are a '*true basket*,' where a seller is not liable for damages below that amount. Other times, the basket is merely a '*threshold*' or '*tipping basket*,' in which case once that level of damages has been reached, the buyer can seek indemnity for all of its damages, including for those below the threshold. The parties may agree that certain liabilities (often for the breach of some of the representations and warranties) will not exceed a maximum level, called a '*cap*'.

Break Fees. Corporate laws in many jurisdictions may impose a duty on the board of directors to consider a superior offer, notwithstanding a contractual prohibition on negotiating with other potential bidders. Some agreements provide for the payment of a fee to the proposed buyer if the seller accepts a better offer from another bidder. That fee is often called a '*break fee*'.

Data Rooms / Virtual Data Rooms. A '*data room*' is a place where a company's records and other due diligence materials are placed for inspection by prospective buyers. Data rooms can be a physical location. Alternatively, companies may scan those documents into a website, called a '*virtual data room*' to permit inspection from a distance through secure internet connections.

Defensive Measures / Shark Repellant. Companies may implement '*defensive measures*' (sometimes called '*shark repellant*') to help resist being acquired by another company, or to permit a greater opportunity to negotiate better price and terms with the bidder. Common defensive measures include '*poison pills*,' which often permit the target company's shareholders to purchase additional equity to dilute the bidder, '*staggered boards*,' which provide for the election of directors in annual tranches, making it more difficult for the bidder to replace a majority of entire board quickly, and *supra-majority voting requirements*. Business entity and securities laws may govern the adoption of defensive measures. Companies should consider their duties to equity holders and others in determining whether these measures are in the company's best interests. Investors often resist defensive measures, due to their impact on potential sale transactions.

Dilution. See 'Accretion / Dilution' above.

Disclosure Statements. See 'Proxy Statements / Disclosure Statements' below.

Earn-Outs. Buyers sometimes agree to only pay a portion of the purchase price if the business performs at specified levels over time. The deferred portion of the purchase price is referred to as an '*earn-out*'. Earn-outs are often measured on sales, revenue or net income targets. Earn-outs can be used to help bridge disagreements over a target company's value, as well as to motivate the sellers to help contribute to the future success of the business.

Fairness Opinions. A '*fairness opinion*' is issued by an independent valuation firm to provide comfort to the equity owners of a seller that the consideration offered for their shares is fair.

Greenmail. Some bidders for a company will acquire a large block of the target's equity and then threaten to launch a hostile tender offer for more shares unless the target purchases that block of stock at a premium. That tactic is often called '*greenmail*'.

Hart-Scott-Rodino Approval. The *Hart-Scott-Rodino Antitrust Improvements Act* requires larger companies to provide the US government with advance notice of a pending acquisition, so the government can review the anti-competitive impact of the proposed transaction. The filing fees can be quite steep and are payable by the seller unless the parties agree otherwise.

Holdbacks. Buyers may withhold payment of a portion of the purchase price (or that portion is placed into escrow with an escrow agent) to provide security for the seller's indemnity obligations. The withheld amounts are often referred to as a '*holdback*'.

Hostile Takeovers / Hostile Tender Offers. A process whereby a bidder attempts to acquire a target company when the target's management does not wish the company to be acquired on those terms. In a hostile transaction, the bidder will seek to acquire ownership of the company directly from its equity owners. A '*tender offer*' is a process in which shareholders tender their shares to a bidder in exchange for an offered amount of consideration. Tender offers are regulated by business entity and securities laws, especially for public companies.

Lock Up Provisions. Buyers attempt to prevent target companies from selling to another prospective buyer through contractual restrictions sometimes known as '*lock up*' provisions. Lock ups can include use of voting agreements by significant equity owners, 'no-shop' provisions discussed below and other methods.

Management Agreements. See 'Transition Services Agreements / Management Agreements' below.

Mini WARN Acts. See 'WARN Act / Mini-WARN Acts' below.

No Shop Provisions. Contractual restrictions on engaging in negotiations with other bidders are called '*no shop*' provisions. If the sellers have a fiduciary obligation to consider unsolicited offers and eventually accept another, they may be required to pay a break fee, discussed above.

Poison Pills. See 'Defensive Measures' above.

Proxy Statements / Disclosure Statements. A *proxy statement* is a disclosure document describing the material features of a transaction to be voted on by the equity owners when they are asked to give a voting proxy to another. If the equity owners are not being asked to approve the matter, applicable law often requires that they be furnished with similar information through a *disclosure statement*. Proxy solicitations and disclosure statements are regulated by business entity and securities laws.

Reverse Mergers. A *reverse merger* is a process in which an active, non-public company merges into a shell company with no significant operations but has a class of equity securities registered with the securities administrators (such as the US Securities and Exchange Commission). In that manner, the private company can rapidly become a public one.

Shark Repellent. See 'Defensive Measures' above.

Staggered Boards. See 'Defensive Measures' above.

338(h)(10) Elections. This section of the US Internal Revenue Code of 1986 allows the parties to treat a sale of stock as if it were a sale of assets, which may be beneficial for tax purposes.

Transition Services Agreements / Management Agreements. *Transition services* or *management agreements* are frequently used to enable a seller to provide services to the buyer for an interim period until the buyer is able to assume those duties. The agreements set forth the rights, obligations and terms under which those services will be performed. Transition services agreements are often used while buyers obtain necessary licences and permits, or implement technological conversions necessary to operate the newly acquired company.

Virtual Data Rooms. See 'Data Rooms / Virtual Data Rooms' above.

WARN Act and Mini-WARN Acts. The *Worker Adjustment and Retraining Notification Act* requires that companies provide the employees and the US government with advance notice of mass layoffs before those employees may be terminated. Many states have similar laws (called '*Mini-WARN Acts*'), but the thresholds for when the notices are required may differ.

Richard Lieberman is chairman of the Corporate, Securities and Finance Department of Jennings, Strouss & Salmon, PLC.

Recent developments in Canadian M&A

BY FRANK P. ARNONE

In recent years merger activity in Canada has reached record highs. Growth in M&A transactions has been most significant in the energy and mining sectors with Canadian proven oil reserves, dominated by the oil sands in Alberta, providing a major source of M&A activity. In spite of the recent tightening of credit availability, there is optimism about the outlook for M&A activity in Canada.

Current state of the M&A market in Canada

Several trends have emerged in this historic period of growth and consolidation. Private equity continues to play a significant role in Canadian transactions with both foreign and domestic private equity dealmakers active in Canada. The majority of foreign private equity firms have been based in the US, while at home, Canadian institutional investors have been allocating greater portions of their assets to Canadian private equity funds, both internally managed, and those managed by others through investment in other funds. There is also an increasing prevalence of companies from countries such as Brazil, Russia, India and China as buyers in Canadian M&A transactions and income trusts continue to play a significant role as both buyers and targets. Going forward, developments in the regulatory environment impacting Canadian M&A should have a positive effect on the volume of transactions in Canada.

Recent changes to tax legislation

On 31 October 2006 the Canadian federal government announced proposed changes to Canadian tax laws that will significantly reduce or eliminate the tax advantages previously enjoyed by Canadian income trusts. Prior to the announcement, income funds could be structured in such a manner as to avoid paying 'entity level' tax (unlike corporations) as long as they paid out all their income by way of distributions to their unit holders. The new proposals, when implemented, will create a tax regime for most publicly-traded trusts and partnerships and their investors that will, in effect, be similar to that for public corporations and their shareholders. For income trusts with units listed on a stock exchange before 1 November 2006, the tax changes will commence beginning in the 2011 taxation year, providing a four-year 'grandfathering' period.

Until these legislative changes were announced, income trusts had served as a liquidity vehicle; including as an exit vehicle for private equity funds, and an attractive vehicle into which certain corporations could convert. But, with income trusts set to lose their tax advantage over corporations in 2011, the Canadian M&A marketplace has seen an upswing in income trust M&A activity, largely spurred by financial sponsors looking for stable income buyout opportunities.

A recent study we commissioned in

association with mergermarket identified stable and predictable cash flows and a capital structure that is designed to pay out dividends on a regular basis as the most attractive characteristics of income trust businesses.

Developments in competition regulation

On 22 January 2008, the Federal Court of Appeal released its decision in *Commissioner of Competition v. Labatt Breweries Limited*. The significance of this decision is in its affirmation, with appellate authority, of the Competition Tribunal's earlier decision to allow Labatt to conclude its takeover bid for rival Lakeport Breweries on its original timeframe.

The Competition Tribunal, in making its decision, held that extensions of the 42-day statutory review period for M&A transactions are not to be granted lightly. Indeed, extensions (with consequent delays in closing) should only be granted in situations where the Commissioner can show that closing will substantially impair the Tribunal's ability to remedy the merger at a later point.

As a result of the Labatt decision, it is more likely that parties to a merger that raises competition issues may be able to close on the basis of a negotiated hold-separate arrangement some time shortly after the initial 42-day waiting period. In this manner, it is clear that the Canadian Courts are mindful and facilitative of M&A market realities: timing and certainty of closing are critically important features in certain transactions (e.g., transactions involving public companies, in deals involving foreign jurisdictions where only part of the deal involves Canada, and in corporate auctions, where vendors seek an expeditious closing and potential purchasers want to make bids with as few conditions as possible). The Labatt decision means that the Competition Act restrictions should not hamper these mergers with undue delay and unnecessary bureaucratic obstacles. In fact merger review in Canada will, as a result of this decision, increase certainty and reflect market realities.

Deal certainty in the current credit environment has become very important, as evidenced by the emphasis on material adverse change clauses in acquisition agreements and on reverse break fee provisions.

The impact of private equity on deal activity in Canada

Canadian private equity has seen record buyout activity in the past two years. This has been fuelled by Canadian and US based institutional investors allocating greater percentages of their portfolios to private equity funds.

The recent tightening of financial markets has, however, dampened activity in leveraged buyout transactions especially in the consumer products, industrial manufacturing and financial services sectors. Deal certainty in the current credit environment has become very important, as evidenced by the emphasis on material adverse change clauses in acquisition agreements and on reverse break fee provisions. The mid-market nature of the Canadian marketplace has, however, placed Canada in a position well suited for the year ahead. Although the decline in large M&A transactions is predicted to continue, transactions in the mid-market are expected to present the most opportunities.

It is expected that growth in private equity transactions will outpace growth in M&A activity in Canada generally.

The year ahead will likely also see the continued widespread participation of Canadian pension plans; a relatively unique characteristic of the Canadian private equity M&A marketplace. Private equity investments by these plans cover a wide spectrum, including LP investments, co-investments with private equity funds and direct and co-sponsored buyouts. These are expected to continue in the mid-market. Canadian pension plans have also diversified their private equity investments to include a number of different sectors, including infrastructure. Due to foreign ownership restrictions in certain industries in Canada, Canada's pension plans have proven to be valuable strategic partners. Canadian pension plans are well positioned to continue this trend of active investment, with many allocating an increased amount of capital to private equity investment strategies over the coming years.

Although the credit environment has dampened M&A activity in the latter part of 2007 and into 2008, it is expected that growth in private equity transactions will outpace growth in M&A activity in Canada generally. In light of the recent dramatic appreciation of the Canadian dollar against the US currency, in particular, increased outbound investment and acquisitions by Canadians is also likely.

Controlled auctions in Canadian M&A

In recent years the Canadian M&A market has seen a significant increase in the use of 'controlled auctions' by sellers. The prevalence of this auction process was the result of numerous factors, not least of which, was the existence of a 'sellers market'.

Although there are various permutations in the process, generally controlled auctions in Canada involve the following elements. At the outset a Confidential Information Memorandum (CIM) describing the business for sale is prepared. Potential buyers are then identified and contacted. Bidders then sign confidentiality agreements with the seller before they review the CIM. At this point bidders are generally given access to additional due diligence materials. Non-binding expressions of interest are then submitted from which the seller narrows the field to create a short list of bidders. Further access to more detailed due diligence material is usually granted to the short list at this stage. Bidders then submit an offer. Consideration and clarification of offers results in the selection of one bidder (or more than one) and the parties entering into negotiations (which can be exclusive), with the hope of concluding a binding agreement.

Throughout the process the seller may maintain control and the flexibility to negotiate with one or more bidders and accept any offer, regardless of price or terms. The predominance of sophisticated parties in the process and emerging technology have come together to create a positive climate for controlled auctions in Canada. This is a trend that will likely continue in the Canadian M&A marketplace where circumstances warrant.

Conclusion

The announced income trust taxation changes have brought about M&A opportunities in the form of business with stable cash flows that are designed to pay regular dividends. In addition, the recent Labatt ruling indicates that there is a favourable antitrust environment for M&A activity in Canada. With these developments, a new face has been placed on the deal landscape in Canada. For non-Canadian buyers, this landscape has made the Canadian market an attractive place to shop for businesses; particularly those businesses in the mid-market.

Frank P. Arnone is a partner and co-chair of the Private Equity Group at Blake, Cassels & Graydon LLP. *The author would like to thank Caroline McGrath (Student-at-Law, Blake, Cassels & Graydon LLP), who assisted in the preparation of this article.*

New rules of the game in Canadian antitrust

BY SUBRATA BHATTACHARJEE

A recent ruling of the Canadian Federal Court of Appeal suggests that the antitrust review of mergers in Canada may be subject to new rules of the game, in which parties in some cases may seek to close transactions more aggressively than in the past. The decision in *Commissioner of Competition v. Labatt Brewing Company Limited* (2007 Comp. Trib 9; aff'd 2008 FCA 22.) may make it more difficult for the Canadian Competition Bureau to seek temporary orders to stop parties from proceeding with a merger after the expiration of waiting period contained in the Canadian Competition Act.

Canadian merger review

The Canadian merger review regime requires parties to transactions that exceed certain financial thresholds to notify the Bureau prior to completing the transaction. Following notification, the parties must observe statutory waiting periods. It is a criminal offence to close a transaction prior to the expiration of the applicable waiting period. These waiting periods are dependent on the form of filing chosen by the parties, being either 14 days for 'short-form' filings, or 42 days for 'long-form' filings.

The Bureau has taken the position that in some cases (in particular, complex and very complex cases), it requires more time to review mergers than provided in the waiting periods. The Bureau has issued service standards which provide guidance as to the length of time it will require to perform its substantive analysis of a transaction, notwithstanding the waiting periods. Notifiable transactions are classified by the Bureau as being non-complex, complex or very complex, with maximum service standard for completion of its substantive analysis of 14 days, 10 weeks and five months, respectively. As can be seen, other than for non-complex transactions the service standard is much longer than the statutory waiting period.

This 'disconnect' between the statutory waiting period and the service standard period leads to situations where the parties are permitted to close by statute but the Bureau has not completed its review. Notwithstanding that the parties in such a situation are legally entitled to close (and be subject to any post-closing remedies the Bureau deems necessary) many parties choose to wait for the Bureau's review before they complete a transaction. This is largely because the Commissioner of Competition has the power to ask the Competition Tribunal to issue an interim order under section 100 of the Act, preventing the parties from closing until the review is complete. It was customarily thought that the standard for securing such relief was relatively low. However, the result in *Labatt* may have altered this belief.

The Tribunal's decision in *Labatt*

In early 2007, Labatt Brewing Company, one of Canada's largest brewers, announced its proposed acquisition of Lakeport Brewing, a smaller niche brewer. The parties expected the transaction to close at the end of March, 2007.

The Bureau classified the transaction as 'very complex', subjecting it to a service standard of five months. However, the Bureau had a statutory obligation to complete the review in 42 days (as the parties used a long form notification) failing which the parties were entitled to close the transaction unless the Tribunal issued a section 100 Order.

Initially, Labatt planned to close the transaction after the expiration of the 42 waiting period. Labatt apparently feared that if the deal was not closed in a timely manner, other competing bids could have been made for Lakeport, with the possibility that Labatt would lose the acquisition. Court filings suggest that Labatt had lost a target in an earlier transaction, when, during a lengthy review by the Bureau, Sleeman Breweries was snatched away by a rival.

It became clear in its review of the Labatt/Lakeport deal, however, that the Bureau would not be able to complete its review within the 42 day period. Labatt offered to enter into a consent agreement with the Commissioner, allowing the transaction to close into a hold separate arrangement in which Labatt and Lakeport would be kept under different management and run as two separate corporations until the Bureau completed its review.

While the Bureau historically permitted parties to close into hold-separate arrangements, just prior to the Labatt transaction the Bureau issued guidelines stating it would not consider hold separates until after its substantive review was complete and refused to agree to Labatt's proposal.

In Canada, merger remedies only have to restore competition to the point there is no substantial lessening of competition as a result of the merger.

With the Commissioner firm in her stance that a hold separate arrangement would not be consented to, and with Labatt uninterested in allowing the transaction to remain outstanding for the five-month service standard period for very complex transactions, Labatt and Lakeport decided to exercise their statutory right to close the transaction at the end of the 42 day waiting period. They were met with an application from the Commissioner seeking a section 100 Order from the Tribunal to prevent the brewers from closing or taking steps to close the deal for 30 days.

The Tribunal surprised observers by dismissing the Commissioner's application. The Tribunal noted that any merger remedy ordered by the Tribunal (in the event of a contested transaction) did not need to restore the pre-merger situation (as in the US). Rather, in Canada, merger remedies only have to restore competition to the point there is no substantial lessening of competition as a result of the merger. This result is typically obtained through structural remedies such as divestiture. The Tribunal found that the Commissioner had failed to address how these post-merger remedies could not be implemented as a result of closing.

The Commissioner appealed the Tribunal's ruling, but the Federal Court of Appeal dismissed the appeal without even hearing the argument of the brewers, delivering its judgement after submissions by the Commissioner's counsel.

Implications

The decision in *Labatt* confirms that the Bureau cannot look at the issuance of a section 100 Order as a rubber stamp, thereby emboldening merging parties to insist that review be conducted closer to the statutory waiting periods. Though this may not be as significant in the context of multi-jurisdictional deals, where other jurisdictional waiting periods may be longer, for purely domestic deals, *Labatt* sets the stage for a more aggressive approach to merger review.

Subrata Bhattacharjee is a partner at Heenan Blaikie LLP.

Canada's foreign investment review process

BY SUBRATA BHATTACHARJEE

Recent developments suggest that the landscape for foreign investment review in Canada is changing in a manner consistent with trends in other G8 nations. Responding, perhaps, to a number of high-profile transactions, some of which involved state-owned enterprises (SOEs), the Federal Government has now: (i) issued new guidelines for foreign investments by SOEs; (ii) announced its intention to institute a 'national security' screening mechanism for foreign investments; and (iii) asked a blue-ribbon Competition Policy Review Panel to review federal policies relating to competitiveness, including foreign investment regulation.

Guidelines for foreign investments by state-owned entities

On 7 December 2007, the Minister of Industry announced new guidelines applicable to foreign investments by SOEs. The Guidelines were issued under the Investment Canada Act, R.S.C. 1985, I-21.8 (ICA), which is the statute containing Canada's foreign investment review regime. Pursuant to the ICA, if a foreign investor proposes to acquire control of a Canadian business, and the asset value of the Canadian business exceeds certain financial thresholds, the investment is subject to review by the Investment Review Branch (IRB) and the Minister must determine that the investment is of 'net benefit' to Canada before it can proceed. In assessing whether an investment is of 'net benefit' to Canada, the Minister examines six economic factors, none of which explicitly refer to the state affiliation of the investor or to national security. The Guidelines do not alter these factors, or amend the ICA; however, they clarify what the Minister should consider when applying the factors in reviews of investments by SOEs.

In particular, the Guidelines suggest the following as being relevant. First, the SOE's adherence to Canadian laws, practices, and standards of corporate governance, including commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders. Second, the nature of and extent to which the SOE is controlled by a foreign government. Third, whether the acquired Canadian business will continue to operate on a commercial basis regarding: where to export; where to process; how Canadians participate in its operations; how ongoing innovation and R&D is supported; and what level of capital expenditures is appropriate to ensure global competitiveness.

The Guidelines suggest that foreign businesses should submit specific undertakings to IRB in support of a proposed transaction. Examples of possible undertakings include: (i) appointing Canadians as independent directors on the board of directors; (ii) employing Canadians in senior management positions; (iii) incorporating the new business in Canada; and (iv) listing the shares of the acquiring company or the Canadian business on a Canadian stock exchange.

The Guidelines essentially confirm the approach taken under the ICA in previous reviews involving investments by SOEs. Although SOEs will have to satisfy the Minister's concerns regarding corporate governance, commercial objectives and the extent and nature of state control, the Guidelines do not otherwise restrict the scope of possible investments.

The government has established a committee to develop guidelines for a national security test that will apply to foreign investors, and plans to announce the guidelines by mid-2008.

National security test

On 9 October 2007, the Minister announced that the government would consider how best to respond to national security concerns in the context of investments by foreign investors. The government has established a committee to develop guidelines for a national security test that will apply to foreign investors, and plans to announce the guidelines by mid-2008. In a January 2008 article in *The Globe and Mail*, the Minister stated that "[t]hese new guidelines will in no way create obstacles or signal any change in the government's openness to foreign investment in Canada...Their intention is in fact to provide clarity to investors around the world so that we can continue to attract foreign investment that benefits Canada."

The Guidelines will likely be based on the tests currently in place in other G8 countries, such as France, which requires foreign investments in specific sectors (defence, security, weapons and ammunition) to be formally approved by the French Treasury prior to implementation. As well, they will likely be sufficiently narrow in scope to prevent against protectionist pressures, since the previous national security test proposed by the government was met with significant opposition due to its vague definition of national security and the resulting amount of discretion granted to the Cabinet with respect to allowing transactions subject to such review to proceed.

The competition policy review panel

The Panel's mandate is, in part, to recommend changes to the ICA in order to ensure that Canada will continue to attract foreign investment and that Canadian businesses will invest both domestically and internationally. To this end, on 30 October 2007, the Panel produced a consultation paper, 'Sharpening Canada's Competitive Edge', which poses a number of questions. The Panel invited interested parties to provide written submissions on the questions, which would help inform the recommendations that it aims to present by 30 June 2008.

The Panel is considering two issues particularly relevant for foreign investors contemplating acquisitions in Canada, though much of its mandate in this regard has been superseded by the release of the Guidelines and the announcement of the intention to institute a national security screening mechanism. First, the Panel is examining the question of whether a purported increase in acquisitions of Canadian businesses by foreign companies has resulted in what the media has commonly described as a 'hollowing out' of Corporate Canada. In particular, it has asked interested parties to consider the importance of the following factors on Canada's economic prospects and ability to create jobs and opportunities for Canadians: (i) domestic control and ownership of Canadian business activities; and (ii) company headquarters and global divisional head offices.

Second, the Panel is also examining the net benefit test under the ICA. It intends to address concerns regarding the lack of predictability in how the test is applied and what combination of factors is required for a proposed transaction to be viewed as a 'net benefit' to Canada. It also seeks to ensure that foreign investors fulfill any undertakings that they make. Finally, it intends to examine the issue of reciprocity in connection with acquisitions of Canadian enterprises by foreign businesses based in jurisdictions in which a Canadian enterprise cannot make a corresponding acquisition.

The Panel's recommendations will likely introduce practical and constructive changes to the ICA that will increase the clarity of the Investment Canada review process and the net benefit test, as well as increase the degree of certainty with which foreign investors can approach the process.

Subrata Bhattacharjee is a partner at Heenan Blaikie LLP.

New developments spur M&A growth in Latin America

BY AMAURI COSTA

For the past few years, Latin American countries have seen a high level of M&A activity. According to some statistics, the value of Latin American M&A transactions approached $110bn in 2007, with more than 40 percent of acquiring companies based outside the region. Acquisition targets range from small family owned businesses to major corporations, all in a wide range of industry sectors – with industrial, energy, transportation and logistics, technology and telecommunications being among the business areas with most activity.

Although the global tightening of liquidity can be expected to slow M&A activity somewhat, Latin America appears well positioned for cross-border and domestic market business combinations to continue expanding because of several fundamental factors. Many countries in the region have established a perception of political and economic stability that provides a strong foundation for investment. These countries have also taken steps to modernise their legal systems, seeking to create additional confidence in local institutions and reduce the burden on foreign investors. In addition, some of the challenges still presented to countries in the region (e.g., shortage of natural gas) may offer opportunities to spur investment activity.

Economic advancement

With a few notable exceptions, the countries of Latin America have largely made the commitment to political and economic stability. These initiatives, coupled with improvements in their legal systems, have helped raise the confidence of business investors, particularly those from other parts of the world. Peru and Mexico, for example, are pursuing responsible fiscal policies and economic liberalisation efforts, and even Argentina, which had many problems early in the decade, has a much improved business climate. Brazil has stayed the course of the last decade's economic advances since controlling its rampant inflation, and the country hopes to achieve 'investment grade' status soon.

Improvements in legal systems

As companies seek market expansion beyond their original borders, they also help influence developments in the local legal systems. This phenomenon has not been different in Latin America, where the influence of the common law systems (particularly from the US) is very strong. This influence has been greatest in the areas of corporate governance laws and commercial finance regulations.

Corporate governance. As part of their effort to attract and maintain foreign investments, many Latin American countries – including the two largest economies in the region, Mexico and Brazil – have updated or are in the process of updating their corporate laws and have implemented other rules to modernise and strengthen their capital markets.

Brazil's 'Novo Mercado' Program, implemented by the country's securities regulatory agency – CVM – has created more transparency and professionalism in corporate governance for publicly-traded companies in Brazil. Companies following its rules benefit from improved treatment of their minority shareholders and enjoy better overall market acceptance. As a consequence of this strengthening of Brazil's capital markets, the country witnessed an explosive growth in the volume of IPOs in 2006, followed by healthy numbers in 2007. These publicly traded companies have used a large portion of the proceeds of such IPOs to fuel expansion, either organically or through acquisitions. In some cases, the M&A activity has also crossed borders to other countries in the region or even in the Northern hemisphere, a trend that should continue in the near future. Keeping pace with the need for continued improvement, Brazil has recently introduced additional updates to its corporate laws, bringing reporting requirements more in line with internationally adopted standards.

Mexico is currently studying changes to its corporate laws also addressing corporate governance pitfalls still encountered in the country's laws. Mexico is also seeking to strengthen its domestic capital markets, currently the second largest in Latin America.

Credit transactions. Along with an improved environment for capital markets activity, countries in Latin America have strengthened and modernised laws affecting commercial lending activity. In recent years, a number of jurisdictions in Latin America have provided enhanced support for commercial lending by updating their laws governing creation and perfection of security interests. Those innovations include a more frequent use of trusts, express permission to create floating charges, or other mechanisms allowing more effective pledges of accounts receivables. Most of these secured transaction concepts, or their different applications, are not typical for countries with a civil law tradition.

Laws in Mexico, for example, now validate the concept of floating liens. In addition, both Mexico and Honduras have instituted legal reforms that make possible the creation of trust estates to secure a loan, and this alternative is used in long term and/or large transactions (e.g., aircraft finance). Brazil has not yet adopted the trust concept, but its new Civil Code has made it easier to create floating liens on accounts receivable without the burdensome requirements of the previous law.

It is important to note that Latin American countries are not abandoning fundamental civil law concepts. Rather, they are modifying them to incorporate some concepts existing in the legal systems of other countries. While some of the modifications have not been fully tested in court, they have helped boost lending activity in countries like Mexico, Brazil, and those in Central America and present good opportunities for additional cross-border credit facilities. This is particularly true for transactions involving international commercial banks, giving acquiring companies access to a much wider range of credit facilities.

Brazil has also revised its bankruptcy code with the goal of improving the chance of recovery for insolvent companies seeking court protection. In this case as well, Brazil looked to other countries' experience when preparing its new bankruptcy code, although it is still too early to feel confident about the application of the law by Brazilian courts.

Remaining challenges

Despite advances in the legal systems in Latin America, a foreign investor will still face many challenges. This often means that acquiring companies should spend additional time structuring the transaction and negotiating agreements to ensure that all parties are in accord. For instance, representations and warranties and legal opinions relied upon in common law countries can cause a great deal of confusion in Latin America. As the enforceability of representations and warranties has not been extensively tested in local courts in Latin America, it is safer for the acquirer to rely on a thorough due diligence rather than contractual representations and warranties.

In addition, acquiring companies can still expect some level of bureaucracy to obtain the necessary regulatory approvals for acquisitions in Latin America. While the degree of transparency in the application process, the sophistication of the regulator and procedural complexity may vary from one country to another, the approval process throughout Latin America can pose a considerable challenge, and delays are common.

The energy sector provides a good example. Many developers have sought to acquire interests in energy companies already holding licenses and permits. However, in countries such as Brazil, prior approval from one or more governmental agencies (such as those that regulate competition laws or regulated industries) for the licence-holder's change of control is mandatory. Acquisitions that involve real estate can pose a different set of issues; countries such as Guatemala prohibit foreign investor ownership of land, while in Brazil, foreign land ownership may require prior government approval or a carefully considered structure.

Despite advances in the legal systems in Latin America, a foreign investor will still face many challenges.

Potential opportunities

Looking ahead, it is likely that the regional energy sector will continue to be a primary focus of M&A deals. One example is renewable energy in Brazil. In the past few years, the government has sponsored various incentives and policy initiatives to spur the growth of alternative energy sources. The increased oil prices and the world's search for alternative energy sources has also created a favourable environment for the unprecedented development of the ethanol industry, attracting acquisition capital from both foreign and domestic investors (including as a result of the increased IPO activity mentioned above). In 2007, Brazil saw an intense level of M&A activity that is anticipated to continue in 2008. Other countries, such as Peru, are considering their own incentive programs to foster growth of their renewable energy sector.

Ironically, the recent announcement of record-breaking oil and gas reserves in Brazil and last year's shortage of natural gas in Argentina and Chile may also contribute to growth of M&A activity in the region.

Challenge and potential

Latin American economies are highly diverse, and each country faces many economic challenges. But the overall direction of the region is toward fuller integration in the global economic system, and greater political and economic liberalisation (with a few exceptions). Today, Latin America represents an excellent example of how a developing region can transform itself to make possible a level of business expansion that is poised to take full advantage of its vast potential.

Amauri Costa is a partner at Bracewell & Giuliani.

New incentives for investing in private equity in Chile

BY EDUARDO DE LA MAZA

After publication of the so called 'Second Capital Market Reform' on 5 July 2007, investors and investment managers have good reason to celebrate. The reform amended the banking law, the insurance law and the securities market law. It also addressed the subordination of debts and the custody of securities and pledges. Further, it introduced significant measures to promote investment in private equity by way of investment funds, an area which currently represents only 3.6 percent of the total portfolio of Chile's investment funds, with investments that amounted to US$167m in 2006.

Tax benefits

One of the main incentives is tax exempt income received by contributors to investment funds registered before the securities market regulatory authority. This benefit only applies to income obtained by the fund through the sale of shares of companies that do not trade on a stock exchange. To access this benefit, the total assets of the fund must be destined exclusively to investment in stock portfolios and debt issued by companies that comply with a number of requirements, including: (i) it has been constituted within seven years prior to the investment; (ii) it carries out its activities mainly in Chile; (iii) it has a net annual income of less than $17m; and (iv) it is not involved in the real estate or investment markets, utilities, roads or other concessions.

There is also a tax benefit for those that have previously been shareholders of companies in which the abovementioned funds have acquired shares for an amount greater than 25 percent of the total capital, permitting these other shareholders to consider as the cost of their shares for taxation purposes the highest price paid by one of these funds in the most recent placement of shares of the respective company, in order to reduce the taxable capital gain.

New forms of finance

The capital markets reform also contemplates other promotion measures, such as authorising banks to invest up to 1 percent of their assets in venture capital and private equity. This could inject more than $1.5bn into the asset class.

In addition, the reform introduced measures aimed at enhancing the role of the state agency CORFO, an organisation created in 1939 to contribute to economic development and growth. It currently concentrates on the promotion of competitiveness and innovation of private companies, especially small and medium size companies, which annually receive from CORFO close to $127m in loans placed through the private banking system and close to $81m in financial assistance.

Currently CORFO performs an important role in private equity, providing lines of finance to funds that make capital contributions or grant loans to small and medium size companies that are in their creation or expansion phases, and whose equity is less than $4.2m at the time of the first fund investment. These credit lines are bullet loans, with up to 15 year terms, and may be expressed in local currency or US dollars, for an amount between $1.5m and $17m. They generally permit leverage of up to two times the amount of the contributions paid and committed to the respective fund. The interest rates are favourable: 2 percent as the base rate in local currency (the current interest rate of notes issued by the Chilean Central Bank being 2.6 percent) and LIBOR as the base rate for loans in dollars, considering in both cases an additional interest rate of 3 percent if the earnings obtained from the financed fund exceeds this figure.

The reform establishes a new system that will permit CORFO to be a contributor in private equity funds, through a program that is scheduled to be implemented in March 2008. The program will consider a total amount of up to $150m that may be increased by the Ministry of Finance up to a total of $260m.

The contributions of CORFO may be made in funds that invest in shares of closed corporations that comply with same requirements referred to above in respect of the tax benefit and may represent up to 40 percent of the total capital of the fund.

To strengthen the effect of investments in companies whose shares will be acquired by the funds, the program will establish the obligation to agree upon shareholder agreements that consider an active participation of the fund in the financial, administrative and commercial management of such companies, in addition to mechanisms of takeover by the fund in certain critical situations.

As CORFO authorities have indicated, the program will contemplate call options in favour of private contributors of the funds in which the institution invests. It will permit them to purchase, from a determined term, the fund's shares owned by CORFO, at a price that includes an implied interest rate dependant upon the focus of the fund, which may even reach zero in the case of specific areas that are being incentivised.

In this way, the private contributors of funds may receive the full benefit of upside earnings, ultimately transforming the contribution of CORFO into a type of loan.

We are certain that the existence of this tool will constitute a strong incentive for the participation of private investors in these types of funds, as for them it distributes the value created by the fund in an optimal manner.

Eduardo de la Maza is an associate at Grasty Quintana Majlis & Cía.

CHAPTER ELEVEN:

Regional view – Europe

Managing pan-European transactions for US buyers

BY ROBIN JOHNSON

In May 2007 the world of M&A was such that credit was cheap and financial engineering had gone beyond the furthest imagined process. In one deal, no interest at all was payable on debt – it was all rolled up in PIK (payment in kind) instruments for five years. Leverage was at all time highs, synergies counted for little and every day secondary, tertiary or even quarterly institutional buyouts were taking place.

A seller could dictate all the deal terms, as well as impose ridiculous timetables. Acting for the seller, a legal representative could insist upon limited due diligence, general disclosure and limited warranties. For example, in one deal, two financial buyers were happy to sign the first draft of a vendor friendly auction process sale and purchase agreement provided they were given exclusivity. One financial institution said they felt they could do away with external lawyers and could just have an internal lawyer to double check the drafts that had been produced by bank's lawyers, seller's lawyers, etc. The same institution said it was happy to rely upon vendor financial due diligence; a vendor having commissioned an accountant to produce a longform report on the business, even though typically an accountant limits their liability to a buyer.

The role of the M&A lawyer both on the sell-side and the buy-side seemed to be limited to doing the basic commoditised formalisation of a stock transfer form or transfer of assets. While deal flow was strong, the actual role of the lawyer was becoming almost meaningless.

But today, strategics are back in town. Financial buyers now have to compete against synergistic benefits and cannot simply rely on cheap credit. Deals that closed as recently as the summer are already being renegotiated. A number of financial buyers, however, had agreed such limited covenants that some deals can only be renegotiated in the case of a major event of default due to the lack of financial covenants that were put into deals. Banks and financial institutions, as well as strategic buyers, are insisting upon focused due diligence. The role of vendor due diligence remains important, as vendor financial due diligence reports, as well as updates, are being sought, and detailed reviews are taking place. A proper balance between risk for the purchaser and reward for the seller is being put in place and deals now have realistic timetables. This does not mean that lawyers can simply go back to increasing fees but it does mean that the role of a lawyer in deals is now being recognised again.

It seems there were a number of deals done in the early part of 2007 which could cost general partners a significant amount of money and which bankers would be embarrassed about by mid 2008. While there will be a role for PIK deals, these will only now become more appropriate on lower leverage; quasi equity instruments deals. The following top ten issues are arguably the most important to be addressed on a European transaction if the purchaser is based in the US.

First, culture, culture, culture. Can an acquisition be managed from 4000 miles away? Do not underestimate the difference in lifestyle approach, social protection and history. Job security is often key in Europe and the entrepreneurial spirit is not as live as it is in the US. A number of Eastern European assets have been acquired from state-owned businesses as recently as 10 years ago. The culture of social protection – the culture of the state providing for all – remains alive in a number of key European territories.

Second, while more typical US style agreements are getting more recognised in Europe the difference in transactional documentation approaches must be understood. There is a lack of litigation post-deal. This does not mean due diligence was done better, but it means that settling matters out of court and in a 'handshake way' is more prevalent in Europe. Escrows or holdbacks have become commonly accepted to deal with issues that arise out of due diligence but unlimited indemnities are rare. Most European deals have closing balance accounts dealing with net working capital and debt, and a lot of Europeans see this as a way of settling warranty and indemnity claims such as through completion accounts mechanism. There are too many deals which completed more than a year ago where completion accounts have not been settled. Finally, the approach to disclosure is very different. While specific disclosures are included there is a general acceptance in Europe that the buyer has to acknowledge general disclosure of information provided to it during the disclosure process.

Third, process and timetable. Scoping due diligence is vital. Europeans hate duplication of due diligence from different vendors. Agreeing and scoping upfront and spending some time with each provider is key. Having a central point of contact at the buyer who coordinates everything and avoids duplication is a vital role. The seller needs to have control, proper communication, proper reporting structures and time must be built in to reflect the distance between travel and time zones involved. The need for physical meetings must not be underestimated, as this could take three days out of a week, and the disproportionate amount of time and energy that will be expended compared to a domestic deal. Dealing with 'other jobs' could become difficult and there are higher costs associated with travel and management compared to a domestic deal.

Fourth, in a structured way, do not be afraid to 'due diligence to death' to replace contractual comfort. Use due diligence as part of the integration plan. Do not underestimate the value of vendor financial or legal due diligence. Rely upon it, use it, update it, comment on it. Use due diligence as part of integration. Integration together, with cultural issues, is key to the success of a European M&A deal from a US buyer.

Fifth, antitrust is a big issue in Europe. Build enough time into the project plan to assess antitrust. Each EU jurisdiction has different rules on antitrust, so do not assume that a 'one-stop shop' in Brussels is an easy solution. Most Europeans do not understand the need for good compliance going forward. If they have not been exposed to a US purchaser before, their compliance policies, particularly in relation to antitrust and FCPA, will be completely inadequate for a US buyer's purposes.

Sixth, taxation. Buyers should look at early structuring of deals to create a tax efficient basis. There is no equivalent of the 338 in Europe. A mixture of asset deals and stock deals should be considered. In addition, transaction costs associated with the deal, notary fees and stamp duty should not be underestimated; these often come as a surprise to a US purchaser. How are future profits repatriated? This may not be straightforward as there may be local withholding taxes. In Europe, transfer pricing has become a hot topic when selling businesses out of a group. Also, do not underestimate the tax cost of stock options, which may be terminated on a sale.

Seventh, most US buyers do not understand labour and social law protections that are in place. Europe has wide social legislation and most companies will have works counsels or unions. There is no single European law. On the whole, this issue needs to be addressed on a country by country basis. Compliance programs in relation to labour law should not be underestimated. This could be in relation to data privacy, whistle blowing and a general need to ensure that what is trying to be imposed through US exterritorial reach can work in Europe.

Eighth, separation issues need to be planned early in the sale process. It is not uncommon to discover six months down the line that a key integration cost has been underestimated. Businesses that are required to become 'standalone' upon sale – leaving behind a group and its licences, permits, consents, real estate, IT and share of pension costs – should address long term structural issues upfront as they cannot be dealt with through the S&PA.

Ninth, taking security on a leveraged deal is not as straightforward as it is in the US. There are rules against targets granting security, often called financial assistance. There are registration costs associated with taking security and other tax and there are antiquated processes about registering security, which often take time to put in place.

Tenth, establishing compliance processes post-deal needs to be worked on immediately. Preventative and proactive legal care is the only way an acquisition can be properly managed. Getting immediate buy-in to a compliance ethos – from a cultural perspective – is key. Few European organisations with a US arm have compliance structures that are as robust as a US company.

Robin Johnson is a corporate partner at Eversheds.

Glimmers of optimism: better times ahead for the UK M&A market

BY MATTHEW MIDDLEDITCH

Unlike liquidity, bad news about the M&A market is in plentiful supply. Deal volumes sank to their lowest level in four years during the first quarter of 2008 as the credit squeeze slammed the brakes on private equity and corporate chief executives kept potential deals in check.

A year ago it was a different story. During the first half of 2007 a deal boom, fuelled by easy credit, was in full-swing. This came to an end in late June and during the second half of the year credit came at a premium following the rapid constriction in the debt markets.

One year on from the peak, it is clear that tight credit conditions are continuing to constrict the M&A market. With US economic woes spreading across the globe, and credit markets showing little sign of a recovery, headline-grabbing deals seem likely to stay muted throughout 2008. The conditions that have provoked a rapid slowdown in UK M&A deal volume are unlikely to improve significantly before the third quarter of 2008.

While the big ticket line has gone quiet, there have been exceptions in the last six months. RBS sold Southern Water in October 2007 for £4.2bn to a consortium of JPM Asset Management and Australia's Challenger Fund. Furthermore, Rio Tinto's bid for Canadian aluminium producer Alcan proved that the credit squeeze will not prevent mega-deals, as long as conditions are right. Rio Tinto did not have problems raising financing, even though its bid came in July as the markets were beginning to experience extensive volatility. It raised a record breaking $40bn to fund the takeover: the largest loan raised by a UK-listed company, according to Dealogic, and a bold move that created the largest aluminium producer in the world.

Material changes

So what has changed in the M&A market? There is still no consensus on whether we will see a hard or soft landing for leveraged M&A, but there are signs that the price expectations of corporate sellers are lower than they were before the credit markets experienced difficulties and that debt multiples are lower.

In the US market there are some high profile examples of investors pulling away from deals. KKR and Goldman walked away from their $8bn deal to buy audio and electronics manufacturer Harman International, claiming that a material adverse change (MAC) gave them a contractual excuse not to buy the company. This scenario remains exceptional outside the US, largely because UK sellers expect to see 'certain funds commitments' on their buyer's financing and have been reluctant to agree MAC wording in their sale contracts.

However, we foresee that this situation might change for two reasons. First, as the seller's market disappears, buyers will look for more 'outs' in their purchase contracts. Second, banks are now looking more closely at any conditionality in the sales contracts to allow them to get out.

However, there is plenty of motivation – aside from hefty break fees – to see deals through, including the need to put money to work, guarding hard-won reputations and the danger of legal action if parties pull out.

Terms of deals

The terms of M&A deals remain broadly the same now as before the credit squeeze. But for acquirers needing leveraged finance, the covenants and terms are stricter.

The days of ready access to private equity's favourite investment tools such as cov-lites, equity bridges and PIK notes are over. In this sense, we have shifted from sponsor-friendly terms to a renewal of tensions between sponsors and lending banks. This looks set to continue for some time.

Another significant shift is that we are seeing more equity inserted into deals.

Picking up the slack

Although the honeymoon is over for easy liquidity, this does not mean that M&A will dry up. While private equity dominated the market in 2006 and the first two quarters of 2007, there is now more appetite from trade buyers who face less competition from the large buyout houses.

Thus, a tricky market for some creates advantages for others. We should see corporates looking to maximise these opportunities in the coming year. Big-cap companies are still eager to invest and regard this as a buyers' market where they can unlock opportunities previously unavailable to them at reasonable terms.

There are plenty of cash-rich FTSE companies that are eyeing potential acquisitions at the moment while prices are affordable. Many of their targets' share prices are depressed, so this year is likely to see some knockdown bidding.

There are plenty of cash-rich FTSE companies who are eyeing potential acquisitions at the moment while prices are affordable.

Sovereign wealth funds are also starting to pick up some of the slack in the market. These funds began to make inroads into the M&A space and established themselves as a major market force during the first quarter of 2007 with investments that, at a total of $25bn globally, reached nearly half the size of the global volume registered by private equity investors. SWFs are still expected to play a key role in UK deals this year.

The number of infrastructure funds in the UK market has also expanded and they are playing a stronger role in M&A. Over the last few years, funds entering the UK and European market have raised in excess of £16bn in new equity capital, according to Deloitte.

Where else should we expect activity? Many predict consolidation in the banking sector, particularly among the second and third tier. The drivers for this are greater difficulties in accessing capital and the ongoing effects of Basel II requirements, which impose rigorous risk and capital management requirements on lending and investment practices. The rules mean that some banks need greater sums of capital to safeguard their solvency, making mergers attractive.

Cautiously optimistic

The full effects of the crunch remain unclear but we are optimistic for 2008 and beyond. The world economy remains essentially strong and many opportunities for dealmakers remain. The correction in 1998 was followed by very strong M&A activity in the following two years, and we believe this is what will follow the correction of 2007/08.

Smaller deals are still being done in the UK and the bankers and lawyers are still very busy, particularly with deals in the media and infrastructure sectors. Stable cash flow businesses such as these remain attractive targets and there is no shortage of corporates, or even private equity houses, with war chests of cash to invest. It is access to debt that poses the problem.

Deals are still out there and innovative deal doers will ensure that the credit crunch does not kill the M&A market.

Matthew Middleditch is a global co-head of M&A at Linklaters.

The German M&A and private equity market

BY FRANK BECKER AND DR. JÖRN SCHNIGULA

2007 was not a homogeneous year in the German M&A and private equity market. During the first half, it looked like another record breaker with a total value of disclosed buyout transactions of €20.7bn, according to an Ernst & Young study. The first multibillion takeover of a listed German company, foreshadowed by rumours of a bid from a consortium led by Bain Capital, did not seem far away.

Some €1bn-plus transactions took place, such as Siemens' sale of its VDO division to Continental for €11.4bn, the largest German transaction in 2007, the acquisition of Depfa Bank by Hypo Real Estate for €5.7bn, Blackstone's purchase of Klöckner Pentaplast for €1.3bn and the sale of ProSiebenSat.1 to KKR and Permira for €3.1bn. Such transactions were also facilitated by the average debt to EBITDA ratio for leveraged buyouts rising from 4.2 in 2002 to a record high of 5.7 in the first quarter 2007, as shown in the Ernst & Young study.

But in August 2007, the credit crunch, initiated by the subprime-mortgage market crisis in the US, hit Germany. Suddenly, obtaining bank financing became much more difficult. Some banks even closed books for the rest of the year and debt to EBITDA ratios declined. Consequently, in the second half of 2007, the total value of buyouts fell to its lowest level since 2003. Only two additional buyouts over €1bn took place in Germany: CVC's acquisition of Dywidag Systems International for €1bn and Macquarie's acquisition of Techem for €1.5bn. This compared to eight buyouts in the first half of 2007 and eight in the second half of 2006.

Though it seemed that small and mid cap deals were less affected by this market break, statistics published by Ernst & Young showed a decrease in the number of buyout deals in the second half 2007 compared to the first half for all categories – except for deal values between €500m and €1bn. Interestingly, the value of M&A transactions actually increased in the second half of 2007 to more than €35bn, and reached its highest peak compared to previous years, partly driven by the huge VDO deal. There were 686 M&A transactions involving a German company in the second half of 2007, compared to 428 in the first half of the year, according to figures from VC-facts.

The emphasis among industry sectors did not change much. The highest buyout activity took place in real estate, industrial, services and consumer, with the first two defending their places from 2006.

Shortly before the subprime crisis spread to Germany, financing conditions for financial investors were arguably more favourable than ever before. Debt to EBITDA multiples reached record levels. Banks had sufficient liquidity, were highly competitive and able to quickly syndicate loans. Covenant-lite agreements developed, limiting or even excluding lenders' rights to accelerate debt as a result of a borrower's default.

Such provisions disappeared immediately when the crisis broke – debt to EBITDA multiples were cut back by 1-2 points to match 2006 levels, and syndication became more difficult if not impossible, resulting in huge loan backlogs which strained banks' balance sheets. The psychological effects were probably greater, as market uncertainty made banks reluctant to grant financing even on moderate terms. This primarily concerned mega transactions, but also increasingly affected mid-cap deals.

This downswing continued in the beginning of 2008, with the volume of M&A transactions in Germany reaching an eight-year low of €4.1bn during the first quarter, compared to €15bn in 2007, according to Thomson Financial. EBITDA multiples – the most common method used to calculate enterprise values in buyout transactions – are widely expected to fall further due to lower debt to EBITDA multiples.

Nevertheless, the outlook for 2008 in Germany is more ambiguous than pessimistic. The biggest problems seem to be the banks' financial situation, as nobody seems able to assess which risks are still hidden in their balance sheets, and the general economy, which is about to weaken on fears of a recession (although in March, the German business cycle index, Ifo climate, reached its highest level since August 2007). Apart from buyout investors facing difficulties on the financing side, and sellers facing lower sale prices, public M&A transactions will struggle in the wake of lower share prices and fears of a decreasing stock market. Despite this, fewer financing opportunities will make it difficult for buyout firms to realise large takeovers of public companies or even (strong) minority investments. On the other hand, we may see consolidation in the German banking sector, including the potential sale or mergers of Deutsche Postbank, Dresdner Bank and Commerzbank. Furthermore, due to lower purchase prices, strategic buyers are expected to increase their presence in the M&A market. Also, private equity players willing to invest more equity in their deals and work with lower leverage levels are likely to find interesting targets at an attractive price. In addition, foreign state funds are predicted to invest further in the German market, following on from previous deals such as Dubai International Capital's buyout of Mauser-Werke. One of the industry sectors expected to be active in 2008 is real estate – in particular, listed real estate. One reason is that shares of companies like IVG are traded at a discount compared to their net asset value. Another reason is that rents are expected to rise in Germany during this year and next.

Moreover, it is widely assumed (in the absence of concrete data) that the number of distressed or nearly-distressed situations will increase, especially of buyout targets. According to market rumours, even the senior debt of larger buyouts often trades far below 100 percent. Of course, not all of these companies will become insolvent, but financial restructurings, sales of distressed companies or their debt, or the need to inject further equity may occur more frequently. This is particularly likely given the pessimistic prospects for the buyout market. The trend is underlined by the fact that around €24bn is currently being raised for distressed debt funds, according to Private Equity Intelligence. Many private equity sponsors such as Texas Pacific Group and JC Flowers are reportedly building such funds, which up to now have been mostly smaller, more specialised funds.

From a regulatory perspective, there

are two predominant issues that may affect the German transaction market. First, Germany has lowered its aggregate tax rate for corporations (corporation income tax and trade tax) from about 40 percent to about 30 percent. The positive effect of this is, however, partly offset by the introduction of a so-called interest barrier rule, which limits, in general, the amount of interest expenses that are tax deductible to 30 percent of the borrower's tax adjusted EBITDA. Whether these changes will have a significant effect on the German buyout market remains to be seen. In any case, the interest barrier rule has made it considerably more difficult to structure highly leveraged transactions in a tax efficient manner. Second, the current government announced quite some time ago its intention to pass a private equity law to deal with many tax and other regulatory uncertainties surrounding the buyout industry. However, the current draft laws only deal with narrowly defined venture capital funds and would be of little relevance to the industry as a whole. Due to criticism, the legislative process has now been delayed and the final outcome, as well as its timing, is unclear.

Given these conditions, 2008 continues to be an interesting and rather unpredictable time for the German M&A and private equity market. Though it may be far from a record year, it will definitely not be a standstill period.

Frank Becker is a partner and Dr Jörn Schnigula is a senior associate at Kirkland & Ellis International LLP.

The Spanish M&A market: entering a tunnel?

BY FERNANDO VIVES

The past 12 months have seen a significant level of activity in the Spanish M&A market, continuing the trend set in recent years. Nevertheless, a line can be drawn between two periods, marking a turning point and coinciding, approximately, with the period between March and September 2007, and the period from late summer 2007 to the present date. The first period was characterised by intense activity in the M&A market, with standout deals such as Imperial Tobacco's €14bn tender offer for Altadis.

Although the M&A market remained active, largely due to the closing of deals started before the summer, the second period reflected a shift in the trend. The subprime crisis and its spread to the so-called 'real' economy brought about significant changes in the M&A market. Rather than to generalise this as a 'sharp downturn', it is more accurate to look at some of the market's distinguishing features. For example, there was a fall in the number of highly leveraged, large scale private equity deals, whereas smaller Spanish private equity transactions, usually with a debt to equity ratio of less than 50 percent, enjoyed something of a boom. Real estate deals also experienced a decline in volume. Volatile stock market conditions led to a dramatic drop in the number of public offerings, and virtually all the transactions planned for the first quarter of 2008 have ground to a halt.

On the legislative front, new legislation was introduced on 13 August 2007 to amend the legislation governing public tender offers (Law 6/2007, of 12 April 2007 and Royal Decree 1066/2007, of 27 July 2007) transposing the thirteenth EU Directive into Spanish law. The new regime replaced the prior regime based on intentional tender offers with a system based on mandatory and total tender offers launched after control is taken up. For such purposes, 'control' has been defined as 30 percent of the voting rights of the target company. The new legislation ought to work to the advantage of the tender offers market, with the introduction of mechanisms such as the possibility of agreeing on a break-up fee of up to 1 percent of the total offer value for the first offeror, the obligation to disclose equal information to all offerors and the possibility that the first offeror can bring the tender offer process to a close provided the existing blind bidding process results in a tie. Moreover, the interplay between mandatory tender offers and voluntary tender offers opens the way for fresh planning alternatives for deals of this type.

Another legislative development was the introduction the new Antitrust Law (Law 15/2007, of 3 July 2007), which, among other changes, revamps the legislation applicable to merger control by widening the concept of 'concentration', establishes a simplified procedure for deals less likely to affect competition, and relaxes the rules on mandatory notification with suspended effects until the authorities give their clearance. Moreover, the role of the body created under this law, the

National Antitrust Commission, is further strengthened in scrutinising and overseeing these types of transactions.

Transparency requirements for listed companies have also been tackled in greater depth, with the threshold triggering the obligation to notify significant holdings being lowered to 3 percent from 5 percent under previous legislation, and comprehensive provisions being established to govern the requirements to provide a breakdown of derivatives which can be settled in kind, the underlying assets of which are voting shares in listed companies. There is little doubt that the rationale behind these amendments can be found, at least in part, in the experience resulting from the procedure followed in the tender offer for Endesa.

The outlook for the market has been considerably affected by a credit crisis that looks set to lead to ever harsher credit conditions and availability. It appears that, as things stand, we are still at the mouth of the tunnel. Nevertheless, we believe this tunnel will not be as gloomy for the M&A market as some are predicting. Indeed, the market will be affected not so much in terms of the number of transactions but rather in the changes to the behaviour of the market players and to the nature of the deals.

On the one hand, LBO transactions will continue to take place, albeit characterised by their smaller average size, lower leverage ratio and the 'safe-haven industries' in which they are carried out, such as food, security or other industries which provide basic goods and services.

As for the banking industry, crises at a significant number of US and Eurozone financial institutions will give rise to new opportunities for consolidation and leave many with no choice but to sell off their industrial investments.

The real estate industry crisis, on the other hand, will see a flurry of deals to refinance the debt taken on by groups in recent years. Sometimes these deals will go hand in hand with mergers, spin-offs and asset sell-offs. Taking place against the backdrop of insolvency or pre-insolvency proceedings, these deals will undoubtedly become a particularly prominent feature in the coming months.

On another note, the fall in the share prices of many companies will make them a target for tender offers. It should not be forgotten that many hedge funds and private equity firms had raised their funds just before the subprime crisis hit. Such funds will have to be put to use, and the current situation is little more than an interlude before prices adapt to dearer credit conditions.

It does not, therefore, appear that M&A activity in Spain is set to undergo a drastic decrease. Rather, cyclical change will affect the type of deals that are done and the behavioural patterns of operators. Nonetheless, it will be necessary to wait and see how the financial crisis – the effects of which we are only just beginning to detect – eventually plays out, before reaching any conclusions on future trends in M&A activity.

Fernando Vives is a partner at Garrigues, Abogados y Asesores Tributarios.

Trends and prospects for the Spanish M&A legal market

BY CHRISTIAN HOEDL AND JAVIER RUIZ-CÁMARA

As in other areas of the world, M&A activity continued to boom in Spain during the first half of 2007. The market was dominated during this period by the sell-side and its advisers. The result was that most, if not all, of the Anglo-Saxon inventions that favoured the seller in an M&A transaction continued to be used in Spain. These transactions included auctions that replaced buyer-driven proprietary deals, vendor due diligence exercises aimed at substituting the seller's representations and warranties with the liability of the advisers and locked-box rather than traditional post-closing net debt / EBITDA adjustments.

As a result of the favourable market conditions, the first half of 2007 was also another record year for M&A financing. In such a highly competitive market, banks were willing to finance an ever increasing multiple of the target EBITDA. In contrast, bank covenants were either reduced or their enforcement was made more difficult. As in most other European jurisdictions, financing became more and more stratified. This resulted in an increasing number of senior, mezzanine, second lien, profit sharing and other tranches and facilities. Certainty of funds was imposed by borrowers and sellers even in private transactions and ratio defaults could be cured during the course of several consecutive periods. Representations and warranties in respect of the target were subject to increasingly generous clean-up periods. Except in particularly exceptional circumstances, decisions were adopted by a simple majority of syndicate banks. As a further factor, consent was presumed by the lapse of time, yank-the-bank provisions were increasingly common and mortgages and other liens were replaced by the borrower undertaking to create the security interest at a future, potential-default-related event. As a result, the enforceability of these undertakings is arguable. This is particularly true for insolvencies or bankruptcies.

After the credit crunch that began in the summer of 2007 (which paved the way for the severe crisis of the Spanish real estate sector), the situation changed rapidly and Spanish involvement in M&A activity slowed significantly. Private equity buyouts have almost entirely vanished. Large private equity exits have also dried up as IPOs and secondary LBOs have been postponed until market conditions improve. Regardless, expectations in the mid-market and below remain relatively sanguine. Market conditions could also affect the type of businesses sold as owners hold their top performers for later in the business cycle. Acquisition finance activities are also much lower as compared to the same period a year ago. The mood in the market has changed noticeably in recent months: even the most competitive banks (RBS, HBOS, ING and Banesto among others) have become more cautions about acquisition financings due to either specific targets or to more general industry concerns.

The industry that has arguably suffered the most severely from the credit crunch in Spain has been real estate and industries closely related to it. Following several years of a robust and liquid market and the rapid rises of property prices, the industry is now facing an uncertain future. Although Spanish banks have not been directly affected by the subprime mortgages crisis, the world's adverse financial situation coupled with the rise in interest rates and excessive mortgage backed indebtedness have brought an abrupt end to the industry's 'golden age'.

The legal framework governing capital markets in Spain underwent a significant transformation during the course of the previous year.

Legal developments

Corporate and takeover law. The legal framework governing capital markets in Spain underwent a significant transformation during the course of the previous year. The Stock Market Law of 1988 was amended in crucial areas such as market abuse, official listings and public offerings, the information to be disclosed by listed companies and their shareholders, the clearing and settlement of market transactions, other regulated markets and investment services firms, among others.

More importantly, however, Spain introduced a new takeover regime in 2007 that has fundamentally modified Spanish takeover rules. The key developments relate to the thresholds, timing and scope of the takeover offer. Now, the offer becomes mandatory, and at an equitable price, once the investor has acquired control of the target, which is considered to exist whenever the investor reaches 30 percent of the voting rights of the target or, in the event that the investor appoints half plus one of the directors of the target within 24 months from the offer. The new Takeover Regulation therefore replaces the (exclusively Spanish) compulsory ex ante, in whole or in part, takeover bids by ex post bids which must be made toward 100 percent of the shares and certain other securities. Nevertheless, voluntary (either in whole or in part) offers remain possible. For the first time in Spain, the new Takeover Regulations include squeeze-out and sell-out rights provided that: (i) as a consequence of the offer, the offeror holds at least 90 percent of the capital-carrying voting rights; and (ii) the offer has been accepted by at least 90 percent of its addressees.

Competition law. Spain has implemented a new competition law which, among other things, provides for a higher filing threshold linked to market share (increased from 25 to 30 percent) while the turnover threshold remains unchanged gives the ultimate decision on merger control to the competition authorities rather than the government, established a simplified form for the filing of concentrations unlikely to cause competition concerns and aligns the Spanish merger control rules with the EU merger regulation in respect to joint ventures.

Prospects for the coming months

The impact of the credit crunch will

probably have a more marked effect on the value of M&A deals rather than the actual number of transactions in Spain. The difficulties for raising bank financing will most likely lead to deals characterised by lower leverage but not necessarily to a dramatic reduction of midcap deals.

Some private equity houses may suffer from excessive prices driven by auctions and the obscurity in the debt market in recent years.

Finally, the reduction in the availability of financing may also lead to scenarios in which the bidder cannot raise enough debt to acquire 100 percent of the target company. Investors may therefore explore other alternatives (less common in the recent 'golden years') such as co-investment schemes with other bidders and acquisition of minority / majority stakes to the sellers (retaining a significant stake in the target).

Christian Hoedl is a partner and Javier Ruiz-Cámara is a senior associate at Uría Menéndez.

Developments in the Netherlands' corporate and takeover law

BY WILLEM CALKOEN

Before 2000 the average Netherlands listed company had quite a few legal defence mechanisms. Many companies did not list shares but depository receipts. A foundation friendly to the board owned the shares which had the voting rights. There were mechanisms for the company to issue preference shares at a low price to a friendly foundation, which could then vote on these preference shares. There were also stipulations in articles of association such as co-optation of supervisory directors and managing directors. Sometimes special priority shares owned by a friendly foundation were the only shares that could nominate new directors. In addition, most large companies were subjected to the two-tier board regime, where the supervisory directors by mandatory law co-opted themselves.

In short, there was a very defensive and protected situation for the managing and supervisory boards. Shareholders meetings were characterised by absenteeism; on average about 15-20 percent of shareholders came to shareholders meetings. There was little communication between boards and shareholders. Large Dutch pension funds held many shares in Dutch companies, but did not want to try to influence directors. Shareholdings in Dutch companies were mainly owned by Dutch institutions and Dutch individuals.

Over the years, the percentage of foreign shareholders has grown drastically. Dutch pension funds invested in foreign companies and foreign institutions invested heavily in Dutch companies. At present 80 percent of Dutch shareholders are foreign. Gradually, companies voluntarily dropped some of their defence mechanisms, partly due to substantial pressure from the Amsterdam Stock Exchange.

In 2004 the Corporate Governance Code 'Tabaksblat' was issued. It emphasised responsibility of supervisory directors to shareholders, more power of shareholders, mandatory proxies to depository receipt holders so that they can vote on the shares that they held beneficially and ideas to eliminate defence mechanisms. In addition, it was made possible to have one-tier boards in the UK style.

On 1 October 2004 an important change to the Dutch corporate law was introduced with the following items. First, in companies with the two-tier board regime (large companies) the supervisory board no longer co-opts itself. The shareholders' meeting appoints and dismisses the supervisory directors. There is still a situation where the supervisory directors nominate their successors with some influence for the works councils in these nominations, but the shareholders may refuse to follow the nomination. The fact that shareholders may dismiss the complete supervisory board was an important shareholder power in the Stork deal in 2008.

Second, shareholders who own 1 percent,

or in very large companies, shareholders who hold at least €50m, may force the board to put certain points on the agenda of a shareholders meeting. This also proved to be an important shareholder power in the Stork deal, and the VNU deal of 2007. A draft law proposes to raise this threshold to 3 percent.

Third, shareholders have the power to consent to the policy for payment of salary and fringe benefits and share option schemes for executive directors and supervisory directors. This proved to be important in the Ahold case. There is much debate about high CEO incomes.

Fourth, Article 2:107a of the Civil Code obliges the board to request consent at the shareholders' meeting for decisions which change the character of the company, such as: (i) the disposal of nearly the complete enterprise (which was already applied as a rule of practice in the merger of P&O and Nedlloyd); (ii) a joint venture of high importance; (iii) and the disposal or acquisition of a subsidiary which has or would have a value of one-third of the company. However, if this consent is not given, it does not block the power of the board to represent the company towards third parties in such matters.

Article 2.107a of the Civil Code was a central aspect in the case of ABN Amro selling LaSalle Bank. LaSalle Bank had a lower value than one-third of the total value of ABN Amro, but nonetheless the Enterprise Court of Amsterdam decided that ABN Amro should have asked the shareholders' consent to sell LaSalle because ABN Amro was in that period for sale. The Enterprise Court used arguments of English and US law where a company that is up for sale has to request consent for any important decisions. The Dutch Supreme Court overturned this decision, because article 2:107a of the Civil Code provides an exact threshold on when to request shareholder consent, which is one-third of the value and not less. The Supreme Court therefore decided that the article should be interpreted restrictively, to provide clarity of law for boards and companies.

As mentioned, foreign shareholdings of Dutch listed companies have increased tremendously in recent years. At present 80 percent of the shares in Dutch listed companies are owned by foreigners.

About 10 years ago the majority of managing directors and supervisory directors of Dutch companies were Dutch. There has been a substantial change here too. Many CEOs and CFOs of Dutch companies are now foreigners. Interestingly many CEOs of the largest companies are still Dutch, such as Shell, AKZO and Philips, but the CFOs are often foreign. At present the CEO of Fortis, ING and Unilever are foreign. There are many supervisory board members who are foreign as well, such as the chairman of the supervisory board of ABN AMRO.

In addition to the legal changes of 1 October 2004 which favoured shareholders, the trend of foreign shareholdings has also increased shareholder activism. A shareholder activist argued that Shell should review its board structure, which led to the merger of Royal Dutch and Shell UK into a UK public company with its head office in the Netherlands. The advantage of a UK public company is a better trading platform in London. There are substantial tax advantages of keeping the head office in the Netherlands.

Shareholder activism forced the boards of VNU and Stork to seek acquisitions by private equity. Other companies were forced to undertake necessary disposals by shareholder activists, and also sell to private equity, such as the sale by Philips of its chips division to KKR.

There is debate in the Netherlands about the 'sell out' of Dutch companies, which gained impetus from the Stork and ABN AMRO deals. The Minister of Finance has been in favour of an open economy and wishes to promote acquisitions by foreign entities of Dutch companies, provided the work is still done in the Netherlands. There are special committees and foundations in the Netherlands to promote the quality of services and infrastructure, so the Netherlands can maintain its position in the financial and service areas.

Notwithstanding all of the above, the Netherlands remains an open economy. It has always realised that it is more important that the work of highly qualified specialists is done in the Netherlands than the owners of a company remain Dutch.

Willem Calkoen is a partner in the Mergers & Acquisitions Group at NautaDutilh N.V.

Forced unbundling of Dutch energy companies

BY HARM KERSTHOLT AND MIRIAM VAN EE

On 3 August 2007 a Royal Decree was published in the Netherlands to implement the so-called 'group ban' as laid down in an amendment to the Dutch Electricity Act and Gas Act. Although no other European country introduced similar legislation with regard to the unbundling of energy companies, as from 1 July 2008 Dutch energy companies must fully separate their networks business from their commercial activities. After an extensive legislative history the forced unbundling of the Netherlands energy companies is a fact and goes beyond the unbundling requirements currently under debate in the European Union for vertically integrated energy companies. The European debate focuses on the separation of transmission network companies only and does not extend to distribution networks.

In this article we focus on the consequences of the separation of the energy companies in the Netherlands, because it will increase M&A in the Netherlands energy market.

Timeframe

The Act requires the separation of integrated energy companies – such as Nuon, Essent, ENECO and Delta – into separate companies: (i) a commercial company which engages in the sale, distribution and/or production of energy and (ii) a network-company operating gas and/or electricity networks. Since RWE sold its network business last year to the Municipality of Eindhoven, all vertically integrated energy companies in the Netherlands are (once again) publicly owned by municipal and provincial shareholders. This will not change in the foreseeable future as the Electricity Act and Gas Act do not allow the sale of network businesses outside the current circle of (public) shareholders.

No later than 1 January 2011, commercial and network companies can no longer be part of the same group or hold shares in the capital of each other's group companies. This means that from the commencement date of the Act the integrated energy companies have two and a half years to finalise the separation.

The procedure for a legal split of the business starts with the preparation by the management of a split-off proposal. This proposal defines, among other things, which assets and liabilities will be acquired by the respective companies. In other words, which assets and liabilities are related to network activities and which are related to the commercial business. The proposal has to be approved by the Minister of Economic Affairs, after advice of the Netherlands Competition Authority has been obtained. Approval has to be granted before 1 July 2009. After approval the companies can start the split in conformity with the proposal.

Europe

One of the main reasons for the forced unbundling is to create a level playing field in the energy consumer market in the Netherlands. Separation should safeguard that it becomes impossible to cross-subsidise commercial activities through (monopoly) network activities. The Act has been and still is controversial. Several integrated energy companies have instituted legal proceedings or have announced their intention to seriously consider doing so. Furthermore, the two biggest incumbent players, Nuon and Essent, attempted a merger last year to create a national champion. The merger was not completed because public shareholders could not agree on the terms.

In the midst of this turmoil, large utility companies appear to be very interested in the Dutch commercial parts and it is expected that these parts will become subject to takeovers after unbundling within the next couple of years.

Public shareholders

At the moment, public shareholders are examining their options concerning the possible sale of their shares in commercial energy companies. Until the full implementation of the separation is a fact, the shareholders cannot freely transfer their shares in the integrated energy companies because these companies include the network business. After separation, the sale of the commercial business is expected as the rationale for public shareholders to keep their shares in the commercial business disappears. The sale of the network business will, however, still require the consent of the Minister of Economic Affairs. Such consent will only be given if the alteration in the ownership of the network or the shares in a network manager remains within the current circle of shareholders. This circle has recently widened, so that from now on all regional and local authorities can hold shares in network managers. An enumeration of all public legal entities that can hold shares in a network manager is recently laid down in a ministerial regulation.

The debate about the possibility to sell a minority of the shares in the network operator to private parties (i.e., outside the circle of the authorities) did not make it to a legislative proposal due to resistance in the House of Representatives. The public shareholders might however seek opportunities to refinance the network business to free cash, which creates opportunities for banks.

Exit commercial activities

The separation of energy companies implies that shareholders can freely transfer their shares in the commercial companies to third parties. Many shareholders indicate that indeed they are planning to sell or investigating the possibility to sell these shares. Often heard reasons for the decision to sell the shares in the commercial companies are that: (i) share ownership is no longer the obvious means to secure the public interest involved with the trade and supply of energy; (ii) the local authorities do not have enough expertise to give substance in a good manner to their share ownership; (iii) the financial risk of the participation in the commercial company will strongly increase due to the separation; and (iv) the sale of the shares will release a considerable sum of money at once.

It will be interesting to see how the sales, if any, are being structured. The expectation is that the commercial businesses will be offered in controlled auctions not long after the separation is implemented. This is, however, by no means certain. In the last two years, smaller companies that voluntarily split up were sold without auctions. Minority shareholders could also decide to sell their shares while other shareholders retain their shareholdings. The province of Gelderland (a major shareholder of Nuon) recently indicated that it will retain its shareholding in the commercial business for several years. None of the current shareholders has strongly indicated interest to actually increase their shareholding, but this cannot be ruled out.

Our expectation is that the commercial business will be sold sooner rather than later. This is mainly because public shareholders will not want to bear responsibility for the enormous risks involved with the commercial energy business. Moreover, after separation the commercial energy companies may lack the size and power to effectively compete in the European energy market with competitors such as RWE, E.ON, Suez and EdF.

The developments in the Dutch energy market will inevitably influence the European unbundling discussion, as did E.ON's recent decision to voluntarily separate its transmission network business. The coming period will be important for shareholders, management and those companies looking to buy commercial positions, as they each have a part to play in the unbundling process. Since various stakeholders have different interests, the period leading up to the actual implementation of the unbundling will be challenging for everyone involved.

Harm Kerstholt is head of the Energy & Utilities Industry Group and Miriam van Ee is a senior associate at NautaDutilh N.V.

Private equity and public takeovers in Switzerland: finally a happy marriage?

BY FRANK GERHARD

Last year, the first leveraged public takeover was successfully closed in Switzerland. Unilabs, listed on the SWX Swiss Exchange, was acquired by the Swedish-based and private equity-backed healthcare provider Capio, creating a leading laboratory services group in Europe. Approximately 40 percent of the offer was financed through equity, while approximately 60 percent was financed through a syndicated credit facility. This transaction followed a series of unsuccessful attempts by private equity investors to take private Swiss listed companies (e.g., CVC / Forbo in 2004/05 or CVC / SIG in 2006/07).

This successful LBO of a public company has raised the interest level of various private equity investors for Swiss listed targets. This interest has been enhanced by share prices coming down in the last six months. In addition, while it appears that the credit crunch has resulted only in the private equity deals in the CHF 1bn-plus bracket struggling to find any acceptable finance, deals worth less than CHF 1bn seem still to be flowing. Finally, LBOs in Switzerland benefit from changes in the legal and tax framework which came into force in 2007 and 2008. The conjunction of these elements should open new opportunities in the mid-market segment in Switzerland for private equity investors.

Challenges of LBO financing

In Switzerland, private equity investors have long been reluctant to operate in the public M&A market because the typical financing structures often conflicted with the interests of minority shareholders of the target. Indeed, for purposes of the public takeover offer, the private equity investor will set up an acquisition vehicle to be funded by a mix of equity, senior debt and subordinated debt. As the debt portion will trigger interest payments, proceeds need to be generated in order to enable the acquirer to service such interest and amortisation payments. Furthermore, in order to achieve tax savings, the acquirer will want to allocate interest payment obligations on the level of a fully-taxed subsidiary company. In other words, the acquirer will want to balance the acquisition debt with the operating profits in order to (re-)finance the debt with minimal corporate and tax consequences.

Swiss legal particularities

Swiss law has three particularities which are important to understand when structuring efficient acquisition financing.

First, Switzerland knows no group tax consolidation, except for VAT. Each company is tax-assessed on a standalone basis. Therefore, a tax-efficient structuring of acquisition financing usually involves some kind of an upstreaming of profits or assets from the target group to the acquisition vehicle (financial assistance) or a pushing down of the acquisition debt from the acquisition vehicle to the target group (debt push down). Particularly if not at arm's length, such transactions can trigger adverse tax consequences on the level of the Swiss assisting or benefiting company.

Second, Swiss corporate and bankruptcy law does not recognise the overall legal concept of an integrated group of companies. This explains why the law protects assisting companies against distributions and financial assistance that could harm the creditors of the assisting company by unduly decreasing assets or increasing debt. Consequently, the board of directors of a Swiss target may not take a consolidated view and fulfil its fiduciary duty by merely considering the overall interests of the entire group.

Third, the capital gain realised in a sale by Swiss residents of shares held as private assets, is, in principle, tax free. However, this favourable tax treatment is only upheld if the restrictions emanating from the concept of 'indirect partial liquidation' are respected. Under the 'indirect partial liquidation' concept a tax free capital gain is re-classified into taxable income in three situations. First, a sale of a participation of a least 20 percent of a company's share capital from the private assets of an individual investor to the business assets of an individual or a company takes place. Second, if within five years after the acquisition, the acquirer distributes funds from the target which, when the sale took place, were contained in the target, were not needed for operational purposes and were distributable from a corporate law standpoint. In this context, a merger of the target and the acquirer, as well as financial-assistance transactions entered into by the target, are considered as a distribution of such funds. Finally, if the seller and buyer cooperate in the financing. In case of a public offer, such cooperation is in fact rarely given for retail shareholders.

Upstream loans as financial assistance

Arm's length principles and corporate law implications

Usually, a target would upstream profits or assets to the acquisition vehicle by way of a formal distribution of dividend or by a capital decrease. Both necessitate shareholder approval and include minority shareholders in the distribution. Another way of financial assistance by the target would be to grant an upstream loan to its parent. The funds for making this loan can come from existing undistributed cash or from dividend proceeds by the operational subsidiaries. Besides making an upstream loan, the target can also provide financial assistance by other means, such as providing security for the obligations of the parent vis-à-vis third parties. If there are minority shareholders, the granting of an upstream loan to the majority shareholder is subject to the protection of the interests of the minority shareholders.

In any event, such loan must meet arm's length conditions, as they would be requested by an unrelated third party when granting the same loan to the same borrower. In addition, an upstream loan by a Swiss lender must be examined in the light of the restrictions and conditions imposed by certain general principles of corporate and tax law. This is particularly important where there are reasonable doubts as to whether the terms of an upstream loan are at arm's length. First, if the loan is not entirely at arm's length it is advisable for the Swiss lender to extend the purpose clause of its articles of incorporation to provide explicitly for the granting of financial assistance to group companies. Second, the upstream loan must comply with the principles of adequate risk diversification and diligent liquidity management of the lender (duty of care). Third, unless the upstream loan clearly meets the arm's length test, the upstream loan must be limited to the freely disposable equity of the lender. An upstream loan exceeding such amount could be deemed to be an unlawful return of the shareholder's capital contributions and to violate the statutory limitations on the use of the company's reserves, in particular if the upstream loan has been fictitious or where it was clear from the beginning that the borrower will not be in a position to repay the loan when due. Fourth, an upstream loan which does not clearly have arm's length terms could be deemed a constructive dividend. As a consequence, the board of directors of the lender would be forced to demand immediate repayment of the loan. In this context, it has become customary to require formal approval of the upstream loan not only by the board of directors, but also by the shareholders of the Swiss lender.

Non-compliance with the preceding may lead to the invalidity of the upstream loan as well as to directors' and officers' personal liability. Furthermore, non-compliance may qualify as a criminal offence or as fraudulent conveyance under bankruptcy laws.

Tax implications for assisting and benefiting companies

From a tax perspective, should the conditions of the upstream loan not be at arm's length, the loan will be treated as a constructive dividend. This has three implications. First, the distribution (e.g., minimal interest rate requirement not met or even the total loan amount if the loan was fictitious) may be subject to dividend withholding tax of 35 percent of the fair market value of the gross distribution. Second, the withholding tax is in general fully recoverable if the borrower is a Swiss company. Foreign recipients can fully or partially recover the withholding tax based on double taxation treaties, including the agreement between Switzerland and the EU on the taxation of saving income which also covers dividends to EU parent corporations. Third, the distribution received by a Swiss company or target is largely exempt from corporate income tax if the benefiting company is a major shareholder in the assisting company.

Debt push down

By way of merger

If the acquisition company and the target effect a statutory merger, their assets and liabilities are combined in one legal entity, with the effect that the target's assets can be used to repay or service the acquisition debt. Such a merger requires at least two-thirds of the capital and the votes of the shareholders of both companies. If the acquisition company controls 90 percent or more of the target's votes, it can squeeze out minorities against payment of cash.

A statutory merger is usually not accepted by the Swiss tax authorities. Hence, the interest expenses cannot be deducted from the taxable income for a period of usually five years. In addition, it may lead to a reclassification of the formerly tax free capital gain of Swiss retail shareholders into taxable income based on the theory of indirect (total) liquidation.

By way of dividend

Dividends may be a straightforward way to refinance the acquisition vehicle or to push down debt (by assumption of certain loans). Dividends require shareholder approval and can only be made from freely disposable reserves as evidenced in audited financial statements. Remaining minority shareholders are entitled to a proportional dividend and may challenge the resolution.

A dividend paid by the target to a non-Swiss acquisition vehicle triggers withholding tax of 35 percent unless a treaty provides for relief or refund. A Swiss acquisition vehicle receiving the dividend may benefit from the participation exemption largely exempting dividend from corporate income tax. As dividends may be seen as an indirect partial liquidation, the target's Swiss retail shareholders' tax free capital gain may to that extent be reclassified as taxable income.

By way of capital reduction

After the takeover offer, the target's share capital can be reduced in order to distribute the corresponding amount to the acquisition vehicle to repay the debt. The capital reduction requires a resolution of the shareholders' meeting, creditor notification and an auditor's certificate. A capital reduction is likely to require three to six months.

A reduction of nominal share capital neither triggers Swiss withholding tax nor corporate income tax. In addition, such a reduction is exempt from income taxation for Swiss private investors. As a consequence, the theory of indirect partial liquidation should not apply.

Sale of activities within the target group or to third parties

Upstreaming revenues or assets up to the acquisition vehicle can also be achieved by the sale of assets, which can be structured in various ways. For example, the target can be split with the effect that parts of the target's business activities will be transferred to a new sister company (Newco). The acquisition vehicle would then sell Newco either to a third party (if the activities are no longer desired) or to a profitable operating subsidiary. The purchase price may be used to repay the acquisition debt or, if sold to a subsidiary, remain unpaid for the moment, thus resulting in an interest-bearing loan of the acquisition company to the subsidiary.

Conclusion

Leveraged takeover offers – including financial assistance and debt push down – are possible in Switzerland, provided they are carefully prepared and structured. Additional transactions in the near future will demonstrate the proof of concept.

Frank Gerhard is a partner at Homburger.

Current state of the Nordic M&A market

BY PETER SARKIA, ERIK SWARTLING AND PHILIP HEILBRUNN

In recent years, the Nordic M&A market has boomed, mostly due to the active private equity houses and the availability of attractive financing. However, the subprime fallout has in some respects affected the financing options for financial acquirers, and there has been some impact on the Nordic market as a consequence.

Trends in the Swedish M&A market

Prior to the subprime fallout, we saw the following trends, especially in private equity related transactions. Opportunities for thorough due diligence were very limited. Especially in secondary buyouts, private equity to private equity, very few reps and warranties were provided by vendors and in some cases the representations and warranties would not survive a closing of the transaction. Acquisition financing was highly leveraged and controlled auctions were very competitive, which led to high purchase prices.

During 2007, several of the major Swedish private equity houses raised substantial funds. Our impression is that there is a lot of capital available for investments. When it comes to financing larger buyouts and other investments, private equity players have stated that whereas previously they could talk to only one or two banks, today several banks have to be approached. Consequently, there are increased difficulties for primarily private equity houses to find attractive high leverage acquisition financing. At the mid-market level, however, there is still a lot of activity since it is still possible to find reasonable financing.

Another trend is the increased activity of trade buyers, possibly as a consequence of lower valuations and the fact that the trade buyers are generally less dependant on highly leveraged financing.

During 2007 there was a lot of attention on the top individuals at leading private equity houses, and their salaries. This attention seems to have subdued lately. The extent of negative publicity in Sweden has not reached the levels seen in the UK during 2007. To the contrary, the general opinion seems to be more favourable towards private equity at present.

As indicated above, deal activity in the mid-market seems to have declined only slightly. How much of this decline is attributable to the credit crunch is difficult to say. It has definitely not been as severely impacted as international leveraged mega deals.

In Sweden, investors have shown interest in a wide range of sectors. In recent years, there has been a lot of focus on the real estate market, but this seems to have decreased slightly. Further, financial institutions and media related companies appear to be in focus at present. Interest for investments has been shown from many jurisdictions, but chiefly from investors domiciled in the US, Norway, Iceland and Germany.

Competition between strategic and financial acquirers in the M&A market

In the Nordic region, there are currently few deals that do not have a private equity component. However, the presence of trade buyers has definitely increased and private equity houses seem to prefer trade sales to initial public offerings.

Due diligence. Private equity houses generally acquire businesses on a standalone basis, as opposed to trade buyers, and therefore their concerns in acquisitions usually involve a narrower assessment of liabilities and financial performance. Consequently, the different approaches compared to trade buyers can lead to some frustration on the private equity side at the pace of a trade buyer's review.

Private equity sellers normally prepare vendor due diligence reports, drafted by accountants and lawyers covering financial and legal aspects of the target's business. This speeds up the due diligence process.

Representations and warranties. In secondary buyouts, private equity to private equity, it was previously common to see warranty cover limited to the ability to transact, title to shares and no encumbrances. In extreme circumstances, the warranties provided have not even survived closing. This trend has recently subsided. At least basic business warranties now seem to be the main trend. Private equity sellers seem to acknowledge that the internal compliance rules of trade buyers necessitate at least limited business warranties.

Another issue always discussed, once the scope of warranty cover has been agreed, is the level of liability taken on by the seller. Private equity sellers do not retain much of the purchase price consideration. Funds need to be closed and proceeds distributed as soon as possible following an exit. On the other hand, the trade buyer needs to be able to recover on a warranty claim. An escrow arrangement in which private equity sellers accept to hold back approximately 10 percent of the purchase price is not an unusual solution to the problem.

Purchase price adjustments. The purchase price adjustment mechanism typically falls into two main categories: the 'locked box' which is normally what private equity houses prefer as sellers, and post-closing pricing adjustments in the form of, for example, completion accounts.

The purchase price when using the completion account mechanism is calculated as the agreed headline price (enterprise value), adjusted for actual net debt at completion and for the excess or shortfall of actual working capital at completion, in comparison to target working capital or the target net asset value. This method is usually preferred by trade buyers, since if any adjustment is needed, it is normally to the detriment of the seller in the form of a reduction of the purchase price.

On the other hand, the 'locked box' mechanism entails a fixed equity price calculated on the basis of an agreed balance sheet, accompanied by 'locked box' protection for the buyer to prevent loss of value ('leakage') from the target business in the period from the reference balance sheet date to completion. Completion accounts are thus not required in this solution.

Prospects for 2008

Due to the present volatility of the market, the prospects for 2008 are difficult to predict. However, as regards mid-market deals, we do not foresee any major impact from the international credit crunch. Deal structures and the level of leverage in the financing of private equity acquisitions may be affected, but at present deal activity does not seem to have declined. The ongoing privatisations of large companies owned or controlled by the state will probably contribute to some PE activity. For example, Sweden's largest PE house EQT has expressed an interest in participating in the controlled auction of Vin & Sprit AB, the state owned distributor of i.a. Absolut Vodka.

Clearly, adoption of the euro as the lawful currency in Sweden would facilitate cross-border acquisitions into Sweden. However, this does not seem to be likely in the near future. Further, it would naturally facilitate acquisitions into Sweden if Swedish accounting principles fully corresponded to international accounting standards.

Peter Sarkia, Erik Swartling and Philip Heilbrunn are partners at Advokatfirman Hammarskiöld & Co.

Financing options and capital structures

BY PETER SARKIA, ERIK SWARTLING AND PHILIP HEILBRUNN

Up until June 2007, when the credit crunch started to affect global markets, including Sweden, there had been a constant growth in the number of private equity investments in Sweden. The increasing expertise and sophistication, and the increasingly aggressive approach of sponsors active in the Nordic market, contributed to this steady rise and development of a borrower-friendly leveraged finance environment. Even though the credit crunch has had some affect on liquidity and leveraged finance in Swedien, interest from European buyout houses has remained high, even when it seems to have waned in other regions of Europe.

As in other jurisdictions, leveraged transactions in Sweden involve the lending of funds to a SPV controlled by an equity sponsor (often a private equity sponsor and, in some cases, the management of the purchased company) to acquire the target company and refinance its existing debt. The acquisition facility is paid with the cash flows generated by the target company, which are upstreamed to the purchase vehicle through dividend payments or other available methods.

Swedish based leveraged transaction structures are similar to those in the UK and certain parts of Europe (in particular the Nordic countries), although some particularities in Swedish law may require tailoring the structure of the transaction and the finance documents to be in compliance. Swedish law is sometimes used to govern acquisition finance documentation but this depends on various circumstances, mainly the size of the transaction, the original lender's origin and the targeted syndication market. In any event, leveraged transactions not governed by Swedish law require significant input from Swedish lawyers in many areas, when a Swedish SPV is involved.

Standard structure

The standard starting place is a draft tax structure paper prepared by the sponsor's tax accountants. As tax advisers, the accountants will have prepared the structure to maximise tax efficiencies. However, they often do not consider corporate and financial law issues and the impact of the structure on the borrower's and lenders' legal position.

Generally, investors set up a newly incorporated SPV, irrespective of the nationality of its shareholders. In the basic structure, the SPV tends to be a company resident in Sweden and subject to Swedish corporate income tax. In this structure, the SPV raises the finance to purchase the stock of the target company. The SPV is usually a private limited liability company, which limits the shareholders' liability to the capital invested and requires few formalities to be set up. An asset deal as opposed to a share deal is rarely used in Sweden by private equity sponsors.

The acquisition is usually funded by a

mix of senior and mezzanine bank debt (or independent mezzanine debt) and shareholder funds, both pure equity and unsecured shareholder loans. The shareholder loans are treated as equity between the lenders and the shareholders. In the vast majority of cases, banking facilities are used. Most private equity acquisitions have been financed with credit facilities provided by banks, combined with mezzanine provided by banks or by specific independent debt providers. Unlike certain other jurisdictions, debt security instruments are not commonly used to finance acquisitions.

In Sweden, limitations on the security available to the lenders arise due to, among other things, financial assistance and dividend restrictions.

Trends following the credit crunch

Much has been said and written about the impact of the credit crunch on the European leveraged lending market. In the Swedish market, certain trends are identifiable in recently negotiated deals, but it is in our view too early to conclude whether any significant changes in the previously borrower-friendly environment have occurred. Prior to the credit crunch, leveraged lending was, and has for a few years been, characterised by borrower-friendly terms. There is however no doubt that the recent year's development towards even more sophisticated borrower-friendly terms and solutions has ceased. The credit crunch has provided the banks and other lenders on the European leveraged buyout market with an opportunity to reconsider certain terms upon which pre-credit crunch acquisition deals were made and to take a new look at certain terms on which lenders have committed funds to mergers and acquisitions. Lenders and their legal advisers seem to take the opportunity to reconsider some of the borrower-driven terms found in the most aggressive leveraged acquisition deals before the credit crunch.

Security

In UK and US based leveraged transactions, the lenders – from a Swedish legal perspective – seem to expect to obtain as close to full security from the target group as possible. In Sweden, limitations on the security available to the lenders arise due to, among other things, financial assistance and dividend restrictions, corporate benefit requirements, and other Swedish specific requirements, such as Swedish perfection requirements under Swedish law imposing inter alia difficulties to obtain security over assets which are used in the day to day business. Security is normally granted on a cost / benefit analysis and there is no Swedish equivalent of the UK whitewash procedure. In UK based leveraged transactions, we have noticed the lenders' increased requests for additional or other security. Due to the aforementioned limitations to provide certain types of security under Swedish law, it does not presently appear as if the credit crunch will have any long term effects on security provided by Swedish entities in leveraged transactions. The effect experienced so far has been that the lenders' previous occasional acceptance of share pledges as the sole security when providing financing has decreased substantially, at least if alternative security is available and can be justified based on a cost / benefit analysis.

Capital structure

The capital structures in recent deals are reverting to traditional senior / mezzanine arrangements. Furthermore, we have noted that that pricing and leverage levels have clearly been affected. The credit crunch has resulted in decreased levels of leverage which in turn has affected the pricing negatively.

Warrants / equity sweeteners

Independent warranted mezzanine has in recent years more or less disappeared from the Swedish leveraged buyout market. The demand for warranted mezzanine and also for mezzanine financing combined with other equity sweeteners seem to have increased significantly during the last six months. Specialist mezzanine lenders and other mezzanine and debt / equity hybrid financing providers have returned with an interest in taking a larger portion of the pure equity as well as quasi equity of the SPV. The reawakened interest of specialised mezzanine providers in the Nordic region has also led to the return of certain intercreditor discussions which usually are not relevant in acquisition deals without equity sweeteners, since the mezzanine lenders' will more frequently be acting both as lender and investor.

Peter Sarkia, Erik Swartling and Philip Heilbrunn are partners at Advokatfirman Hammarskiöld & Co.

Directors and officers duties according to Swedish law

BY SUSANNA NORELID AND CHRISTER A. HOLM

M&A is a difficult and sometimes unsuccessful undertaking. There are many risks, some of which are quite difficult to foresee. Statistics show that failure rates are high. Yet directors and officers (D&Os) of companies carrying out M&A are willing to take the risk, even though they personally face potentially costly lawsuits for actions taken while performing their duties.

D&O liability insurance in Sweden

D&O liability insurance protects D&Os from legal responsibility for wrongful acts connected with their positions. A standard D&O insurance product may cover damages and defence costs in the event that D&Os are sued by stockholders, employees, clients or competitors. Without such insurance cover, a director or officer may be held personally liable for acts of the company and thereby put his or her personal assets at risk. D&O insurance cover provides economic security for the directors, and facilitates the recruitment of skilled directors. The sufferer would also be more certain to receive reimbursement, since an individual director or officer may be incapable of paying large amounts of damages, whereas an insurance company can.

Usually D&O insurance is purchased and paid for by the company/employer, although it is for the benefit of the D&Os. This is permitted in Sweden as long as the decision to buy insurance cover is taken by the right company body.

As of today, D&O insurance is common in Sweden. D&Os are facing high demands from owners, shareholders, competitors and consumers, not least in M&A transactions. The relatively new possibility of bringing a class action in Sweden has also contributed to the sharpened business environment. Moreover, courts have recently shifted towards a stricter view on liability issues for D&Os.

The scope of the liability of D&Os

The Swedish regulation on the liability of D&Os consists primarily of the Companies Act and a Code of Conduct compiled by major companies on the Swedish stock market. The purpose of the Companies Act is primarily to encourage business in general by allowing limited liability for the owners. Other purposes are the protection of creditors and minority shareholders of the company. The regulation covering the personal liability of D&Os aims to prevent D&Os from causing financial harm to the company, its shareholders or any other third party, and to compensate the legal entities who suffer loss in the event of non-compliance with the rules.

The general rule in the Swedish Companies Act (which is the same as liability in tort) is that a managing director, member of the board, founder, auditor, shareholder or other individual is liable for damages that he or she intentionally or negligently causes while fulfilling his or her duties for the company.

The board or the directors may be held personally liable if they fail to fulfil duties to take action if the share capital is less than one-half of the registered capital, if they fail to pay the company's taxes in time or if they provide incorrect information to the tax authority. However, D&Os are not held personally responsible for any violation of the employment legislation. This liability rests on the company.

Liability for damages can also be based on crimes according to the Swedish Penal Code. According to Swedish law, a legal entity cannot commit a crime. Therefore, there is always a natural person that will be held responsible if a crime is committed. Possible crimes in the Penal Code that a director or officer might be guilty of, relating to his or her position in the company, are fraud, embezzlement, disloyalty and diverse kinds of economic crime.

As a general rule, D&Os are expected to act in the best interest of the company. There is of course room for risk taking while making business decisions, and for all practical purposes Sweden applies the 'business judgement rule'. Again, D&Os may be held liable to pay damages to the company if they cause financial loss to the company intentionally or as a result of negligence falling outside the scope of normal business risk taking. If the company is obliged to pay damages to the shareholders and other third parties as a result of a director's negligence, it could in turn make claims against the director for the loss suffered.

According to the Companies Act, the board members and the managing director can, with some exceptions, be granted discharge from liability through a shareholders' meeting. The decision is made for each individual director, and not for the group as a whole. If it is decided that the directors shall be granted discharge from liability, it constitutes a waiver from the company, but only to the extent that the discharge was based on full and complete information. Should that not be the case, the decision to grant discharge from liability is just an empty formality without providing any legal protection.

If D&Os are not granted discharge from liability and thus could be exposed to liability claims, D&O insurance cover will be brought into force.

Who and what is covered by D&O liability insurance?

D&O liability insurance is governed by the Swedish Insurance Contract Act (2005:104). The Act sets minimum standards that may be deviated from only if it is to the benefit of the insured, but it also contains several parts that can be set aside through consensus by the parties. The Act is applicable if the damage occurs in Sweden, since the principle of *lex loci delicti* is applicable to such claims.

In Swedish law, the only D&Os that are regulated are the board of directors and the managing director, including the deputy managing director. The company's auditors and other executives (e.g., the CFO) are not legally defined as D&Os in Sweden, and are therefore not covered by a D&O policy. Coverage for other persons, such as a CFO who is neither a member of the board nor a managing director, can of course be achieved by way of specifically adding him or her to the policy. The auditors must follow their own rules and have their own liability insurance.

If damage is caused intentionally by the insured director or officer, the insurer is normally not liable since a D&O insurance does not provide cover for intentional acts. There is no legislation regulating the formalities of claims handling, therefore it is the policy wording that will govern this area.

M&A transactions related liabilities

In Sweden, as well as in most other European countries, M&A transactions have increased substantially in recent years. This has opened up a new field of liability for D&Os. Increasingly M&A transactions include a due diligence investigation by the potential buyer. It normally ends up with a report stating the shape of the target company. The D&Os of the seller that participates in providing information to representatives of the buyer must do so in a truthful and comprehensive way. In the final agreement there is, of course, possibility for the seller to limit its liability for information provided, but normally the seller is forced to issue certain guarantees regarding the status of the target company. Deviations from the guarantee above a certain amount normally entitles the buyer to reclaim part of the purchase sum in some way (e.g., tax related claims, labour or law related extra costs, environmental liabilities discovered after the purchase, etc.). The seller could, in such a situation, find that it is entitled to claim damages from its D&Os due to negligence. Such liability should be covered by D&O insurance.

In relation to this, the Swedish Supreme Court, in a new procedure in 2006, held that flawed annual reports duly signed by the board of directors normally falls within the liability scope of the D&Os (with the possibility of joint liability with its auditors). In a typical M&A transaction the buyer normally relies on a number of annual reports to scrutinise the profitability of the target company, its sustainable profit generating level, and so on. Needless to say, the liability exposure for the contents of the annual reports is increased in M&A transactions and also increases the need for a D&O insurance cover for D&Os.

Conclusion

Being a director or an officer is risky, due to the increasingly tougher business climate in Sweden, the relatively new possibility to bring class action against D&Os, and the courts' stricter view on the responsibilities of D&Os. It is thus increasingly common that companies buy D&O insurance. In addition to the steadily rising volume of M&A transactions, involving 'new' scopes of liability for the sellers, the market for D&O insurance should expand further.

Susanna Norelid and Christer A. Holm are partners at Advokatfirman NorelidHolm.

Takeovers of Norwegian listed companies

BY TERJE GULBRANDSEN

As party to the European Economic Area Agreement, Norway has implemented the MiFID, the Takeover Directive and the Transparency Directive in a new Securities Trading Act (STA), which came into force in two steps on 1 November 2007 and 1 January 2008. Consequently, the Norwegian takeover rules to a large extent correspond to the rules within the EU. Notwithstanding this, there is some local variation within the EU and EEA. Further, there are always some cultural differences, as well as differences in market practice. Below is an outline of certain key topics in a typical process of acquiring a company listed on the Oslo Stock Exchange.

There are two regulated markets in Norway, the Oslo Stock Exchange and the Oslo Axess. There are 218 companies listed on the Oslo Stock Exchange, of which 178 are Norwegian companies, 12 are based in the EU and 28 are based outside the EU. On the Oslo Axess 29 companies are listed, of which 22 are Norwegian companies, four are based in the EU and three are based outside the EU. The Norwegian takeover regulations also apply to foreign companies listed on one of the Norwegian regulated markets (exceptions may apply if such company is also listed on another regulated market).

At the end of January 2008, the ownership of the companies listed on the Oslo Stock Exchange was split as follows: the Norwegian State and municipalities 30 percent; private companies 22 percent; foreign investors 41 percent; private citizens 4 percent; and funds 4 percent. Of the foreign investors, US and UK based investors accounted for close to 60 percent.

Due diligence. A target company may give a bidder access to non-public information for the purpose of conducting due diligence investigations, as long as the target company deems this to be in the best interest of the company. A target company would normally not accept giving a bidder access to detailed information about its operations unless there is a high probability that an offer will be successful. Consequently, the most common approach is for a bidder to conduct its due diligence after the offer has been made.

Disclosure to a bidder is subject to procedural rules and strict insider trading provisions. To the extent the bidder receives 'inside information' (i.e., precise information about the company or other circumstances that may noticeably influence the pricing of the financial instruments), this would prevent the bidder from trading until the information is made public. The disclosure requirements for listed companies refer to the same definition, i.e., a listed company shall immediately disclose to the market any inside information related to the company as soon as it receives such information, unless the rules on delayed publication may be applied. In theory this should mean that due diligence should not uncover any inside information. In reality, this is not necessarily the case. Finding positive information about the company, which is regarded as inside information, would prevent the bidder from trading until the information has been shared with the market. Therefore, the scope and structure of due diligence investigation varies. The bidder will usually require the target to disclose to the market, or permit the bidder to disclose in the offer document, any finding, thereby eliminating the bidder's position as an insider in relation to the company.

Such processes involve complex considerations as to what time the target company's disclosure obligation, with respect to inside information, is triggered.

Stake building or voluntary offer. A bidder may choose to acquire shares in the market up to a certain level. The bidder will need to comply with the disclosure requirements, giving the market notice when its ownership reaches or passes either of the relevant thresholds (5, 10, 15, 20, 25, 33⅓, 50, 66⅔ and 90 percent). Further, a mandatory offer obligation is triggered at one-third of the voting shares. Most takeovers, however, start with a voluntary offer. Voluntary offers may be conditional, and usual conditions include two-thirds or 90 percent acceptance (usually 90 percent to allow for a subsequent squeeze-out of the remaining minority shareholders), MAC, due diligence and regulatory approvals. The offer period in a voluntary offer shall be no less than two and no more than 10 weeks.

In the Norwegian market, a bidder will normally contact major shareholders with the intention of obtaining hard (unusual) or soft (fairly usual) irrevocable pre-acceptances, and will also inform the company on a more general basis of its intention to make an offer. In some instances, the bidder enters into a dialogue with board members of the target company to explore the possibilities for a successful offer and seek the board's backing of the contemplated offer. Such processes involve complex considerations as to what time the target company's disclosure obligation, with respect to inside information, is triggered. The target may have a different view on this than the bidder, and should always act with caution. The company may delay disclosure if disclosure would prejudice its legitimate interests, provided that a delay is unlikely to mislead the public, and provided that the company is able to ensure confidentiality. The target would need to immediately inform the Oslo Stock Exchange of the delayed publication and the reason for it. The Oslo Stock Exchange may, at least in theory, choose to disclose the information if it does not agree with the decision of the target. In friendly takeover processes, the bidder and target will generally have ongoing discussions on these disclosure issues. The company has an ongoing obligation to maintain lists of all persons that have access to inside information about the company.

Pursuant to the STA, the Ministry of Finance may provide further regulations on mandatory offers, to regulate if and to what extent interests in and rights to shares may trigger a mandatory offer obligation. The current regulations state that where a person's acquisition of rights to shares has to be regarded as an effective acquisition of shares, the regulated market may impose a mandatory offer obligation if such person would pass the threshold by exercising said rights.

However, a green paper has been provided by the Oslo Stock Exchange with a proposal for new regulations, and the process to amend the regulations is still ongoing. Pursuant to the proposal from the Oslo Stock Exchange, an acquisition of certain interests in and rights to shares may trigger a mandatory offer obligation, irrespective of whether it must be deemed an effective acquisition of shares or not. The green paper explicitly states that pre-acceptances with respect to offers that are not subject to public approvals will represent a right to shares that may trigger a mandatory offer obligation. This means that if the bidder obtains irrevocable undertakings from shareholders for shares that, together with any shares held by the bidder, represent more than one-third of the voting shares in the target, a mandatory offer obligation is triggered, and the bidder may come in a position where it is required to make a mandatory offer even before the voluntary offer is completed.

Mandatory offer obligations. Any person who through an acquisition becomes the owner of shares representing more than one-third of the voting rights in a Norwegian company whose shares are listed on a Norwegian regulated market is obliged to make an offer for the remaining shares in the company, or to dispose of a sufficient number of shares so that the person owns one-third or less of the voting rights. The offer shall be made or shares disposed of within four weeks after the obligation was triggered.

Under the mandatory offer rules, shares owned or acquired by close associates, are considered equal to a shareholder's own shares. A mandatory offer obligation will apply whether it is the shareholder or a close associate that acquires shares, resulting in the mandatory offer threshold being passed.

A green paper has been provided by the Oslo Stock Exchange with a proposal for new regulations, and the process to amend the regulations is still ongoing.

The mandatory offer must be made without undue delay and no later than four weeks after the obligation was triggered. The offer shall be for all outstanding shares and cannot be made conditional in any respect. The offer price must be at least equal to the highest price paid or agreed to be paid by the bidder during the six month period prior to the obligation being triggered. Protection clauses given to selling shareholders having given irrevocables may raise pricing issues. The offer shall be cash settled, however, alternative consideration may be offered, as long as there is a cash alternative. The offer period must be no less than four weeks and no longer than six weeks.

Public approvals. Approval from the Norwegian Competition Authority is usually required. The threshold to trigger such requirement is very low, and generally it should be expected that it will be triggered unless the bidder has no operations in Norway. Further, there may be a need for a competition filing with the EU Commission. If this is in fact required, there is no need to seek the Norwegian competition clearance. With respect to financial institutions and investments firms, further approval from the Ministry of Finance/The Financial Supervisory Authority of Norway will be required, if the bidder will reach the relevant thresholds (10, 20, 25 (financial institutions only), 33 and 50 percent) of the capital or votes.

Squeeze-out. If a bidder acquires more than 90 percent of the share capital and voting rights of a Norwegian limited liability company, the bidder may acquire the remaining shares through a squeeze-out. If the price offered for the shares is not accepted by all shareholders, an independent valuation may be required, and this shall in the outset be conducted at the bidder's expense. Provided that the bidder initiates the squeeze-out within four weeks after the completion of the voluntary offer resulting in the 90 percent threshold being passed, the bidder may (on certain further conditions) do so without first making a mandatory offer.

Terje Gulbrandsen is a senior lawyer at Advokatfirmaet Steenstrup Stordrange DA.

M&A in Finland

BY ANDREAS DOEPEL

In September 2006 Finland took a major step towards liberalising company law along freedom of contract principles with its adoption of a new Companies Act. The new law also impacts merger and acquisition activity and its effects were gradually seen in the Finnish marketplace in 2007.

More than a year after the introduction of the 2006 Companies Act, amendments to the Finnish Tax Code have not yet been implemented, effectively preventing the use of many innovations provided by the Companies Act. Unfortunately, the much awaited changes will not be implemented before 2008.

In July 2007, the Finnish Accounting Act was amended, introducing a requirement that limited liability companies must appoint only chartered accountants (or accounting firms) for financial statement accounting. Smaller businesses are released from the requirement to appoint an accountant altogether.

Another major development affecting M&A activity in Finland will be the implementation of EU cross-border rules (Directive 2005/56/EEC) through an amendment of the 2006 Companies Act, which is expected to come into force by 15 December 2007. The changes will enable Finnish limited liability companies to merge with companies situated within the EU and vice versa. As a Finnish peculiarity, the possibility to implement a cross-border de-merger or split will also be introduced by the same amendment.

Amendments to the Finnish Companies Act

The new Finnish Companies Act entered into force on 1 September 2006, increasing the operating freedom of limited liability companies by removing different restrictions and formal requirements and by introducing new operating methods. At the same time, provisions aimed at protecting creditors and minority shareholders were enhanced.

The most fundamental change, by far, introduced by the 2006 Companies Act is the elimination of the requirement to stipulate a par value for each share. Although the previous Companies Act recognised shares without par value, the shares were nevertheless assigned a counter-value (the total share capital divided with the number of registered shares).

The new act abolishes the counter value of shares, allowing companies to sever the connection between shares and share capital. This reform enables companies to amend the share capital and issue shares independently. Bonus issues are possible without having to increase the share capital and, for example, a share split can be put to effect simply by issuing new shares for free.

The previous prohibition on issuing shares for a consideration less than the par value (or counter-value) of the shares was also abolished. The positions of creditors or minority shareholders are safeguarded by the rules concerning full payment for the share capital and the permanent nature of the capital.

Investments made in the unrestricted equity of the company are separately regulated. Such investments are held separate from the profit fund, clarifying the somewhat unclear application of the previous act on investments into the free equity.

Even directed bonus issues of shares, without observing other shareholders' pre-emption rights are possible, provided that there is an exceptionally weighty reason for the issue, e.g., incentive systems directed at key employees or situations where shareholders of a more 'valuable' class of shares (e.g., due to a greater number of votes per share) need to be compensated when combining different classes of shares.

The 2006 Companies Act introduced a new requirement that no funds may be distributed if, when making the decision on the distribution, the persons knew or should have known that the company was insolvent or that it would become insolvent as a result of the fund distribution.

Furthermore, a limited liability company cannot give financial assistance in the form of loans or other securities for the purposes of a person acquiring shares in the company or a parent company (the 'Financial Assistance prohibition'). The prohibition covers the acquisition of issued and outstanding shares as well as new shares to be issued. In practice this means that no Finnish group company can give financial assistance to the extent it would be used to finance the acquisition of that company or any of its parent companies.

The rule is based on Article 23 of the EU Capital Directive and, compared to the previous rules, its field of application is more restricted. The Financial Assistance prohibition only applies to acquisitions of the providing company's own shares and those of its parent (the previous prohibition applied to acquisitions of shares in any group company).

This means that a Finnish Ltd. can participate in financing the acquisition of, for example, its subsidiary, provided the general corporate interest requirements are met (e.g., that the transaction is compatible with the purpose of the company and that the transaction does not breach the principle of equality).

Furthermore, the financial assistance prohibition does not, as a rule, apply to earlier acquisitions. In a management buyout scenario, it is possible to merge the acquiring company with the target company.

Breach of the Financial Assistance prohibition will not, generally, lead to an obligation to return the funds or be deemed as a Corporate Law Offence as the acquisition does not usually constitute distribution of funds. If the intent of the arrangement has been to distribute funds from the company, the arrangement may, in such exceptional cases, be deemed to be an illegal distribution of funds.

In connection with the upcoming amendment due to EU cross-border rules, the rules governing the loss of equity will also be adjusted. According to the current proposal, the obligation to convene a shareholders' meeting whenever the equity falls below 50 percent of the share capital will be restricted to apply only to public companies. Further, the rules on calculating the equity for the purpose of ascertaining whether the equity has been lost (triggering a requirement that the loss of equity be reported to and registered with the trade register) will be amended to allow for a more balanced view of the equity situation.

Finally, the Finnish Securities' Association has established a working group to assess the needs to update the Finnish Corporate Governance recommendation and the possibility of establishing common corporate governance principles for the Nordic countries.

Amendments to the Finnish Securities Markets Act

The provisions of the Finnish Securities Markets Act (statute 495/1989) were amended on 1 July 2006 in order to implement Directive 2004/25/EC of the European Parliament and of the Council on Takeover Bids, also known as the Takeover Directive.

Pursuant to the amended Securities Markets Act, a shareholder whose holding in a listed company exceeds 3/10 or 5/10 of the total voting rights attached to the shares of the company, after the commencement of a public quotation of such shares, must make a public tender offer to purchase the remaining shares and other securities entitling holders thereof to shares in the company.

The obligation to launch a mandatory bid is triggered only by a shareholder's own actions. In other words, it does not come about if the proportion of voting rights increases purely due to the company's or other shareholders' actions (e.g., through the acquisition or redemption of own shares by the company).

The Finnish legislation does not distinguish between hostile and friendly public tender offers.

In conjunction with the implementation of the Takeover Directive a new special Panel has been set up in connection with the Finnish Central Chamber of Commerce. The Panel gives non-binding recommendations primarily regarding company law issues arising in public takeover situations. The Panel has issued a general recommendation on the procedures concerning takeover bids and a couple of opinions to the Financial Supervision Authority (FIN-FSA) on questions such as insider registers for projects and disclosure obligations for listed companies and shareholders.

Typical for the Finnish takeover legislation and rules is a neutral approach to public offers. The Finnish legislation does not distinguish between hostile and friendly public tender offers.

In addition to the Securities Market Act and the Panel, public takeovers and mergers are mainly regulated by the FIN-FSA, which monitors and controls compliance with the SMA. The FIN-FSA also issues standards, regulations and guidelines that supplement the provisions of the SMA. Other essential provisions are the Rules of the Helsinki Stock Exchange, The Act on Competition Restrictions, which provides national merger control, and The Companies Act.

There are also special regulatory control provisions designed to control ownership in certain industry sectors, for example, banking and insurance. Whenever holdings in a listed company reach, exceed or fall below certain thresholds, the shareholders of listed companies must disclose the changes in their holdings by notifying the company itself and the FIN-FSA.

Under the Companies Act, the bidder must without undue delay notify the target when its holding exceeds or falls below 90 percent of the shares and votes of the target. The price paid by the bidder when building a stake in the target before announcing the bid may affect the determination of the price to be paid for the shares in a mandatory offer.

Typical market practice in takeover situations is for the target company and the bidder to enter into a combination or similar agreement in a friendly takeover, where the board of the target usually recommends the bid. According to recommendation number six of the Panel, the board may enter into a combination agreement with a bidder, if it considers the agreement to be in the main interest of the shareholders. However, the target's board should reserve the opportunity to reconsider the offer in case a competing offer is made, and it should disclose the information concerning the signing and the main terms of a combination agreement to the market.

Andreas Doepel is a specialist partner at Borenius & Kemppinen.

In search of deal security – the Finnish version

BY JYRKI TÄHTINEN

The M&A market in Finland has been particularly noteworthy. From the autumn 2006 leading up to the spring of 2007, deal volumes were at record levels. Asset prices were high and terms and conditions seller-friendly. Banks competed for acquisition financing and loan terms were accommodating. It was, in short, a heated period of deal activity.

Representations and warranties in share purchase agreements were limited, and many times sellers effectively represented solely that they were the legal owner and that they had the authority to sell.

The market reached a point where bidders in controlled auctions marked representations and warranties against themselves just to make the point that they were very keen to sell. These were heady times. That said, the terms of representations and warranties during this heyday mirrored events that transpired in other markets. Representations and warranties were lax elsewhere, too, and were a reflection of the seller-friendly deal environment.

The harder they fall

But where events in Finland differed considerably in 2007 from the UK and the US relate to deal protection issues. Even at the height of the M&A boom, buyers in Finland were in most instances able to walk away from the deal if they could not drawdown on bank financing. Sellers effectively continued to take the risk that banks may utilise the material adverse change clause in the finance agreements to halt the deal.

In the current environment, liquidity is tighter, lending covenants are back to what can be considered a more normal level, prices have fallen and sellers are beginning to look to more strident deal protection to secure the transaction. What happened in other jurisdictions much earlier in the market cycle in terms of seller-side deal protection is only now gaining momentum in Finland.

This phenomenon is very particular to Finland and shows, in some respects, how the Finnish market is often a bit slower to adopt the latest trends. Sellers' refusal to grant buyers any finance-related walk away movement spread from the US to our neighbouring Sweden in spring 2007, a country that is traditionally quicker to adopt new ideas than more-conservative Finland.

Comparisons can be made to the dotcom boom in the early part of the new millennium. Finnish venture capital firms were hesitant to invest in newfound dotcoms; Swedish VC firms, in contrast, were quicker to provide financing. When the bubble finally burst in 2000, numerous Swedish VC firms went belly up, but no Finnish VC firm shut its doors.

This statement is not intended to wave the Finnish flag. As a consequence of Finnish hesitance, market players may often be unable to reap the highest returns at the height of a bubble. But, on the upside, Finnish investors also may not fall as far if the cycle ends abruptly. Dexterous market plays are something Finns have yet to learn. The poker game in this particular Nordic market, in that sense, is at times less high stakes.

Show me the money

Deal security is vitally important for sellers and buyers. The media regularly publishes news items on an impending acquisition at the time of signing and little mention is made of conditions precedent to closing the deal. The deal is effectively done in the eyes of the public. Buyers that walk away before closing can create havoc for the seller. A new buyer has to be found, and the investing public may begin to wonder if something is wrong with the seller's assets. Lower prices are possibly negotiated, and the seller's brand potentially tarnished.

From the buyer's perspective, a condition that is buyer-friendly allows it to walk away if it cannot drawdown on the agreed upon financing without fear of impending litigation. In public auctions with private equity bidders, especially, acquisition financing is an important part of the purchase price, making availability of bank liquidity a vital prerequisite to closing the deal. And in Finland during this 2007 boom, private equity investors, indeed, took the leading role on the buy-side. The principles that "We will buy you at the agreed terms and conditions *if* we can drawdown on bank financing" prevailed in Finland throughout 2007, and sellers most of the time accepted this important condition precedent even though the market was otherwise extremely seller-favourable.

The state of affairs on the other side of the Atlantic during the pre-credit crunch period was quite different. Sellers negotiated 'no financing out' and specific performance clauses as a prerequisite to deal signing. Sellers refused to accept any MAC risk that resulted from financing availability on behalf of the buyer. This tendency also gained hold in Sweden and effectively resulted in shifting the risk of MAC clauses in financing agreements to the buyer.

All went well in the US until the spring credit crunch. Banks stopped providing financing and buyers tried to use the MAC clause to halt the deal. Buyers, in turn, sued based on no financing out language and demanded specific performance. Costly litigation ensued (See *United Rentals, Inc. v. RAM Holdings, Inc.*, Civil Case No. 3360-CC).

During this same time period, parties agreed to 'reverse termination fees' as a means to deter costly litigation and payment of damages should banks prevent drawdown on loan financing. This strategy was effectively used in at least one instance to thwart potential litigation. On 4 January 2008, it was announced that PHH Corporation reportedly received $50m in reverse termination fees from Blackstone Capital Partners V L.P resulting in a failed merger that stemmed from the inability of the buyers to receive acquisition financing.

For many international banks, the credit crunch meant that they were left with large loans that they were unable to syndicate, thus preventing the issuance of further loans for new deals. The market abruptly came to a halt.

Meanwhile, in Finland, deals continued to progress quite smoothly until July and August 2007 when banks temporarily halted deal financing. The history of this occurrence is traceable to the subprime mortgage crisis in the US and the subsequent backlash to international banks. A number of pending transactions were temporarily delayed; but, interestingly enough, starting in September, banks (either the same or competing ones) started providing financing anew, and the terms and conditions started to shift back to what had been seen some 18 months earlier. It has now been reported that Nordic banks operating in Finland do not have significant US subprime mortgage holdings.

The party is almost over – or is it?

Even in the autumn 2007 very few, if any, deals in Finland died as a result of the buyer not being able to drawdown on financing. There are about eight to ten banks in Finland that are willing to do acquisition financing under Finnish law. None of the banks in this group have written-down loans in any meaningful way even post-credit crunch.

But following in line with international trends, by the end of 2007, Nordic banks expressed concern that buyers were paying too much. Lending covenants became stricter and liquidity less available. A number of sellers still stuck to valuations that were no longer possible; deals were pulled by sellers at times, and buyers expressed disinterest in the high-end price terms of the good old days.

Only now are sellers looking to secure deal protection at signing through 'no financing out' clauses. It is possible that buyers in Finnish markets may have to agree to the full risk of financing in the near term. In this environment, pre-set reverse termination fees look like attractive alternatives to costly litigation should financing fall through.

Predicting the future is always difficult, and it is quite possible that spring of 2008 in Finland will end up resembling the spring of 2003 when the M&A market dried up and deals were very limited. At this point, however, there is still some room for optimism.

Private equity interest in Finnish assets still remains. PE houses have been able to sell assets at good prices and have raised new funds. For banks, the smaller size of deals in Finland means that there is not the same need for syndication as exists in larger markets. This is important, as syndication in this post-credit crunch environment is difficult.

Market participants certainly no longer expect a repeat of spring 2007, but how big a volume drop-off will be experienced remains to be seen. At the moment, no public deals in Finland have ended up in litigation as a result of deal protection issues. If there are disputes, those are being handled in confidential arbitration, which is the norm for M&A in the Finnish markets.

Where we are seeing M&A litigation increasing is where buyers are alleging that assets are not as represented. In contrast to events in the US, litigation surrounding deal protection issues have not come to the forefront, at least not yet – and due to the possible future use of reverse termination fees coupled with no financing outs, may not come to fruition in the future, either.

Jyrki Tähtinen is the managing partner of Borenius & Kemppinen Ltd.

Practices, trends and acquisition structures in the Finnish property market

BY NIKLAS THIBBLIN

The interest of foreign investors in the Finnish property market has remained high in recent years leading to a quick internationalisation of the sector.
The Finnish property market is today characterised by high levels of transparency and liquidity as well as fairly attractive growth prospects.

According to market studies, the aggregate volume of property transactions in Finland amounted to around €6bn in 2007 up from €5.5bn in 2006. For comparison, in 2002 the transaction volume was as low as €2bn. Last year, foreign investors accounted for more than 64 percent of all property transactions by value.

From a global perspective, the prevailing view is that returns on property will be lower in 2008, based mainly on declines in capital appreciation, which will only be partially offset by holding rental levels. Nonetheless, it is generally believed that the Finnish property market will continue to be attractive in 2008, although no major increase in the transaction volume is expected. Contrary to property markets in many other European countries, Finland is still expected to have fairly good prospects for total returns. Also the risks associated with the Finnish property market are considered to be moderately low and the risk/return prospects are considered to be among the best in Europe.

Foreign investors are today not only interested in the Helsinki metropolitan area but also in medium size cities and municipalities that have busy retail and commercial businesses. It appears that foreign investors often concentrate on a niche, be it warehouses, hotels, retail and shopping centres outside the city centres, or large commercial properties whose tenants are large and reliable corporate entities. In particular, retail properties have recently attracted foreign investors in smaller cities and municipalities since these investments tend to offer a fairly high return in circumstances where the cash flow is secured by a long term lease. It is generally expected that foreign investors will sell parts of their Finnish holdings in 2008 and that the restructuring of the property portfolios by traditionally dominant Finnish investors will continue, which enhances market liquidity further.

Investment practices

The emergence of new players in the Finnish property market (including an increasing number of domestic private equity real estate funds), in combination with the increased internationalisation, has resulted in new market practices in the property investment process. Sophisticated due diligence reviews as well as auction procedures have become standard approaches, especially in transactions involving larger property portfolios and international players. In smaller transactions and among domestic investors familiar with the Finnish property market, more traditional and less formal transaction procedures may still be applied.

Another trend in recent years is the increasing role of leverage and, generally, external financing. It seems more like a rule than an exception that properties are being purchased by highly leveraged investors. From a foreign investors perspective, this together with the lack of any specific Finnish thin capitalisation rules enables, inter alia, tax efficient debt push down structures for Finnish property investments (although harsh intra-group debt financing could, at least theoretically, be challenged by the Finnish tax authorities by virtue of general tax avoidance provisions).

Finnish property structures

From a legal point of view, owning property in Finland means, in essence, owning the underlying plot and the buildings located thereon (although the plot may also, instead of freehold, be leased). In reality, property ownership is often organised through a Finnish real estate company (REC) or a Finnish mutual real estate company (MREC), whose sole objectives are to own and manage the underlying property. Both a REC and a MREC are by definition Finnish limited liability companies with more or less similarly organised governance.

However, a specific feature of a MREC is that the lease income is allocated directly to its shareholders whereas in a REC the lease income is allocated to the REC itself. Accordingly, in a MREC-structure the lease contract is concluded between the shareholder of the MREC and the tenant, as opposed to a REC-structure where the lease contract is concluded between the REC and the tenant.

A MREC does not normally aim to show any profit. The operating costs and expenses of a MREC are usually covered by maintenance and management fees payable by its shareholders to the MREC whereas the rental revenue is channelled directly to the shareholders of the MREC from the tenants. In general, a MREC may for all intents and purposes be used in Finnish property investments to minimise the overall tax burden. In particular, in circumstances where the amount of tax deductible depreciations of a MREC can be matched with the amount of its loan instalments (which are included as a part of the maintenance and management fees received from the shareholders), the total tax burden is effectively reduced. Accordingly, a MREC is basically in a position to deduct for tax purposes the acquisition cost of its underlying property. A REC, as opposed to a MREC, can in principle not benefit from the corresponding matching of loan instalments with depreciations.

Property acquisition structures

Income from Finnish property, including income (gain) derived from the disposal of Finnish property as well as shares in a REC and a MREC, is taxable in Finland as Finnish source income. Therefore, it is generally not feasible for a foreign investor to hold property directly. As Finland under most tax treaties similarly is entitled to tax such gains, a Finnish holding-structure is more or less necessary to enable a tax-efficient exit. The reason for this is that shares in an 'ordinary' Finnish limited liability company (such as a pure holding company) are in Finland by definition considered as movable property, why the gain derived from the disposal of such shares is generally not covered by the provisions of tax treaties.

However, there is no case law whether general Finnish tax avoidance rules could become applicable in a clear tax avoidance situation causing Finland to claim the right to tax regardless of the formal status of the holding company in question. Such an outcome would, however, seem farfetched where sufficient business reasons can be found behind the selected holding structure. Holding structures have to date been widely used for Finnish property investments.

Domestic Finnish property investments have, in turn, increasingly followed the international trends of indirect property investments through private equity real estate funds. The funds targeted for domestic investors are most commonly structured as partnerships. Partnerships are able to utilise debt financing, which often is an important incentive for such structures at least from a tax perspective. In addition, partnership-structures facilitate a third party management. However, pure and direct Finnish partnership-structures cannot, as a rule, be beneficially applied in property investments where foreign investors are involved.

Recent amendments and future prospects

The Finnish property industry has long aimed for a REIT type tax-transparent property investment vehicle. Yet, in practice, no concrete actions have been taken for the launch of such a vehicle. Although certain amendments to the Finnish property fund and mutual fund legislation were recently made, they appear not to bring about any significant benefits for the property industry (at least from a tax perspective).

As a result of the declining stock market, increased uncertainty and general overpricing of many asset classes, property investments can, however, still provide an opportunity to achieve higher returns. Why then invest in Finnish the property market?

There are a number of reasons for this. Undoubtedly, the ability to obtain higher yields in combination with a highly liquid market and large transaction volumes should qualify as motivating factors. In addition, the Finnish property market offers a solid framework for doing business, along with virtually no corruption. Also a modern, dynamic and understandable legal structure supports the property market. The market is open and investors can obtain virtually all the necessary information they desire about specific companies and properties. Last but not least, there is a surprisingly large number of experienced domestic and international professional players on the Finnish property market providing depth to the same.

Niklas Thibblin is a lawyer at Waselius & Wist.

Regional regulatory features of M&A deals in Russia

BY TATIANA KACHALINA AND SVETLANA DUBINCHINA

The recent volume of both domestic and foreign capital attracted by the Russian economy has grown demonstrably. The volume of M&A deals and a sizeable number of professional investors on the market inevitably resulted in a gradual displacing of raider methods for more civilised mechanisms for organising and executing M&A deals.

The prevailing practice of dealmaking in this area increasingly permits investors to gain the most clear-cut insight into a potential target, avoid blind purchasing, consider identified risks in the context of a proposed transaction, go through all necessary preliminary target acquisition approval formalities at administrative authorities and hit the mark while forecasting projected resources, time and costs associated with a deal.

There are a number of specific features in the regulation of M&A deals in Russia that prospective investors must consider when designing deals, to protect their own interests on the capital market and to exclude competition blocking.

The Russian legislation acknowledges a wide spectrum of corporate structures within the bounds of which a proprietary organisation may exercise its business activity. Two corporate structures have gained greater acceptance. The first structure is the limited liability company (abbreviated in Russian to 'OOO') and the second form is the joint-stock company (AO) subdivided into open AO and closed AO. Most Russian companies targeted by investors as targets exist within one of these two main corporate structures.

Much of the regulation depends on a corporation's structural set up. Proper consideration must be paid to statutory requirements providing the pre-emptive right to buy shares of closed AOs sold to third parties as well as that of OOOs' participants to buy shares in OOOs' charter capitals when they are sold to third parties, non-participants of the OOOs. Generally, the procedure for exercising pre-emptive rights is set by a business entity's charter, which can also fix the pre-emptive right for the entity itself to buy shares.

Most heavily regulated deals are still acquisitions of stocks in an open joint stock company's charter capital. Particularly, Chapter XI.1 of the Federal Law 'On Joint Stock Companies' sets forth special requirements for the procedure of acquisition of a large stock by investors. Thus, an investor planning to purchase more than 30 percent of the total number of voting shares has to take into account that: (i) prior to purchasing the said holding of shares he has the right to send to the open joint stock company a voluntary (bona fide) offer addressing shareholders who own shares of corresponding categories or types with a public offer to purchase their shares; otherwise (ii) within 35 days after buying the said holding of shares he will have to send to owners of the rest shares of corresponding categories or types and holders of other securities convertible into such shares a mandatory offer containing a public offer regarding the purchase of the securities from them. On acquiring more than 95 percent of shares the investor is obliged at the request of shareholders to buy the remainder of shares placed by the company (hereafter the specified course of action by the investor is referred to as 'tender offer').

The procedures indicated above are not unique to Russian corporate law, as legal systems of other countries also incorporate similar institutions. To a foreign investor the practical application of the cited chapter of the Federal Law 'On Joint Stock Companies' in 2006-2008 is of utmost interest.

It is essential to note that the tender offer procedure is controlled by the FFMS of Russia, a state authority regulating Russian financial markets. The order of exercising the tender offer is regulated by the Order of FFMS of Russia as of 13 July 2006 No 06-76/пз-н (ed. as of 16 October 2007) 'On Affirming the Provision for Requirements for the Procedure for Specific Actions While Purchasing more than 30 percent of Shares in Open Joint Stock Companies'. The strict and orderly observance of the procedure is a prerequisite of validity of a transaction related to the purchase of shares by the investor within the procedure itself.

Fixing a redemption price of shares determined within the tender offer is a question that arises frequently in the application of the Chapter XI.1 of the Federal Law 'On Joint Stock Companies'. The law strictly stipulates the procedure for determining a price for shares which cannot be lower than their weighted average price calculated with basis on trading results of a stock market trade institutor for six months prior to the date a mandatory offer is sent to the federal executive authority for the securities market. If securities are traded by two or more trade institutors, their weighted average price is determined upon trading results of all stock market trade institutors when the said securities have been traded no less than six months. If securities are not traded on the stock market or have been traded for less than six months, the purchase price of securities cannot be lower than their market value estimated by an independent appraiser. Notably, the market value in this case is calculated for a single corresponding share (another security). If within six months prior to the date a mandatory offer is sent to an open company, the sender or its affiliates have bought or taken a liability to purchase the corresponding securities, the price for securities due to the mandatory offer cannot be lower than the maximum price the sender has bought or taken a liability to purchase these securities at.

The practice of exercising mandatory and voluntary offers has revealed cases when minority shareholders disputed the price estimated by independent appraisers.

Despite the consistent approach to determining a redemption price, the practice of exercising mandatory and voluntary offers has revealed cases when minority shareholders disputed the price estimated by independent appraisers.

Specifically, such a case is reflected in Decree of the 9th Arbitration Appeal Court as of 07 November 2007 No 09АП-14428/2007-ГК on Case No A40-23719/07-34-161. In future such disputes are likely to bring about still more strict and formal criteria for determining the redemption price within execution of mandatory and voluntary (bona fide) offers procedure, including more stringent requirements for independent appraisers estimating the redemption price.

The second essential point a prospective investor is to bear in mind is the requirement for the investor to secure payment of the share price to shareholders who have accepted the tender offer. Pursuant to Paragraph 2 of Article 84.1 and Paragraph 2 of Article 84.2 of the Federal Law 'On Joint Stock Companies' a tender offer should be supplemented with a bank guarantee which should secure the guarantor's liability to pay the price of sold securities to their former holders in case a sender of voluntary (bona fide) offer fails to carry out his commitment and pay for the securities on time. Need in the guarantee is conditioned, on the one hand, with the necessity to protect rights of a company's minority shareholders who have accepted the tender offer and, on the other hand, to avoid numerous lawsuits of minority shareholders in case a sender of the offer fails to carry out his commitment and pay for the securities transferred to him. Hence, the requirement results in higher standards for solvency and creditability and financial status of a prospective share acquirer, as potentially he must be ready to purchase up to 100 percent of an open AO's shares.

Thus, in planning acquisitions of a large blocks of shares in open joint stock companies it is necessary to familiarise oneself with the legislative requirements, both in terms of time cost and financial planning.

Applying business entity shareholder agreements

Another significant factor one has to bear in mind in contemplating M&A deals in the Russian market is primacy of the federal legislation and foundation documents in regulating relationships between shareholders (participants) of business entities as to the management of the company.

The international practice recognises agreements negotiated between and entered into by participants (shareholders) that provide the parties with regulation for the company management issues. This cannot be applied to a full extent in the Russian context, as according to the federal laws 'On Joint Stock Companies' and 'On Limited Liabilities Companies' the management of a business entity is exclusively governed by the company's charter.

The participant agreement can regulate only certain questions related to rights of the company's participants that are explicitly stated by the law. For instance, Paragraph 4 of Article 21 of the Federal Law 'On Limited Liabilities Companies' sets regulation for execution of pre-emptive right to purchase shares. It is inadmissible to regulate matters concerning (i) the status of a Russian legal person and rights and obligations of its participants as to the OOO's activity, and (ii) meetings of the OOO's participants and other company's authorities with agreements regulated by foreign laws, as these matters are subject to the Russian legislation, which is explicitly stated in Article 1202 of The Civil Code of the RF. This is also reflected by the emerging court practice in similar cases related to joint stock companies set up under the Russian legislation dealing the question of applying provisions of shareholder agreements governed by foreign laws (Decree of the Federal Arbitration Court for West-Siberian District as of 31 March 2006 No Ф04-2109/2005(14105-A75-11), Ф04-2109/2005(15210-A75-11), Ф04-2109/2005(15015-A75-11), Ф04-2109/2005(14744-A75-11), Ф04-2109/2005(14785-A75-11) on Case N A75-3725-Г/04-860/2005).

Under the circumstances, potential investors need to take into account the regulations on a wide spectrum of issues related to the company management with regard of the foundation documents of a business entity.

Tatiana Kachalina is a partner and Svetlana Dubinchina is an associate at Liniya Prava.

Antimonopoly policy in Russian M&A deals

BY TATIANA KACHALINA AND SVETLANA DUBINCHINA

In Russian M&A, it is essential to meet the requirements of the antimonopoly law aimed at ensuring sound competitive environment on the commodity and service market. For this reason most deals implying redistribution of capitals are subject to the antimonopoly regulation. In Russia the main law governing the area is the Federal Law 'On Competition Protection' No 135-Ф3 as of July 26, 2006. This law stipulates regulation for M&A deals both on the financial service and commodity markets. In this article we dwell upon controlling the purchase of equity interest (shares) in the charter capital of business entities and purchase of fixed assets and intangible assets of business entities.

While carrying out transactions for the purchase of equity interest in the charter capital of a limited liability company (abbreviated in Russian as 'OOO') or shares in joint-stock companies (AOs) of non-financial organisations, attention should be paid to the following forms of control over this category of deals executed by the antimonopoly bodies on the territory of the Russian Federation.

Obtaining preliminary approval

A preliminary approval must be obtained for investment deals involving purchase of equity interest in charter capitals of OOOs and shares of AOs if: (i) the aggregate assets cost in recent balances of purchasers of shares (equity interest in charter capitals, rights, property) and the business entity (its group of persons), equity interest, shares, rights or property of which are acquired exceeds 3bn rubles; or (ii) their aggregate proceeds from selling goods in the last calendar year exceeds 6bn rubles with assets in recent balances of the business entity (its group of persons) equity interest, shares or property of which and/or rights over which are acquired exceeds 150m rubles; or (iii) if any of the indicated persons is put on the register, run by the Federal Antimonopoly Service, of business entities with a market share on a specific commodity market of more than 35 percent.

This form of control is practiced when an investor or a group of persons, including an investor, purchases in a non-financial organisation: (i) more than 25 percent of shares on condition that prior to the acquisition such a person (a group of persons) was not in command of this joint stock company's voting shares or was in command of less than 25 percent of voting shares of the joint stock company; (ii) more than 50 percent of shares provided that such a person earlier was in command of no less than 25 percent and no more than 50 percent of shares of the joint stock company; (iii) more than 75 percent of shares on condition that before the purchase the investor had the right over no less than 50 percent and no more than 75 percent of shares of the company; (iv) more than one third of equity interest in the charter capital of an OOO provided that prior to the purchase the investor did not have any equity interest in the charter capital of the OOO or such interest amounted to less than one third; (v) more than one half of equity interest in the charter capital of an OOO on condition that before the purchase the investor owned no less than one third and no more than one half in the charter capital of the OOO; (vi) more than two thirds of equity interest in the charter capital of an OOO on condition that before the purchase the investor owned no less than one half and no more than two thirds in the charter capital of the OOO; (vii) acquisition, usage or ownership over fixed production-related assets and/or intangible assets of another economic entity, if the balance value of the property rendering subject to the deal (or interrelated deals) exceeds 25 percent of balance value of fixed production-related assets and intangible assets of the economic entity alienating or transferring property; or (viii) as a result of one or several deals (also pursuant to the property trust contract, agreement of cooperation or contract of agency) an investor acquires rights enabling him to specify conditions for business operation of the economic entity or to act as its executive body.

The last category of deals is the greatest challenge for law enforcement. Thus, the regulatory control does not deliver any clear criterion for identifying a circle of deals that as a result provide the investor with rights enabling him to specify conditions for business operation of the economic entity. It is very important to consider this form of antimonopoly control while drafting agreements between shareholders of foreign holdings that are already shareholders or are just planning to acquire a controlling share (equity interest in the charter capital of an OOO). Assuming such an agreement contains provisions under which a minority shareholder of a foreign holding gets the right to make decisions as for forming a position in the name of the holding company while voting for specific agenda items at the stockholders meeting as a shareholder of a Russian company, it may be subject to the antimonopoly control of the Russian Federation, including cases when it leads to competition restrain (Paragraph 2 of Article 3 of Federal Law 'On Competition Protection').

Subsequent notification

When equity interest in the charter capital of an OOO, shares of an AO or property of Russian organisations as well as rights in respect of such organisations are acquired, this form of control is executed in the same volume and in the same cases a preliminary approval is applied. Though subsequent notification is applied in respect of deals involving companies with less asset volume and proceeds, than it is established for a preliminary approval, namely, if aggregate asset cost in the last balance or aggregate proceeds from selling goods of the acquirer (its group of persons) as well as of the company in respect of which rights (shares, equity interest and/or property) are acquired in the calendar year prior to the year of executing such deals (other transactions) exceeds 200m rubles, and aggregate asset cost in the last balance of the entity (its group of persons) whose shares, equity interest and/or property are acquired or in respect of which rights are obtained exceeds 30m rubles, or one of such persons is put onto the register of business entities with a market share on a specific commodity market of more than 35 percent.

Such a notification is to be issued within 45 days (no later) since the execution of the corresponding deal or transaction.

Failure to meet requirements of the antimonopoly law on the procedure of endorsement of deals for acquisition of rights in respect of commercial organisation, shares (equity interest in charter capitals) or/and property can lead to a situation where the court may find such deals ineffective at a lawsuit of the antimonopoly authority, provided that such deals have brought about or bring about competition blocking including cases of emerging or strengthening dominance (Paragraph 2 and 4 of Article 34 of the Federal Law 'On Competition Protection' No 135-Ф3 as of July 26, 2006).

Special regulation for acquiring blocking shares in banking

There are specific forms of control over concentration of capital on the financial service market, which includes a segment that has become particularly popular recently: banking.

Acquiring equity interest in charter capitals (shares) of credit institutions investors have to meet both special requirements of the antimonopoly law in respect of financial organisation like banks and special requirements for acquiring blocking shares / equity interest in charter capitals of credit institutions established by the Federal Law 'On Banks and Banking'.

Control and approval of antimonopoly authorities

This form of control is applicable to deals with assets or/and equity interest in the charter capital (shares) of a bank if the cost of assets of the credit institution according to the last balance exceeds 3bn rubles.

By and large a list of deals related to acquiring interest equity, shares and/or banking assets that require a preliminary approval of the antimonopoly authorities agrees with the similar list above regarding deals involving non-financial organisations, with the exception of when credit institution assets are acquired. Thus, a preliminary approval is required for deals when, as a result of one or several deals, the investor acquires financial organisation assets if their volume exceeds 10 percent of the asset cost according to the balance sheet of the financial organisation as of the last reporting date, prior to the date of submitting the application.

Control of the Central Bank of the Russian Federation

Presently, foreign investors acquiring shares (equity interest in the charter capital) of existing credit institutions are subject to the national regime, which means they can acquire equity interest in the charter capital of credit institutions under the same regulation as provided for companies set up under legislation of the Russian Federation. While acquiring large shares in credit institutions a preliminary approval of the Bank of Russia is to be obtained or subsequent notification is to be delivered.

According to Paragraph 8 of Article 11 of the Federal Law 'On Banks and Banking' the purchase and/or asset management of more than 1 percent of shares or equity interest of a credit institution resulting from one or several deals by a legal or private person, or a group of legal and/or private persons constrained with an agreement, or by a group of affiliates dependent on one another, is subject to the notification the Bank of Russia. If more than 20 percent is acquired the deal is subject to a preliminary approval of the Bank of Russia.

Within 30 days from receiving the application the Bank of Russia informs the applicant on its decision – approval or refusal. A refusal should be reasoned. If the Bank of Russia does not inform the applicant on its decision within the indicated period, the purchase of shares or equity interest in a credit institution is considered to be approved. It should be noted that considering acquisitions of large shares in credit institutions for approval the Bank of Russia places emphasis on the financial stability of the acquirer. The criterion here is the sufficiency of the acquirer's own funds for the payment of a corresponding share or equity interest in the charter capital. The aim is to ensure a sustainable financial position of the credit institution for the future and is provided with a general demand of Paragraph 5 of Article 11 of the Federal Law 'On Banks and Banking', which prohibits use of the raised funds for constituting the charter capital of the credit institution.

Today, M&A in Russia is subject to rather consistent control, both inter-corporate and administrative. Companies contemplating M&A deals in Russia have to develop a detailed implementation plan for such deals, allowing for material, time and costs and the ability to address specific regulatory demands under laws of the Russian Federation.

Tatiana Kachalina is a partner and Svetlana Dubinchina is an associate at Liniya Prava.

Recent trends in the Russian M&A mid-market

BY OLEG MIKHAILOVSKY

As the Russian economy continues its impressive growth potential and gradually becomes more sophisticated, M&A has largely replaced the plain 'asset accumulation' that marked the 1990s.

M&A has quickly become the driving force of the country's third redistribution phase of property and assets. The privatisation process of the early 90s was a 'crude affair', but it created myriad investment opportunities that are now beginning to bear fruit, especially in the flourishing mid-market sector.

We expect to see in the near future continued and growing activity in the Russian mid-market, with a focus on the retail and consumer goods sectors. Both sectors are still fragmented, and Russia is a large consumer market. This offers tremendous opportunities for both large Russian as well as international acquirers.

Russia is often perceived primarily as a destination for inbound M&A activities, and as a developing market with a huge growth potential. However, there is also an increasing volume of outbound M&A transactions in the recent years. We expect that outbound activity will continue to grow. One reason is the need for larger Russian players to diversify their businesses or improve their geographic diversification. Moreover, the global credit squeeze and expectations of a possible recession in developed markets have resulted in appealing valuations of some assets in the eyes of potential, cash-rich buyers.

With respect to inbound activity, we expect continued strong demand from foreign players. Moreover, although a few years ago interest stemmed mostly from multinationals, we are now seeing 'a second wave' whereby smaller international players are trying to get a foot in the door of the Russian market. This desire to establish presence in a quickly developing market with high growth potential will increase due to expectations that developed markets will underperform and experience slow growth.

Investors can generally be divided into two major categories: strategic and financial. Strategic investors usually seek a controlling stake in a business. They usually also have a longer investment horizon and are often reluctant to pay higher prices. The major advantage of a financial investor – from a seller's point of view – is that they provide access to capital to capture growth opportunities, do not always demand a majority stake and typically exit within three to five years. Their major disadvantage is that the strategic value-add they offer can be limited.

In the last two years the Russian M&A mid-market experienced a boom in private equity, as more foreign players entered. Russia not only offers higher returns than many other markets, it also has a thriving and comparatively young 'population of entrepreneurs' that prefer to keep control. Consequently, PE players are welcome to provide capital for the further development of the company.

When dealing with this new generation of Russian entrepreneurs it is important to understand the key issues. Most of the major deal drivers resemble those in mature M&A markets, but some are unique to Russia. First, owners conclude that they cannot 'survive on their own' in a market that is increasingly competitive, particularly in the mid-market. At the same time, strong consolidation trends are underway. Second, there is a need for additional capital. Fast growing businesses require significant investments to keep pace with competitors and to achieve ambitious targets. Third, there is a necessity to get access to Western know-how and best practices. Increasingly, Russian small and medium sized businesses would like to implement best practices to increase their growth potential, productivity and business value. Finally, there are succession issues. While the average age of the typical Russian entrepreneur is close to 40, quite a number are above 50 and many of them realise that they need to sell while the timing is favourable.

Of course, the most frequent deal driver for Russian mid-market entrepreneurs is the need for finance to grow their businesses. Currently, a variety of financing options exist in the Russian market, ranging from plain vanilla bank debt to an initial public offering (IPO). Obviously, the financing choice depends on various factors: the maturity of a business, the needs of the current owners, market conditions, etc. For medium-sized businesses, it is easier, simpler and cheaper to finance business growth through retained earnings, bank debt or by bringing in an equity partner through a trade sale, compared to going public via an IPO. Even though an IPO might be an option for a medium sized business, the choice in terms of the 'listing place' is usually limited.

There are many potential rewards of conducting an M&A transaction in Russia, but dealmakers should be aware of, and sensitive to, common acquisition and post-acquisition risks. Those risks, if not addressed or mitigated, can be dealbreakers or ruin potential synergies.

When dealing with this new generation of Russian entrepreneurs it is important to understand the key issues.

First, company cultures can be very different, which may create impediments to people working together smoothly. It is critically important for an acquirer to become familiar with the people it is going to close a deal with. Cultural differences between western investors and Russian entrepreneurs can sometimes be significant. Also, personal relationships in Russia play a much more important role then in Western Europe or the US. You can solve some important deal issues much more efficiently if you have already established a good personal contact and if there is a mutual understanding with the potential Russian partner.

Second, many Russian entrepreneurs still bank on an outdated asset-based approach to company valuation rather than on more sophisticated valuation approaches such as discounted cash flow.

Third, due diligence is a critically important part of the M&A process. Many Russian companies still use various tax optimisation schemes, and there can be significant differences between management and statutory reporting. Prior to entering into a deal, due diligence, accounting and reconciliation issues need to be understood properly to avoid destroying deal value due to poor preparation.

Finally, reporting processes and IT systems tend to be very different. As a result, proper alignment is needed.

In summary, we believe that the emphasis on return on capital (i.e., commercial considerations in doing transactions) is becoming a clear trend in the Russian M&A market. This will inevitably help redistribute property and assets to professional stakeholders.

Oleg Mikhailovsky is a manager in the M&A Lead Advisory practice at PricewaterhouseCoopers.

Nature and scope of M&A in Ukraine

BY BOGDAN BOROVYK AND CAMERON HALL

Ukraine is in the midst of an M&A surge, with growth in transactional numbers continuing to escalate on a yearly basis since the start of the boom in 2004. During 2007, an estimated 683 deals were announced, with a total value around US$15.6bn, according to ISI Emerging Market. Broken down by market sector, investors largely focused on financial, mining and real estate, which made up about 72 percent of all transactions for the year. The financial sector led in terms of investment, with $4.8bn, followed by the mining sector at $4.3bn, and then real estate with $2.2bn.

Despite the prolonged political instability surrounding the snap election and subsequent formation of a new Parliament in 2007, foreign and cross-CIS investors are showing more confidence in Ukraine as an accessible market with hidden value and substantial growth potential. Overall, the growth in M&A activity is forecasted to continue, although the relative monetary value will likely diminish slightly as much of the large scale M&A activity in the most developed sectors has passed.

Relative to western targets, purchase prices in terms of present value are high, particularly in view of the balance sheet value of the assets acquired, many of which are in disrepair and/or not in conformity with present day business standards. However, valuations are justified by the pace of development and the prospect for substantial future market growth in a market where many sectors remain largely undeveloped.

Attractive sectors

The banking and finance sector was the most active in 2007. Most of these deals involved share acquisitions, with several premier Ukrainian banks being acquired by Western European multinationals, including Bank UniCredit (Ukrsotsbank), Commerzbank (Bank Forum) and Intesa Group (Pravex Bank). Overall, the industry experienced a record number of transactions in 2007, with 51 announced deals. The National Bank of Ukraine noted that 35 percent of investment in the banking sector consisted of foreign capital at 2007 year's end, including 17 banks wholly owned by foreign investors

With this, however, the banking industry has largely topped out. Relatively few top Ukrainian banks are still up for grabs, although smaller and medium sized domestics may be the subject of future consolidation. That said, Ukraine's approval as a member of the WTO in February 2008 may generate further interest in the sector, with Ukraine committing to providing non-discriminatory access to the financial service sector, and accession paving the way for foreign banks to establish representative branches in the country.

Other sectors have not strictly been the target of M&A per se, however, insurance and retail and commodity food industries are predicted to be up and coming sectors. For example, the aggregate value of deals in the food industry in 2007 was estimated at $1.3bn, including the acquisition by Pepsi Co. of a 100 percent interest in Sandora, Ukraine's leading juice producer, valued at $760m. The arrival and expansion of larger multinational hypermarket chains will also lead to the consolidation of profitable domestic chains. Insurance M&A is driven by low competition at present, and will likely grow with Ukraine's forthcoming WTO accession.

Foreign investors: potential risks and their minimisation

Foreign investors play a significant role in the M&A sphere in Ukraine. According to ISI Emerging Markets, 297 of the 683 announced M&A deals in 2007 involved a foreign party. In terms of investor origin, the main sources of M&A investment are Russia (43 deals), Poland (18 deals) and the Netherlands (18 deals), with the popularity of the latter partly due to favourable tax conditions between the two countries.

Both Ukrainian and EU counterparts will form holding companies in Cyprus for the purpose of financing Ukrainian operations, largely due to the favourable tax treatment on many forms of passive income established by the Double Taxation treaty between Cyprus and Ukraine. However, in 2007 the Ukrainian Government initiated renegotiations of the Double Taxation treaty with Cyprus. The draft of the new convention on Double Taxation presented by the Ukrainian Government does not establish zero withholding tax on some sorts of passive income as the present agreement does. A new treaty on Double Taxation may be adopted in 2008.
Despite the M&A volume in Ukraine, legislative regulation of M&A remains relatively poor and reform slow. To date, Ukraine has no specific law regulating M&A, requiring an investor to consider and comply with a multitude of laws and regulations. Because of the combined novelty and lack of effective regulation of M&A in Ukraine, foreign investors will often conduct a share deal under foreign law, and provide for disputes to be resolved by international commercial arbitration abroad.

Despite the M&A volume in Ukraine, legislative regulation of M&A remains relatively poor and reform slow.

The lack of familiarity with the M&A process itself is further exaggerated by the chaos and disorder in which many prior corporate ownership rights were achieved. A foreign investor will discover that Ukrainian companies are unable to produce the necessary evidentiary and economic support for a transaction, i.e., in terms of legal due diligence and valuation. Ukrainian owners may also express consternation with the legal demands of their foreign counterparts, particularly with regard to the number of representations and warranties sought by a foreign buyer.

Additionally, the foreign investor should expect to face substantial bureaucratic conditions and requirements, particularly in terms of state issued permits, approvals (e.g., Anti-monopoly Committee), and document authentication, among others.

However, recently the High Commercial Court of Ukraine threw corporate governance in M&A into limbo. On 28 December 2007, the High Court passed a recommendation 'Regarding the Practice of Applying Legislation during Consideration of Cases relating to Corporate Governance,' which cut deeply into the ability to use foreign law to govern corporate relations in Ukraine.

The principle points of the recommendation render null and void: (i) shareholder agreements regulating corporate relations between shareholders of Ukrainian corporations governed by foreign law; (ii) shareholder / participant agreements providing for dispute resolution by international commercial arbitration; and (iii) non-competition agreements between shareholders of Ukrainian companies. While other jurisdictions may enforce such agreements or clauses, the recommendations instruct that such agreements should not be recognised, as they are contrary to the imperative norms and public policy of Ukrainian law, regardless of obligations which Ukraine has as a signatory to the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards. Much confusion has been expressed in the legal field regarding this recommendation.

Bogdan Borovyk is co-head of the Corporate Law Practice Group and Cameron Hall is an attorney, at Beiten Burkhardt.

Sector-specific M&A in Ukraine

BY BOGDAN BOROVYK AND EKATERINA KATERINCHUK

Ukraine's rising M&A market has driven some notable developments in a number of sectors. Those with the most activity are banking and finance, agriculture, telecommunications and IT, and consumer products.

Banking and finance

The banking and finance sector occupies the leading position in terms of M&A transaction volume in the Ukrainian market and is expected to remain active in 2008. The most attractive investment targets in 2007 were banks: 51 M&A transactions were conducted with the shares of Ukrainian banks. According to the official statistics of the National Bank of Ukraine, as of 1 January 2008, 47 Ukrainian banks had foreign capital, with 17 being solely owned by foreign investors. The most notable M&A transaction of the year was acquisition of Ukrsotsbank, one of the leading Ukrainian banks, by Bank Austria Creditanstalt AG which belongs to the UniCredit group, for US$2.2bn.

Although a number of the top 10 Ukrainian banks have been already acquired by foreign investors, experts predict more acquisitions in 2008 as the banking and finance sector has not yet reached saturation. Moving forward, investors are more likely to acquire mid-level banks and small local banks.

Investor demand has also increased in non-banking financial institutions and insurance companies, due to the growing potential and relatively low competition. International insurance groups including Vienna Insurance, Generali, Fortis, BNP Paribas and Allianz have already entered the Ukrainian insurance services market, mainly through acquisitions of Ukrainian insurance companies.

The following specific features are pertinent to M&A transactions in the banking and finance sector: (i) high transactions prices in comparison to other sectors; (ii) involvement of investment banks, financial and legal advisers; (iii) due diligence procedures in the acquisition process; and (iv) acquisition of decisive control (from 75 to 100 percent of share capital). Among the legal regulations affecting such transactions, it should be mentioned that the applicable laws require approval from the National Bank of Ukraine for acquisition of a substantial portion (10 percent or more) of a bank's share capital, as well as approval from the Anti-monopoly Committee of Ukraine (should the transaction satisfy certain quantitative thresholds, which is usually the case in the banking and finance sector M&A).

Agriculture

The Ukrainian agricultural industry is believed to have considerable potential for M&A transactions. Currently, this sector is characterised by a low level of consolidation and competition as the majority of agricultural market players (up to 90 percent) are small retail companies possessing small agricultural land areas. In addition, due to weak development of the real estate market in Ukraine, many experts believe that land is substantially undervalued. The Ukrainian agricultural industry suffers from a lack of funds and investment, in particular, the northern and western regions of Ukraine are considered to have good development potential with a large number of investment targets available for acquisition. Another important factor is the increasing demand in the food market, which is experiencing a substantial lack of high quality raw materials from the agricultural industry.

Due to increasing consumer demand for communications services and the rise in GDP in Ukraine, the telecommunications and IT sectors have demonstrated rapid developments in recent years to become more attractive to potential investors.

Investing in the agricultural industry carries certain risks, such as dependence on climatic and weather conditions, and uncertainty in the Ukrainian land market due to the moratorium imposed on the sale of agricultural land. Nevertheless, experts predict several M&A transactions in 2008, particuarly in the fat-and-oil and sugar industries.

The most notable M&A transactions last year were domestic acquisitions made by Kernel Group (the leading Ukrainian oil producer), Allseeds Ukraine company (a major Ukrainian seeds trading company and oil-producer) and Astarta Holding N.V. (a leading Ukrainian sugar company).

Target companies in this sector are mostly small agricultural enterprises with no modern technology and machinery, sizeable liabilities and low profitability. Major legal flaws are often discovered in the land and real estate title documents of such companies. For these reasons, target companies in the agricultural sector may be acquired for moderate prices.

Telecommunications and IT

Due to increasing consumer demand for communications services and the rise in GDP in Ukraine, the telecommunications and IT sectors have demonstrated rapid developments in recent years to become more attractive to potential investors. Segments with the most potential for M&A are mobile communications and internet services. Investor interest is also growing in media businesses and cable broadcasting services.

The most notable M&A transactions of the last year were the domestic acquisition of Optima Telecom, the Ukrainian fixed line telecom operator and internet services provider, by System Capital Management for US$130m, and the cross-border acquisition by US buyout firm Providence Equity Partners of Ukrainian cable television group Volia Cable for US$200m.

A number of large M&A transactions in the last year have brought major consolidation and intensified competition to the Ukrainian mobile services market, including the substantial acquisition of UMC, a leading mobile communications provider, by MTS, the leading Russian-based CIS mobile communications provider. This has decreased investment opportunities in the sector. Moreover, due to time consuming and complicated licensing procedures, and the absence of any regulations on new communication standards, the mobile services market bears certain administrative risks for potential investors.

Experts estimate that the profits of internet services providers have grown by 90 percent over the last year, making them attractive targets for M&A. Experts note investor interest in the acquisition of local internet providers and small phone companies with values around US$4-5m. When acquiring Ukrainian internet providers, investors favour asset deals, thus acquiring only real estate and equipment to avoid corporate and financial risks.

Consumer products

The increasing wealth of the Ukrainian population and the development of the consumer credit market have provoked a consumer market boom. The most considerable M&A transaction volume has occurred in the food industry, which experts estimate at around US$1.3bn, putting it in fourth place in terms of M&A transaction value.

The most notable M&A transactions of 2007 were the acquisition of Ukraine's leading juices producer Sandora by Pepsi for $US758m, dairy company Fanny by Lactalis Group at for US$45m, mineral water company Rosinka by Orangina Group for US$65m, cheese manufacturer Shostka by Bel group for US$50m, and cheese manufacturer Klub Syru by Renaissance Capital for US$197m.

Despite a large number of acquisitions, the food industry is still considered to have major investment potential as the level of consolidation and competition is low compared to developed economies. However, a number of sub-sectors (e.g., beverages, beer and alcohol) have already seen consolidation as the most attractive targets have already been acquired, so they do not offer many opportunities for new investors to enter these markets.

One of the main risks in consumer products M&A is the lack of high quality raw materials (which must be imported) and the increasing competition which is likely to follow WTO accession, as Ukraine opens up to a large amount of imports.

Bogdan Borovyk is co-head of the Corporate Law Practice Group and Ekaterina Katerinchuk is an attorney at Beiten Burkhardt.

Due diligence in Ukraine

BY BOGDAN BOROVYK AND EKATERINA KATERINCHUK

Generally, due diligence may be described as the process by which a potential investor evaluates a target company or its assets for the purpose of its acquisition. This is made through conducting an investigation and audit of the potential investment. Due diligence plays prominently in nearly all M&A transactions, with the subsequent outcome serving as a basis for the potential investor's decision on whether to go through with a deal, as well as how to structure the deal and define the material terms of acquisition.

The due diligence process varies depending on the different areas concerned, which may include financial and accounting, legal, tax, environmental, technical due diligence, etc. This article deals with certain aspects of legal due diligence.

In the course of the legal due diligence review, the availability of a data room, a sufficient level of documents available for review, and proficiency of the legal due diligence team are considered to be essential for a successful legal due diligence review. In some cases it may be necessary to agree with the investor on a certain threshold, meaning that any document raising risks below the agreed threshold shall be disregarded while conducting the legal due diligence. It allows investors to optimise the expenses related to the legal due diligence and conduct the review within a shorter time limit.

The final stage of legal due diligence summarises the findings and risks in the executive summary. The executive summary should reflect the basic findings relevant to the envisaged transaction and estimate the identified risks either in a quantitative manner (e.g., amount of penalties, fines which may be imposed on the target company for non-compliance with the certain legal requirements), or in a qualitative manner (e.g., the potential risk of contesting certain agreements or property title may be estimated as minor, moderate or high).

While drafting transactional documentation, it is particularly important to consider the outcome of the legal due diligence and minimise the uncovered risks by providing in the acquisition agreement, as the case may be, the seller's obligation to eliminate flaws (if applicable) as conditions precedent to closing, any pertinent representations and warranties of the seller, indemnification and remedial provisions.

Due diligence is quite a new notion for Ukrainian business practices. As a matter of fact, the Ukrainian market for due diligence services started its active development in 2004, to satisfy the massive inflow of foreign investments into Ukraine's economy, and consolidation of assets of major Ukrainian business groups.

Due to the fact that a practice of legal due diligence in Ukraine has only been established within the past few years, there are certain difficulties and specific features to be considered while conducting legal due diligence on a Ukrainian target company.

First, the specific character of the acquisition and allocation of property in Ukraine – which is more likely to be the result of certain historical developments, combined with a rather young and developing legal system, and even the lack of legal regulation of particular issues – has affected the approach to legal drafting and execution of official documents. In particular, this has resulted in a large amount of discrepancies and deviations from Ukrainian statutory requirements contained in the documents, and even the absence of certain documents of the target companies. These flaws are often discovered in the documents while conducting legal due diligence of the Ukrainian target company, particularly with regard to having all title documents to assets and real estate, non-compliance with privatisation procedures or a failure to fulfil privatisation obligations.

Second, additional legal obstacles cause difficulty in the legal due diligence process, and are mainly connected with the lack of sustainability of the legal framework (i.e., frequent revision and amendments of laws, absence of the unified court practice, etc.), and ambiguity and contradictions of the legal provisions, which causes problems even for companies with the highest legal standards in terms of compliance. Consequently, Ukrainian companies are often not in compliance with currency, tax, anti-monopoly and corporate laws.

Third, the mentality and legal consciousness in Ukraine, mainly characterised by a neglectful attitude towards the legal standards and obligation to comply with their requirements, also has a negative impact on legal due diligence practices. It has resulted in extremely irresponsible and negligent attitudes towards proper documentary execution of business operations, titles to property, etc. Thus, in the course of a legal due diligence on a Ukrainian target company, it is often discovered that, while *outwardly* financially healthy and operating effectively, the company has no duly executed title documents, registrations of intellectual property rights, or formally reflected relations with its owners or management.

As a general rule to minimise the risks, investors should obtain as much information about the target company as possible. Thus, a full-scale legal due diligence review of the target company is recommended, as the most efficient way to protect and secure the interests of the investor. However, in some instances, conducting a comprehensive legal due diligence review may appear difficult under Ukrainian conditions. Due to the abovementioned factors, when conducting the legal due diligence the investors often have to face problems related to poor organisation of data rooms, absence of necessary documentation, and/or failure of the target company's managers or employees to provide the requested information. These issues, though of a technical nature, should not be underestimated as they substantially influence the effectiveness and timing of the legal due diligence review. As data room arrangements are usually the responsibility of the seller and/or target company, it is important to agree in advance upon the manner of providing documents (copies or electronic form), availability of data room index, data room working hours and rules, the possibility and form of submitting additional requests and interviewing certain officers of the target company, appointment of the contact persons of each party and a person in charge of the data room, etc.

One more issue to be taken into account is that the applicable laws and regulations of Ukraine generally do not stipulate liability for providing false information during the legal due diligence review. For this reason, investors should pay particular attention to the pre-due diligence negotiations and arrangements as described above, the participation of investment advisers representing the target company and/or the seller, and make sure that the seller representations and warranties regarding the correctness, credibility and authenticity of the documents and information provided for the legal due diligence review by the seller, target company and/or its representatives and officers, are included in the acquisition agreement.

The latest trend in the Ukrainian M&A market is the inclusion of vendor due diligence. While buyer due diligence has become quite common for Ukrainian transactions, vendor due diligence is conducted by a sellers' legal advisers and is intended to present information about the target company to any potential buyers. Vendor due diligence usually expedites auction procedures and facilitates buying the target company at a more favourable price. Moreover, vendor due diligence enables the seller to discover potential risks and legal flaws of the target company and eliminate them if possible. Although, Ukrainian laws and regulations do not expressly charge the seller with an obligation to inform the buyer of potential risks pertinent to an acquisition of the target company, the seller should inform the buyer of the rights of third parties to the target company, if there are any.

Bogdan Borovyk is co-head of the Corporate Law Practice Group and Ekaterina Katerinchuk is an attorney at Beiten Burkhardt.

Antimonopoly laws in Ukraine

BY BOGDAN BOROVYK AND EKATERINA KATERINCHUK

The antitrust laws and regulations of Ukraine are aimed at protecting economic competition and precluding monopolisation of the Ukrainian market. In recent years, the increasing investment of foreign capital in Ukraine and consolidation among major Ukrainian financial groups has resulted in a huge amount of M&A transactions having a substantive effect on the competition and consolidation of the Ukrainian market. Consequently, they fall under the requirements of the antitrust laws and merger regulations of Ukraine. The purpose of this article is to give investors an overview of the antimonopoly laws and regulations of Ukraine and basic information on the requirements to be met and procedures to be followed by the parties to M&A transactions.

The principal legal act regulating anti-monopoly control is the Law of Ukraine 'On Protection of Economic Competition'. The Competition Law is intended primarily to prevent the monopolisation of product markets, abuse of monopoly positions, and the creation of limits on competition. In fulfillment of those goals the Competition Law grants the Antimonopoly Committee of Ukraine (AMC) the legal authority to approve or disapprove of 'concentrations' of business entities, as well as certain contractual and other activity. The Competition Law provides a non-exhaustive list of the types of transactions which qualify as 'concentrations'. In particular, these are: (i) mergers or consolidations of business entities; (ii) acquisitions or obtaining direct or indirect control over one or several business entities, or parts thereof, by means of direct or indirect acquisition of a property complex or a business entity's subdivision, or appointment of a person occupying a managing position in one business entity to a similar position in other entities; (iii) establishments of new business entities by two or more business entities; and (iv) direct or indirect acquisition resulting in the acquirer obtaining or exceeding 25 or 50 percent of the voting rights of the business entity, which is the most common type of concentration under cross-border transactions in Ukraine.

Should an M&A transaction fall within either of the abovementioned criteria, it shall be considered as a concentration. In such cases, the AMC's prior approval of such transaction shall be obtained if the certain quantitative thresholds are met. In particular, the AMC's prior approval is required if during the last financial year the combined asset value or total sales, including those abroad, of the participants of concentration, exceed an amount equivalent to €12m, provided that: (i) the combined asset value or total sales, including those abroad, of at least two participants of concentration exceed an amount equivalent to €1m for each participant; and (iii) the combined asset value or total sales in Ukraine of at least one participant in such concentration, exceeds an amount equivalent to €1m.

The AMC's prior approval must be obtained, irrespectively of the abovementioned thresholds, if the market share of one, or the combined market share of all, the participants of concentration exceeds 35 percent.

Should the parties close a transaction without the AMC's prior approval or in case of post-closing filing, the AMC is authorised to impose fines on the participants of unauthorised concentration. Namely, according to the Competition Law, the AMC may impose a fine of up to 5 percent of a participant's revenues from the sales of products (services, works) accrued within the preceding financial year.

There are also types of transactions that do not fall under the AMC's approval requirements. The following transactions are expressly exempted from obligation to obtain the AMC's approval: (i) acquisition of the shares by the company specialising in financial or securities operations, provided, however, that the shares are resold no later than one year after such acquisition; (ii) transactions between the related business entities provided that the relations of control between those entities were initially established with the AMC's prior approval; and (iii) acquiring control over a business entity by the appointed bankruptcy receiver.

Should an M&A transaction not satisfy the criteria of an exemption, the AMC's approval of such transaction must be obtained prior to its closing. Once the approval is granted it remains valid for one year. If the transaction is not closed within one year, a new AMC approval must be obtained.

In order to initiate the procedure of obtaining the approval, the respective application shall be filed with the AMC. In ordinary cases, the AMC requires 45 days to review an application, consisting of an initial 'preview' 15-day period during which the application can be rejected for formal non-compliance, and 30-day maximum period for substantive evaluation. The AMC's failure to commence evaluation by the end of this period is deemed to constitute an approval, dated as of the last day of this period.

However, in some cases, the AMC may require an in-depth investigation which may take up to three months, whereby the AMC will ask for the provision of additional information or an expert appraisal. Consideration of the application may be also suspended should certain circumstances prevent its consideration (e.g., pending resolution of other related and concurrent cases before courts, international tribunals, or agencies).

As to the filing procedure itself, filing entails preparation of the application, supporting documents and payment of the filing fee. Usually, a few weeks may be required for preparation of the application due to the volume of data, information and documents that must be processed and compiled in the appropriate form. The supporting documents shall be submitted together with the application (depending on the type of concentration this may be constituent documents, financial statements of the participants of concentration, copies of the acquisition agreement, etc.). Any documents issued abroad shall be notarised and, in certain circumstances, apostilled or legalised. Moreover, foreign language documents shall always be supported by an official Ukrainian translation. At present, the filing fee for an ordinary application is approximately €760.

Ukrainian laws and regulations grant the AMC a broad scope of general competence and a large authority in considering concentration applications; in particular, the AMC is authorised to request any additional information, the absence of which prevents the AMC from considering the application. In practice, this approach has resulted in the AMC, at any time and at its discretion, requesting information, data or documents which it deems necessary for the consideration of application. Moreover, the AMC is entitled to dismiss the application without deciding on the merits because of the failure to provide the requested information within a specified term, even though the submission of such information may not be expressly provided by applicable laws and regulations.

While considering an application, the AMC has the authority to request any information, including confidential and restricted access information. In particular, it is common practice of the AMC to request information on the shareholding structure of the participants of the M&A, including information on the beneficial owners, information which foreign investors are usually reluctant to disclose. Nevertheless, the applicable laws and regulations of Ukraine stipulate the AMC's non-disclosure obligations, provided that the information submitted to the AMC is expressly stated to be confidential and to be treated as restricted access information. Otherwise, the AMC is entitled to disclose certain information on the envisaged concentration, in particular, by publishing it on its website.

According to the Competition Law, the AMC shall always grant its approval, unless the concentration causes monopolisation or substantial limitation of competition on the whole Ukrainian market or at its considerable part.

The approval granted by the AMC may be conditioned on certain requirements or obligations being fulfilled by the participants of concentration in order to decrease the negative impact of the concentration on competition in the relevant market. In particular, such obligations may provide certain restrictions related to the management or disposal of property, or obligations to alienate certain property.

The refusal may specify certain recommendations for the participants of concentration to follow, in order for approval to be granted.

If the AMC refuses to approve a concentration, such refusal shall always be supported by stated legal grounds. The refusal may specify certain recommendations for the participants of concentration to follow, in order for approval to be granted. The AMC's refusal may be contested in court. The Competition Law also grants authority to the government of Ukraine to approve concentrations disapproved by the AMC, under condition that the positive impact of such concentration on the public interest will exceed the negative consequences on the limitation of competition in the Ukrainian market.

According to the Competition Law, the AMC is also entitled to revise its own resolutions (approving or disapproving concentration) either at its own initiative, or under application of any person. However, such revision may be made only on the following grounds: (i) discovery of material circumstances unknown to the AMC, if such circumstances result in the unwarranted or unlawful resolution of the AMC; (ii) discovery of false information unknown to the AMC if such information results in the unwarranted or unlawful resolution of the AMC; (iii) non-compliance of the participants of the concentration with the obligations conditioning the AMC's approval of concentration; and (iv) other grounds provided by applicable laws.

The powers of the AMC to revise its approval decision and the non-exhaustive list of grounds for such revision causes a situation of legal uncertainty. However, as a matter of practice, the AMC does not tend to use its revisionary powers, unless the abovementioned grounds occur. Moreover, the Competition Law also provides for statute of limitations for revision of the AMC's decision of three to five years (depending on the grounds for revision) from the date of the respective AMC's resolution.

Bogdan Borovyk is co-head of the Corporate Law Practice Group and Ekaterina Katerinchuk is an attorney at Beiten Burkhardt.

Legal issues in Romanian M&A

BY CĂTĂLIN MICU AND NICOLAE HARIUC

Foreign acquirers targeting all or part of a company incorporated in Romania should be aware of various capital market, labour, environment, competition and fiscal law implications.

Capital market issues around takeover offers

The Law no. 297/2004 on capital market establishes two types of takeover offers: the voluntary takeover offer and the mandatory takeover offer.

The voluntary takeover offer represents a public purchase offer that results, for the entity that launches it, in the purchasing of more than 33 percent of the voting rights in a company. This public purchase offer (i) is addressed to all shareholders of a company listed on the Bucharest Stock Exchange (BSE), for all their holdings and (ii) is launched by a person that does not have this obligation.

In a voluntary takeover offer the price shall be at least equal to the highest price from: (i) the highest price paid by the offeror or the persons acting in concert with it during the period of 12 months prior to the date of submitting to the Romanian National Securities Commission (RNSC) the public offer documents; (ii) the average weighted price of trading, referred to in the last 12 months prior to the date of submitting to RNSC the public offer documents; and (iii) the net assets of the company per shares in circulation, according to the last financial statement of the company.

A person that, as a result of its purchase or those of the persons acting in concert with it, holds more than 33 percent of the voting rights in an undertaking must launch to all shareholders of a company listed on BSE a public offer addressed to all securities holders for all their holdings as soon as possible, but no later than two months from reaching this holding position. Until such mandatory takeover offer is made, all the rights related to the securities exceeding 33 percent of the voting rights within the issuer are suspended, and the said shareholder and the persons acting in concert with it may no longer purchase, by other operations, the shares of the same issuer.

In a mandatory takeover offer the price offered shall be at least equal to the highest price paid by the offeror or by the persons with whom it acts jointly within the 12 months prior to the offer. If no such price exists, the price offered shall be determined in accordance with RNSC provisions, at least taking into account the following criteria: (i) the average weighted price of trading for the last 12 months prior to the offer being made; (ii) the value of the company's net assets according to the latest audited financial statements; (iii) the value of the shares, as it results from an expert's report made by an independent valuator, in accordance with the international valuation standards.

Any person may launch a counter-offer for the same securities, under the following conditions: (i) it addresses the same amount of securities and targets, at least, the same share capital holding; and (ii) it offers a price that is at least 5 percent higher than the first offer. This counter-offer shall be carried out by submitting to RNSC the required documentation within a maximum of 10 working days from the date when the first offer was made available to the public. Through the decision to authorise the counter-offers, RNSC shall establish once the same closing term for all the offers, as well as a deadline for the submission for approval of the supplements regarding price increases within competitor offers. The single term for closing competitor offers may not be longer than 60 working days from the date when the first offer has been made.

Labour issues

Law no. 67/2006 on the protection of the employees' rights in case of transfer of the enterprise, unit or parts of the enterprise or unit transposes into Romanian legislation the Directive 2001/23/EC on the appropriation of the legislations of the member states relating to the maintenance of the workers' rights in case of transfer of the enterprise, unit or parts of the enterprise or unit.

According to the law 'the transfer' means transferring from the assignor's ownership into the assignee's ownership an undertaking, unit or part of the undertaking or unit as a result of an assignment or merger, for the purpose of carrying on the main or secondary activities, without considering its obtaining or non-obtaining of any profit (the assignor being the person that loses its capacity as employer towards the employees of the undertaking, unit or parts of the undertaking or unit, and the assignee the person that acquires the capacity of employer towards the employees mentioned).

The European Court of Justice regulated that the notion of economic entity represents an organised aggregate of persons and elements permitting the performance of economic (essential or secondary) activity pursuing an own objective. In other words, the economic entity is construed as being a unit or a part of the unit, that establishment and/or sector (division) of activity of an undertaking that has or may have an autonomous activity, the necessary and sufficient human, technical and logistic capital.

Pursuant to the above-mentioned legal provisions, the employees' rights in case of transfer of the undertaking, unit or parts of the undertaking or unit shall be protected by informing the employees' representatives with regard to the legal, economic and social consequences of the transfer and by establishing the rule that the employees' rights and obligations entailing from the individual labour agreements or the applicable collective labour agreement, existing on the date of operation performance, shall be integrally transferred to the assignee.

Environmental issues

The Emergency Government Ordinance no. 195/2005 regarding environment protection provides that the notice for establishing the environment obligations, meaning the technical and legal document issued by the competent authority for environment protection, must be obtained in case of the change of the holder of an activity with significant impact on the environment, the sale of the majority block of shares, the sale of assets, merger, split-up, cessation of activity, having as purpose the establishing of the environment obligations as provisions of a compliance plan in order that the parties involved in the situations previously mentioned undertake them.

The issuance of the environment notice is the first step in order to obtain a new environment authorisation.

Competition issues

The specific issues pertaining to the economic concentrations resulted from international mergers and acquisitions are regulated by the Council Regulation (EC) No. 139/2004 on the control of concentrations, which is applicable to the economic concentrations with a Community dimension. In such cases, the European Commission is the competent authority for applying the provisions of the above-mentioned Council Regulation subject to review by the Court of Justice.

For the economic concentrations that affect the competition on the Romanian local market, the provisions of the Competition Law no. 21/1996 are applicable. The competent body for applying these provisions is the Competition Council.

Specific thresholds are set up by the applicable laws for starting the procedure of notifying the European Commission or the Competition Council. In this respect, the parties involved in an international merger and/or acquisition will notify the competent authorities.

The Council Regulation states that an economic concentration has an EU community dimension if the following conditions are met: (i) the combined aggregate worldwide turnover of all the undertakings concerned exceeds €5bn; and (ii) the aggregate community-wide turnover of each of at least two of the undertakings concerned exceeds €250m, unless each of the undertakings concerned achieves more than two-thirds of its aggregate community-wide turnover within one and the same Member State.

Also, a concentration that does not meet the thresholds specified in the paragraph above has a Community dimension if: (i) the combined aggregate worldwide turnover of all the undertakings concerned exceeds €2.5bn; (ii) in each of at least three Member States, the combined aggregate turnover of all the undertakings concerned exceeds €100m; (iii) in each of at least three Member States included for the purpose of point (ii) the aggregate turnover of each of at least two of the undertakings concerned exceeds €25m; and (iv) the aggregate community-wide turnover of each of at least two of the undertakings concerned exceeds €100m, unless each of the undertakings concerned achieves more than two-thirds of its aggregate community-wide turnover within one and the same Member State.

The above-specified thresholds are subject to the Council's modification following the proposals submitted to it by the Commission.

As per the Romanian competition law, the thresholds are the following: (i) the combined aggregate turnover of all the undertakings concerned exceeds the equivalent in RON of €10m and (ii) at least two of the concerned undertakings achieve, in the Romanian territory, a turnover exceeding the equivalent in RON of €4m each. The equivalent in RON is calculated at the exchange rate RON/EUR communicated by the National Bank of Romania in the last day of the financial year previous to the year when the merger or acquisition occurs.

Should the economic concentration not be notified by the undertaking that had the obligation to submit the notification, the Commission or the Competition Council can apply penalties that shall not exceed 10 percent of the undertaking's turnover.

Fiscal issues

For the revenues acquired as a result of the acquisitions of Romanian companies, the Romanian Fiscal Code establishes certain taxes to be paid to the fiscal state authorities, depending on specific criteria, namely the form of incorporation of the company whose shares are the object of the transaction, respectively the person obtaining the revenue (Romanian or foreign natural person or Romanian or foreign legal person, as the case may be).

Moreover, both the trade registry and the independent registry company that holds the shareholders register shall deny the registration of transfer of ownership over the shares, as provided by the Companies Law, in case proof of the due tax payment, as per the above criteria, is not presented.

Cătălin Micu and Nicolae Hariuc are associates at Zamfirescu Racoți Predoiu Law Partnership.

The Baltic M&A markets

BY RAMINTA KARLONAITE

M&A emerged only 17 years ago in Lithuania, Latvia and Estonia, at the beginning of privatisation involving state-owned businesses. From 1991, M&A markets in the Baltics have grown rapidly for a number of reasons including fast economic growth, an influx of foreign direct investment, consolidation of the economies of the three Baltic States, and ongoing integration into the European Union. Transaction practices have undergone significant changes in the Baltics, adopting many standards compatible with M&A in developed markets. From nothing they have evolved to achieve global recognition.

2007 was a record year for Baltic M&A. According to disclosed deal size, the largest M&A deal was the acquisition of the Lithuanian Telecommunication Company by private equity firm Mid Europe Partners for €450m.

In recent years, the economies of the three Baltic States have been among the fastest growing in the European Union. GDP in the Baltic countries last year reached 10.5 percent in Latvia, 8.7 percent in Lithuania and about 7 percent in Estonia. However, there has been a recent slowdown that puts 2008 and 2009 forecasts at 3-4 percent for Estonia, 7.2 and 5.5 percent for Latvia, and 6.5 and 6 percent for Lithuania respectively in 2008 and 2009, according to SEB Economic Research.

Inflation in the Baltic countries has increased considerably, and is expected to remain high in 2008. The Bank of Lithuania predicts that Lithuania's average annual inflation will be around 7.9 percent this year, dropping to 4.9 percent in 2009. Last year, inflation in Latvia reached 14 percent while the forecast is 12.8 percent for 2008. In Estonia, inflation has actually started declining: an average of 8 percent is expected in 2008. Notably, such high inflation rates might cause further postponement of the euro in the Baltic countries.

Experts indicate a number of reasons for a slowdown in the Baltic economies. These include the cyclical downturn, turbulence in global financial market, the large current account deficits of Lithuania, Latvia, and Estonia, low exports, high pay increases in recent years, and high domestic demand. But despite the cooling period, economic growth in the Baltic countries is expected to remain significantly higher than many other European countries. The Baltic currencies' euro pegs should survive.

Prospects for the Baltic economies are bright. The economies of Lithuania, Latvia and Estonia are flexible because they are small, open and offer many opportunities. An economic slowdown should be temporary, giving way to a fast recovery. The Bank of Estonia estimates that in 2008-09 economic growth will drop more than expected, but this would help to decelerate rising prices and trade deficits.

When the adjustment period ends, the Baltic countries will have good chances to continue their rapid growth. The forecasted long term sustainable growth rate of the Baltic States would still be about 6-7 percent per year. However, future growth and economic expansion will have to be more balanced with a need to promote exports. It will be necessary to promote the private sector to invest in industries primarily focusing on the foreign markets. Moreover, taking into consideration the current economic adjustment stage of Estonia, Latvia, and Lithuania, strict and prudent fiscal policies are vital to maintain economic balance and support investments.

In recent years, trends in Baltic M&A practice have included an increase in auction sales, growing activity by private equity funds and a higher volume of local or cross-Baltic investments. All these trends should persist, albeit at a reduced scale. M&A activities should not be heavily influenced by a slowdown in the Baltic economies, since even struggling companies can provide attractive targets.

In this deceleration phase, the leading companies will have strong cash flows that are not too dependent on domestic demand, but rather exporting. They will have healthy balance sheets and strong management capable of acting on opportunities. On the other hand, struggling companies will have weak cash flows that are highly dependent on domestic demand, or highly leveraged balance sheets.

In terms of M&A, winning companies will have a better chance of buying underperforming companies at a lower price, thus expanding their activities and strengthening their position in the market. Nordic or Polish companies could be active acquirers of less efficient Baltic companies, whose shareholders now have fewer illusions about the value of their business. Also, relatively strong Lithuanian companies that benefit from a stronger domestic economy could acquire weaker Latvian and Estonian companies.

Private equity in the Baltics has picked up only very recently, much later than in Western Europe. The credit crunch has imposed limits on the leverage of private equity investments and therefore their global activities are expected to slow down. In the Baltics, this hurdle is reduced because transaction values are relatively small. Furthermore, international private equity funds are now showing increasing interest in Central & Eastern Europe, including the Baltics, where economies are growing faster than those of the Western Europe. For these reasons, the Baltic private equity market should continue to grow.

The economic deceleration of the Baltic States should open new opportunities for M&A activity. Currently, legislation and practices are comparable to developed markets because they are harmonised with the EU. Certain EU Acts covering M&A have been fully implemented in Lithuania, Latvia and Estonia, such as the Directive on Takeover Bids (2004/25/EC; the Takeover Directive) and the Cross-Border Mergers Directive concerning limited liability companies (2005/56/EC; the Cross-border Directive).

The Takeover Directive creates a common set of rules for all EU Member States and thus promotes the idea of unifying the common market in the European Union. The Takeover Directive was aimed at creating efficient takeover mechanisms, a common regulatory framework, strong rights for shareholders, including minority shareholders, and to remove some of the main company-related obstacles which were permitted under national company law (these obstacles meant that takeovers could not be undertaken under equal conditions in the different Member States). After implementation of the Takeover Directive in the Baltic States, acquiring companies are able to rely on the same mechanisms to tackle probable challenges when acquiring companies on a pan-Baltic scale.

All three Baltics States have also adopted measures to transpose the Cross-Border Mergers Directive. The purpose of the cross-border merger legislation was to simplify the procedure for mergers between limited companies registered in the Member States of the European Union. The cross-border merger legislation establishes general requirements for merger agreements and related documents and procedures that are uniform for all parties. The cross-border merger legislation could facilitate company mergers in the Baltics.

In addition, the Estonian Parliament recently adopted amendments to the Securities Market Act transposing provisions of the Markets in Financial Instruments Directive (MiFID), the Takeover Directive, and the Capital Adequacy of Investment Firms and Credit Institutions Directive. The amended Securities Market Act imposes significant new requirements for investment advisers, investment funds, fund managers, stockbrokers, and banks with activities in Estonia as well as new rules pertaining to takeovers and capital adequacy requirements. In addition, the amendments in the Estonian legislation related to the MiFID provide for the creation of deregulated multilateral trading facilities which will provide new opportunities for small to medium size growth companies seeking to raise capital.

Finally, as of 1 March 2008, amendments to the Law of the Republic of Lithuania on Collective Investment Undertakings were adopted. The main novelty under the law is that besides harmonised collective investment undertakings within the meaning of Council Directive 85/611/EEC, special collective investment undertakings – investment funds and investment companies whose operation are not harmonised at the EU level – might be set up in Lithuania. Thus, the law provides legal grounds for establishing in Lithuania private capital, real estate, alternative investment, and other special collective investment undertakings, allowing investors to make indirect investments in perspective and growing companies whose securities are not traded on regulated markets as well as in real estate objects and financial derivatives.

Although the growth rate of Baltic economies is experiencing a slowdown, the M&A market remains attractive, especially for corporate buyers. Legislation and practices are comparable to developed markets and harmonised with the EU. So despite the slowdown, the Baltic economies will have a good chance of continuing their rapid growth.

Raminta Karlonaitė is a senior associate at Sorainen.

Completing a successful deal in the Baltic States

BY VEIKKO TOOMERE AND JACOB STRANDGAARD ANDERSEN

The Baltic States are three different countries. A general misconception is that the Baltics can be regarded as one region of countries, which share a common cultural background and which have similar languages, institutions and mentality. Foreign acquirers planning a business venture in Estonia, Latvia or Lithuania must address this misconception. There are not only differences in languages, but also historical and cultural differences. Doing your homework to achieve a prior basic knowledge of the relevant Baltic country is an important part of success.

Post Soviet legislation versus modern European legal systems. The legal systems in all three Baltic States are relatively new. Less than 20 years ago, sale or purchase for profit was a criminal offence and the legal systems were an echo of the communist Soviet legal system. However, the development of the legal systems is a reality, and EU legislation has been largely implemented following accession to the EU in 2004. Judiciaries that function relatively well have been established, offering protection of contractual rights, enforcements of claims, etc.

Business culture. When looking closely at the business cultures, most foreigners find that the pace is high, and that the Estonians, Latvians and Lithuanians are looking for fast returns on their investments. Part of the reason for this is that the region has only seen progress in the last 10-15 years. This is also reflected in a significant increase in the standard of living.

Economic growth and inflation. Since the re-independence of the Baltic countries, all of them have seen an extraordinary growth in GDP, with some of the highest growth rates in Europe. The disposable income for consumption is high. There are signs of a slowdown, although there is no consensus on how abruptly or by how much the economies will cool down. Inflation is increasing and reached double digits in Latvia and Estonia in 2007. This must be seen in light the virtually non-existent unemployment and growing concern among companies, which are desperately looking for employees to fill vacancies. This is a contributing factor in pay increases. For example, the increase in Estonia averaged 20 percent from Q4 2006 to Q4 2007. It means Estonia is losing the competitive advantage it had because of low manual labour costs.

Challenges with long term planning. Long term planning is not a top priority, and is still new to most companies in the Baltic States. Most businesses are much younger than 15 years, and their managers and owners are much more impatient than their counterparts in Western Europe. When coming from a background where long term strategic and visionary planning is the norm, and where a pragmatic approach is often chosen to ensure steady growth over the coming decade, it takes some time to get used to and appreciate the entrepreneurial atmosphere aimed at fast returns today rather than tomorrow.

Patriarchal style of leadership. When entering negotiations it is always a good idea to approach the owners directly, as they will be the real decision makers. In most cases they will also be the managers. Contact with managers who are not the owners is inadvisable. The style of management is patriarchal and major decisions, particularly concerning sale of a business, will rest solely with the owners.

Until agreements are in writing an acquirer cannot be confident that the outcome of a discussion will be the actual final result.

Issues to consider in M&A in the Baltic States

Disclosure challenges and unwritten established practices. When a foreign acquirer comes to one of the Baltic countries, they often encounter problems with disclosure of information. Companies are generally not keen to disclose as much information as may be customary in other regions. This is particularly true for sellers with a Russian background. The main reason is not necessarily because there are things to hide, but because of a general suspicion towards buyers, who may also become a future competitor. Another reason is that unwritten practices exist, such as special benefits to certain employees or other unusual agreements. Not all of these are registered in the books. These practices appear to be decreasing, but they will still arise for some years to come.

Management interviews and written evidence. The challenges with disclosure and the existence of unwritten practices underline the importance of management interviews. This is important as it partly compensates for slow or challenging disclosure of written information. Secondly, it often gives an insight into how customary unwritten or unusual practices are.

It should be stressed that it is unwise to rely on oral agreements. Information obtained in an interview should always be confirmed in writing. This becomes even more crucial as negotiations progress and a final agreement is within reach. It has caused problems for buyers who have relied too much on an oral discussion 'that only needed to be written down'. Until agreements are in writing, an acquirer cannot be confident that the outcome of a discussion will be the actual final result. This is not due to foul play, just an aspect of business culture and negotiations.

Pricing. Setting the price for a business is often influenced by emotions and speculation. Although sellers today are more likely to use external advisers when appraising the company, many still base the price on their own feelings, which are often unrealistic. This is further complicated by the fact that the price of goodwill is still valued very conservatively. These factors make transactions more challenging, and a potential buyer needs to take them into account.

Not for sale does not always mean not for *sale.* Not only is the price often set based on emotions. Upon contacting a potential target with a preliminary inquiry, an acquirer will likely be met with a "Not for sale", followed by a "Who told you we are for sale?" This should not be taken as a full and final 'no'. The 'not for sale' is rarely final, and can just as easily be interpreted as a 'maybe'. "Who told you?" can often be explained by the size of the Baltic markets. As the business community is small, everybody seems to know each other in a particular business sector, so this is likely a defence mechanism to stop any sales rumours and not show signs of weakness. The essence is that an initial negative response should not immediately stop an acquirer from planning an acquisition.

The Nordic perspective and comparisons

Verbal agreements followed by written contract. It is much more normal to use oral agreements in Nordic markets, which will be confirmed in writing without much difficulty or delay. This is not an approach that is likely to succeed in Estonia, Latvia or Lithuania. Pressing forward with drafting the sale and purchase agreement is necessary during the entire investigation and negotiation process. The typical decision makers in the Nordic countries are managers, although the final and formal decisions are made by the owners, which reflect a much less patriarchal management structure than in Estonia, Latvia and Lithuania.

Disclosure levels. Another difference is a much more open approach to disclosure. Both the management interviews and the data room information are typically more informative in the Nordic area. There is not as much suspicion towards buyers. Unless the purchaser is a fierce competitor, most requested information will be made available.

Professional valuations. Emotions are seldom part of the pricing in the Nordic countries. The value of the company – both the internal value and the value of the goodwill – is in most cases set by professional advisers. This also makes the price negotiations more difficult as an acquirer will need to point out specific reasons, before it will be able to change the professional valuation significantly. Finally a 'not for sale' is exactly what it means.

Recommendations

Local representation. Working with a local adviser is strongly recommended when considering acquiring a company in Estonia, Latvia or Lithuania. The levels of spoken foreign languages are quite high, and many potential business partners work well in English, German and/or Russian. There are, however, other good reasons to work with a local adviser. The cultural differences in the business environment are different so the risk of failure due to misunderstandings is quite high.

Generally an acquirer will be met with scepticism if approaching a seller in a typical Nordic manner. They may have a good idea of exactly what they want and what the terms should be. Slamming such a proposal on the table may offend the target, and portray the acquirer as a 'know-it-all' type. Furthermore, nuances in spoken English are often lost when not all parties are native speakers, and this combination of cultural differences and language barriers can end an otherwise lucrative business opportunity at an early stage. Representatives and negotiators are more respected when they speak the local language.

Be ready for fast decision making. As the pace of doing business in the Baltic States is often found to be much more hectic than in the Nordic region, acquirers should be prepared for the process to become extremely hectic when the closing approaches. In this phase it is still important to get written confirmation of issues discussed in meetings or via telephone. This can help to keep the process focused on a final result.

Try to approach before the company is officially for sale. As the pace is high in the Baltic States, and since a fast and large return is the aim, an acquirer should not sit and wait until a company is officially for sale. The acquirer should be honest and direct, and refuse to take no for an answer right away.

Keep it in writing. The final advice is to keep a written track record. Conversations and interviews should always be confirmed in writing. If not, it will be extremely difficult to push towards a final agreement.

Jacob Strandgaard Andersen and Veikko Toomere are lawyers at MAQS Law Firm.

CHAPTER TWELVE:

Regional view – Asia Pacific

Recent trends in Japan's M&A market

BY MASAKAZU IWAKURA, YOSHIAKI SAKURAI AND JUAN L. RAMIREZ

Decreasing population and continued economic stagnation, together with intense competition among Japanese and foreign companies alike, have exacted a heavy toll on Japanese financial markets. In 2007, the Nikkei average fell nearly 11.8 percent as the subprime crisis spread from the United States to the rest of the world. The market decline has only accelerated in the first quarter of 2008 with the Nikkei falling another 17.3 percent as the strengthening yen added to the Japanese economy's woes. Given the market situation, there were approximately 3000 M&A transactions involving Japanese companies in 2007, the total value of which was about ¥16.8 trillion (roughly US$168bn), representing a slight increase compared to 2006 in both deal volume and transaction value. The most active market participants over the last 12 months included financial institutions, department stores and the pharmaceutical industry.

Although 2007 was not a significant year with regards to market growth, it was notable for several important developments in the legal arena. These include: (i) the endorsement by the Supreme Court of Japan of, essentially, a kind of poison pill by a Japanese corporation; and (ii) provisions of the Financial Instruments and Exchange Law (FIEL) and the Japanese Corporate Law becoming completely effective. The transactions and cases described below highlight some of these developments and will help illustrate the latest market trends in Japanese M&A.

Over the past 12 months, practices relating to hostile takeovers have developed. The decision of the Supreme Court of Japan in *Bull-Dog Sauce Co, Ltd. v. Steel Partners Japan Strategic Fund (Offshore), L.P.*, was the most important legal precedent with regards to M&A during this period. Steel Partners, a US based activist fund, launched its bid for Bull-Dog on 5 May 2007, which was opposed by Bull-Dog's board of directors on 7 June 2007. On 24 June 2007, more than 80 percent of the shareholders of Bull-Dog approved a defensive measure whereby the company issued and allocated three new share warrants to each of its shareholders with discriminatory conditions, such that Steel Partners and its affiliates could not exercise the warrants. Bull-Dog reserved the discretion to repurchase and did repurchase the warrants from Steel Partners and its affiliates based on the tender offer price which Steel Partners initially offered to the shareholders of Bull-Dog, resulting in a drastic reduction of Steel Partners' ownership in Bull-Dog. The Supreme Court, on 7 August 2007, dismissed Steel Partners' appeal, for the first time endorsing a defensive measure adopted in the face of a hostile takeover bid. The Court held that the issuance of the share warrants did not violate the principal of shareholder equity or any other applicable laws and regulations. It also held that the share warrants were not issued in a significantly unfair manner. In addition, the decision of the Supreme Court suggested that pre-bid measures improve the predictability for shareholders, investors, possible bidders and other related parties. Such measures typically include a rights plan using share warrants with discriminatory conditions, where only certain shareholders can execute the warrants and so on, structured so that the company simply notifies in advance the possibility of using this defence, and after a bid is made the company has the right to allot warrants to its shareholders. Though approximately one-sixth of listed companies in Japan have already adopted similar measures as of the end of 2007, the Supreme Court's suggestion may encourage other Japanese companies to do the same.

The year also saw a rare example of a successful hostile takeover of a Japanese investment firm in Ken Enterprise's bid for Solid Group Holdings Co., Ltd, a used car dealer. It would be unwise to draw any conclusions from this deal, however; despite opposition from Ken Enterprise's board, approximately 48 percent of the shares were owned by Lehman Brothers Japan Inc., which supported the deal. Although almost all hostile deals in Japan are unsuccessful, hostile bids may still increase in the years ahead, mainly due to the dissolution of deep-rooted cross-shareholding among Japanese companies and an erosion in the cultural resistance to hostile bids or takeovers in Japanese society, especially as activist shareholders attempt to takeover the companies with low price book-value ratios, such as Steel Partners' ongoing proposed tender offer for Sapporo Holdings Limited, a major Japanese brewer.

The largest M&A transaction by value in the last 12 months was Citigroup Inc.'s acquisition of Nikko Cordial Corporation, one of the top Japanese securities firms, which was on the verge of being delisted due to an accounting scandal. The total transaction value (including the tender-offer made before the triangular share exchange) was about ¥1.6 trillion (about US$16bn), the largest deal in Japanese M&A history. The initial tender offer alone ranked as the largest ever in Japan. Citigroup Japan Holdings Ltd., a direct, wholly-owned Japanese subsidiary of Citigroup, completed the acquisition of the Nikko shares through a triangular stock-for-stock exchange, in which the parent company's shares are used for consideration (i.e., Nikko shareholders received Citigroup shares). Such triangular stock-for-stock exchanges and triangular mergers (in which a subsidiary absorbs and merges with the target, and provides shares of its parent company to shareholders of the absorbed target), which are common in the US, have only been permitted since 2007 under the Japanese Corporate Law. By using this deal structure, a Japanese subsidiary of a non-Japanese company is able to absorb a Japanese company by using its parent company's shares, whereas a merger between a Japanese company and non-Japanese company is still prohibited under the Japanese Corporate Law. Nevertheless, due to, among other things, uncertainty over the tax treatment with respect to triangular transactions, the Citigroup deal is the first and the only one to be structured in this way. Whether this is the beginning of a new trend in the coming year remains uncertain.

Other notable deals include the merger of Mitsubishi Pharma Corporation and Tanabe Seiyaku Co. Ltd., valued at about ¥525bn (about US$5.3bn), and the strategic alliance between the Kyowa Hakko Kogyo Co., Ltd., Kirin Pharma Company, Limited and Kirin Holdings Company, Limited – the value of the integration is approximated to be ¥300bn (about US$3bn). Both transactions are in the pharmaceutical industry, which is experiencing drastic changes, including the revision of Japanese national medical treatment fees and pharmaceutical price reductions, increased global competition and increased research and development costs of new drugs, which have motivated these companies to enter into alliances with one another.

Economic pressures have also led to increased competition in the retail shops market, involving not only department stores, but also general merchandise stores, drug stores and large scale discount stores. The largest department store transaction was the business integration of Isetan Company Limited and Mitsukoshi, Ltd. through the establishment of a joint holding company by share transfer, creating the largest Japanese department store operator. The transaction value of this deal was approximately ¥292bn (about US$2.9bn). This deal was also the first in which new regulations regarding disclosure under FIEL applied. The regulation requires an issuer of new shares delivered in connection with a corporate reorganisation (including a merger) to submit a security registration statement with the regulatory authority and to make the ongoing disclosures as prescribed in the FIEL under certain conditions. These disclosure duties may also be applicable to non-Japanese companies in certain triangular transactions.

As practitioners of the law, it is difficult to forecast the particular industries or sectors where M&A activities will increase for the year ahead. However, current negative market conditions persist. Thus, we expect that restructuring and consolidation will remain at the forefront in Japan.

Masakazu Iwakura is a partner, Yoshiaki Sakurai is an associate and Juan L. Ramirez is foreign counsel, at Nishimura & Asahi.

Buyouts, takeovers and surrounding legal issues in Japan

BY PAUL O'REGAN

While the credit squeeze has impacted severely on the large buyouts seen in 2007 in other parts of the world, it was expected to have little effect in Japan. This is primarily because the size of deals in Japan has traditionally been smaller than the mega deals in the US and Europe, and also because leverage levels have traditionally been lower. However there have been no substantial buyouts announced in Japan in the first quarter of 2008.

In the past 12 months there have been two buyouts at prices in excess of US$2bn: Arysta LifeScience Corporation's acquisition by Permira and Tokyo Star Bank's acquisition by Advantage Partners. Both of these were in effect secondary transactions, with the vendors being other private equity firms. Thus these can be differentiated from other transactions involving a Japanese seller where there is a perceived animosity towards private equity funds in general, and foreign ones in particular. Foreign PE firms thus often find it worthwhile to team up with Japanese funds in a consortium structure to bid for Japanese companies.

The major successes of foreign entities in Japanese M&A have been with distressed assets. Even Arysta was a company put together out of the respective agro-science businesses of two trading companies which had foundered during the 90s. Olympus, the US buyout fund, joined the two businesses and progressively bought out the former shareholders and by following an aggressive acquisition strategy throughout the world turned Arysta into a successful worldwide business. This is a good example of how private equity buyers can turn businesses around. Permira has no doubt taken the view that there is still room for value enhancement in Arysta.

The biggest M&A transaction in Japan in 2007 was the takeover of Nikko Cordial by Citi. These two corporates already had a relationship through a joint venture investment bank trading under the name Nikko Citi. Again the pattern of distressed assets being the targets foreign companies can successfully acquire was followed here in that Nikko Cordial had been the subject of an investigation by the FSA and was found to have intentionally falsified its accounts resulting in a heavy fine, an apparent loss of confidence in it by some of its customers and a deflating share price. While not exactly distressed, Nikko Cordial was certainly on the back foot and Citi took advantage of this to mount a successful takeover bid. It was forced to increase its price because of the hostility to the original offer of several hedge fund shareholders, some of whom refused to accept even the higher offer but Citi declared its offer unconditional once it had reached 66 percent.

Subsequently Citi became the pioneer of the new triangular merger law which allows shares in a company other than the bidding company, including a foreign company, to be used as consideration for a takeover offer when its local bidding vehicle made a further all Citi scrip offer for the minority hold out shareholders. This looked at one stage to be in trouble because of Citi's own share price weakness but the takeover was eventually successfully completed.

Apart from this lone use of the triangular merger law by Citi, there was no evidence of the wholesale takeover of Japanese companies predicted by the japanese business federation (Nippon Keidanren) in its strident opposition to the law coming into force. As wiser heads had predicted the limitations inherent in the law as a result of the way it was eventually enacted ensure that it will be able to be used for takeovers in Japan by foreign companies only in agreed bid situations.

Furthermore the government considerably widened the number of companies subject to a requirement that consent be obtained before a shareholding in excess of 10 percent can be acquired by a foreign entity. Previously the prior consent requirement was confined to companies operating in a limited number of sectors such as defence, nuclear power, telecommunications and the like. Even that resulted in a long list of companies but now, citing concern about the potential for leakage overseas of Japanese technology, the net has been widened considerably.

One company for which such an application has been made is J Power, the electricity company, in which an activist hedge fund, The Children's Investment Fund (TCI), holds 9.9 percent. It has applied to increase its stake to 20 percent but to date no decision has been announced. It is generally assumed that the required consent will not be granted. Meanwhile TCI's proposals to J Power to improve efficiency and increase dividends were rejected by J Power.

The trend of increasing shareholder activism in the US has been followed in Japan, and TCI was not the only activist shareholder endeavouring to improve the lot of shareholders in Japan. The US fund Steel Partners, which holds shares in several Japanese companies, has made business improvement proposals to several of them but with no apparent success to date. However, it has been noted that an ever increasing number of Japanese companies have embarked on share buy back programs and, in some cases, have increased dividends, so perhaps the pressure is starting to tell.

On the other hand the Nikkei, the Tokyo Stock Exchange's (TSE) main stock index, has declined severely over the past few months and this may be due in part to a perceived bias against shareholders in Japanese companies. Over 450 Japanese companies have introduced takeover defence mechanisms and recently a financing package involving Sumitomo companies introduced a form of warrant which would enable the 'friendly financiers' to take significant equity stakes thereby diluting the unwanted shareholder but also all other shareholders. However, to date only one of these formal defence mechanisms has been activated (Bull-Dog Sauce) and ironically its effect was to reward the unwanted bidder (compensated in cash for being severely diluted) better than the other shareholders who were left holding much less valuable shares. This, though, and the recent confirmation by shareholders in Sapporo, the brewer, of that company's poison pill in opposition to another Steel Partners initiative, shows that shareholders in Japanese companies are quite prepared to back management in rebuffing unwanted foreign suitors, even at their own cost.

The equities sell-off accelerated in February 2008, possibly because of a statement made by a government minister that shareholders were too fickle to control the companies they hold shares in. In order to slow down the exodus of foreign investors from Japan, Mr. Atsushi Saito, the head of the Tokyo Stock Exchange, called on Japanese companies "to consider their shareholders' rights" warning that otherwise "Japan's capital markets will not develop". The Financial Services Agency certainly is encouraging better corporate governance too and is keen to see Tokyo become a leading financial centre again (both Hong Kong and Singapore have a much greater claim to such a status than Tokyo now does) but unless there is a change in attitude among Japanese companies (as compliance with basic rules of corporate governance, including the TSE's own Corporate Governance 'Principles' are, for the most part, voluntary only), or the TSE and the government's regulators regulate to force change, this is unlikely to happen.

It has been popular in Japan for subsidiaries to be listed but with controlling stakes retained by the parent, and the takeover and de-listing of some of these would be welcome. One such company (NEC Electronics Corporation) is subject to attack by Perry Capital, an activist US hedge fund, but to date its controlling shareholder, NEC Corporation, has been unmoved. The subsidiary's share price performance has been abysmal and Perry Capital alleges that related party dealings with the parent have been at the expense of the subsidiary. Related party transactions are not regulated by the TSE and accordingly are very common in Japan, usually to the detriment of shareholders.

As long as these sorts of regulatory gaps exist and allow Japanese companies to ignore basic rights of shareholders, there will be a continuation of the pattern of minimal foreign direct investment and Tokyo's declining influence as a global financial market centre. Japanese companies are looking to invest overseas and are increasing their takeover activity in Europe and the US but may face a backlash if the situation in Japan remains so heavily weighted against foreign investment in Japanese companies. What this all means for M&A in Japan in 2008 though, is that the outlook is not strong and M&A activity is likely to be less in 2008 then it was in 2007, perhaps improving in the second half of the year.

Paul O'Regan is head of the Corporate Department in the Tokyo office of Clifford Chance.

Australia's foreign investment framework: a more challenging landscape emerging for M&A

BY MATTHEW LATHAM AND WEYINMI POPO

Australia's foreign investment regime is made up primarily of the Foreign Acquisitions and Takeovers Act 1975 (FATA) and sector/company specific legislation. The FATA provides legislative backing for the Australian Government's foreign investment policy and screening of foreign investment into Australia. The FATA is administered by the Foreign Investment Review Board (FIRB), a non-statutory body which was established in 1976 to perform an advisory function only.

Under the FATA, a foreign person (or an entity in which foreign persons individually or in aggregate have 'substantial interests') must notify and seek the approval of the Federal Government Treasurer for any agreement under which that person acquires a 'substantial interest' in an Australian corporation (or an offshore company whose Australian assets comprise more than half of its total assets) whose gross assets exceed AU$100m (or AU$913m for US investors not investing in prescribed sensitive sectors). A foreign person is deemed to have a substantial interest if they control voting power in or hold (legally or beneficially) 15 percent or more individually or 40 percent or more in aggregate of the issued shares in an Australian corporation. The Treasurer can make orders prohibiting a proposed acquisition, or requiring a divestment where the acquisition has already occurred, if he considers it to be contrary to the 'national interest'. Alternatively, the Treasurer can impose conditions on any approval to deal with national interest concerns.

Takeovers by foreign persons of foreign companies which own Australian assets (comprising less than 50 percent of the target's total assets) valued in excess of $200m also require the approval of the Treasurer under the FATA, as do asset acquisitions and investments in urban land (including via companies or trusts). Direct investments by foreign governments and their agencies must also be approved by the Treasurer, irrespective of their size.

Australia's policy is to encourage foreign investment, such that in the last five years it increased by $168bn to reach $244bn in 2007. Notwithstanding this inflow, like other nations Australia seeks to balance these economic benefits against community concerns about foreign ownership of Australian assets. However, compared with the US and UK, foreign investment in Australia remains closely regulated.

National interest test

The FATA does not define what the 'national interest' constitutes, and past governments have been loath to disclose policy guidelines for any national interest test. The most guidance that the former coalition Federal Government issued was that it determined what is 'contrary to the national interest' by having due regard to the community concerns of Australians.

The failure of the FATA and successive governments to define or provide guidance on the national interest test has been often criticised because it is opaque and allows foreign investment decisions to be made based on prevailing political winds of change. In 1994, a Senate Select Committee recommended that the FATA be amended to include national interest criteria which would be applied in determining foreign investment applications. Successive federal governments have chosen not to implement this recommendation. Certainly, in an M&A context, where it is mandatory for acquisitions above the FATA thresholds to be made conditional on FIRB approval, the ambiguities around the national interest test can sometimes lead to significant execution uncertainty.

The uncertainty around the national interest test is not helped by the fact that there has only been one high profile M&A transaction blocked in recent times on national interest grounds. In 2001, Royal Dutch Shell attempted to acquire Woodside Petroleum, an Australian company that held strategic interests in Australia's North West Shelf LNG project, from which large Australian exports were earned. The then Federal Treasurer blocked the acquisition on the grounds that Shell's ownership and control of Woodside would not have guaranteed the promotion and sale of North West Shelf products over competing international exports.

Foreign investment in the Australian M&A context: recent trends and challenges

Australia has traditionally had a liberal stance towards foreign investment in the M&A context. However, foreign investment policy is likely to face new and evolving challenges due to the: (i) increasing incidence of cross-border investment consortia and the use of corporate structures which (even unintentionally) avoid triggering the mandatory notification thresholds; (ii) increasing geo-political and strategic importance of Australia's non-renewable natural resources driven by demand from rapidly industrialising economies in Asia, but particularly China; and (iii) advance of sovereign wealth funds and sovereign controlled corporate entities into Australian markets.

These three factors will likely make for a more complex foreign investment regulatory climate in Australia in the coming years when compared to the relatively benign foreign investment challenges of the last decade. This means that the balance between foreign investment (and international trade competitiveness) on the one hand, and Australia's strategic interests and populist concerns about 'iconic' and strategically important assets being controlled by foreign persons on the other, will become more challenging for the Australian Government to achieve. The controversy in the US raised by CNOOC's proposed purchase of UNOCAL, Dubai Ports World acquisition of P&O's US port facilities and the hostility in certain European countries to the cross-border flows of capital driven by hedge funds, all show to some extent that similar issues are common to all Western nations.

Corporate structuring

The unsuccessful bid by the Airline Partners Australia consortium (APA) to acquire Qantas Airways in 2007 provides a recent and apposite example of corporate structuring by a consortium comprising foreign investors which, on initial analysis, obviated the need for foreign investment approval. It also illustrates the practical limitations of such structures when confronted with the political reality which surrounds transactions involving 'iconic' assets.

Coupled with the recent investments by sovereign wealth funds in major US and European banks, this has led to some apprehension in Australia as to how Australia's foreign investment regulatory regime should respond to these developments.

In December 2006, APA (a consortium which comprised Australian and foreign investors) announced a takeover offer to acquire Qantas. The structure of the consortium bid vehicle meant that no foreign persons had voting interests above the relevant FATA thresholds (either individually or in aggregate), although the economic interests of certain foreign consortium members exceeded such thresholds. While APA argued that it did not require the Treasurer's approval for the acquisition under the FATA, the intense political pressure and media interest in the acquisition of an iconic Australian company in a Federal election year eventually resulted in APA having to make a 'voluntary' submission to the Treasurer. APA then had to give binding undertakings to the Government as part of the foreign investment screening process about Qantas' continued Australian ownership and control.

The APA bid exposed the limitations of the FATA when faced with corporate structuring which complies with the letter (but perhaps not the spirit) of the legislation. It also showed that in the case of acquisitions of politically sensitive assets, complying with the letter of the law is by no means determinative of whether the Government believes FATA approval is required. The APA precedent suggests that in such acquisitions a 'voluntary' application to FIRB would be politically expedient, irrespective of whether the legislative thresholds are triggered.

Strategic resources and SWFs

The unprecedented demand for Australian non-renewable natural resources by rapidly industrialising Asian nations such as China has fuelled Australia's economic growth and prosperity in recent years. It has also highlighted – for itself and its trading partners – the strategic importance of Australia's natural resources. This has led to an increased interest by countries such as China in securing the supply of such resources by acquiring interests in Australian mining entities, including more recently through bids for outright control of public companies. Chinalco's acquisition in February of a significant minority stake in Rio Tinto has also raised the political temperature in respect of foreign ownership of economically strategic Australian assets. Coupled with the recent investments by sovereign wealth funds in major US and European banks (such as Citigroup, UBS and Morgan Stanley) this has led to some apprehension in Australia as to how Australia's foreign investment regulatory regime should respond to these developments.

The recently elected Labor Government has been relatively quick to respond to some of these challenges. In February, the current Treasurer, Wayne Swan, clarified the national interest tests he would apply to sovereign fund investments in Australia by releasing six principles he would apply when approving investment applications from such funds, namely whether: (i) an investor's operations are independent from the relevant government; (ii) an investor is subject to and adheres to the law and observes common standards of behaviour; (iii) an investment may hinder competition or add to undue concentration or control in the industry or sectors concerned; (iv) an investment may have an impact on Australian government revenue or other policies; (v) an investment may have an impact on Australia's national security; and (vi) an investment may have an impact on the operations and directions of an Australian business as well as its contribution to the Australian economy and broader community.

The Treasurer has explained that Australia "maintains a welcoming stance towards foreign investment", but also appears to distinguish between transparent and commercially driven sovereign investors and those which are not. Proposals by foreign government owned or controlled investors that operate on a transparent and commercial basis are less likely to raise additional national interest concerns than other proposals. The Treasurer also acknowledged that investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives that could be contrary to Australia's national interest, and reiterated that all such acquisitions must be notified to the FIRB.

Concluding thoughts

The recent trends and challenges of foreign investment in the M&A context in Australia discussed above highlight the complexities facing Australia's foreign investment regulatory regime in the near term. The response by the Australian Government to these complexities will be crucial in determining whether Australia remains a competitive destination for cross-border capital flows internationally. The initial response by the newly elected Australian Government is positive, and shows that Australia's foreign investment regulatory environment is still welcoming of foreign investment and that Australia is not adopting a potentially damaging protectionist stance. However, it also shows that the regulatory framework and the manner in which it is interpreted will inevitably need to evolve – perhaps with greater policy guidance around the national interest criteria than has historically occurred – to address the key issues raised by market developments such as the increasing presence of SWFs.

Matthew Latham is a partner and Weyinmi Popo is an associate at Jones Day.

Control of foreign investment in Australia

BY ROD HALSTEAD, JOHN ELLIOTT AND MICHAEL PARSHALL

Foreign investment into Australia has long been subject to a statutory review and approval procedure. The Foreign Acquisitions and Takeovers Act (FATA) was enacted in 1975. Despite several changes of government since then, the processes established by the Act have remained largely unchanged. There is bipartisan support for the Act's major objective – to ensure that the Australian Government retains the ultimate legal right to prohibit proposed investments which are contrary to the national interest.

Of course, the existence of the power is not the same as the exercise of the power. Although the Act requires the notification and examination of a large number of proposed business investments, outright prohibitions of such proposals are very rare: the last prohibition of a foreign takeover was in 2001, when the government acted against Shell Australia Investments Limited's proposed acquisition of Woodside Petroleum Limited, the operator and part-owner of the North West Shelf, Australia's largest developed energy resource. The government's action was prompted by concerns about the resulting foreign ownership of North West Shelf and the potential for underdevelopment of that resource.

Conditional approvals are more common than rejections, but are still only a small percentage of total applications. Conditions typically relate to such matters as maintaining an Australian presence and complying with Australian law.

What have changed over the years have been the monetary thresholds below which proposed investments are exempt from notification or examination. In keeping with the (again bipartisan) official policy of welcoming foreign investment, these thresholds have been raised by several factors since the Act came into operation. The most recent general increase was in late 2006, when the thresholds were doubled.

In practice, therefore, FATA is not a major hurdle to the overwhelming majority of inbound investments. Nevertheless, because of the sovereign sensitivities around foreign investment, compliance with the notification procedures is regarded very seriously by the Australian Government and corporate lawyers. In other words, the fact that a proposed investment is extremely unlikely to raise concerns for the government does not mean that the legal requirement to notify that proposal is to be treated lightly.

Another important aspect of the FATA regime is that it operates at the interstices of law and high government policy. To understand how it works, one needs to consider both the statutory requirements of the Act and the governmental policy which governs its operation. That policy is readily available in published form, which means that: (i) the processes of the Act are predictable and largely transparent; and

(ii) the Act is applied in accordance with existing published policy, thus mitigating the potential for ad hoc interventions by the legislature such as characterised the Dubai Ports affair in the US.

The only policy matter which is not publicly defined is the 'national interest' criterion. The national interest, and what is contrary to it, are matters for the government of the day to decide. However, as noted above, it is rare for a proposed business investment to be rejected on the grounds that it is contrary to the national interest.

In addition to FATA, there are a number of industry-specific statutory controls on foreign investment. These are discussed below.

The national interest, and what is contrary to it, are matters for the government of the day to decide.

How is FATA administered?

Nominally, the Act is administered by the Treasurer of Australia (the Australian equivalent of the Chancellor of the Exchequer in the UK or the Secretary of the Treasury in the US). In practice, most of the administrative work is done by the Foreign Investment Review Board (FIRB). Although formally addressed to the Treasurer, notifications under the Act are lodged with FIRB. FIRB assesses notifications and makes recommendations to the Treasurer.

The Act empowers the Treasurer to prohibit any proposed foreign investment on the grounds that it is contrary to the national interest. However, a foreign investment would only come to the Treasurer's attention in one of three circumstances: (i) the value of the proposal is above a statutory threshold, in which case the Act requires that it be notified to the Treasurer; (ii) government policy requires that the proposal be 'voluntarily' notified under the Act (because it is in a designated sector of the economy, for example); and (iii) although notifiable under one of the two categories above, the proposal was not formally notified in accordance with the Act (in which case, the investor faces the possibility of an order to unwind the transaction if the Treasurer subsequently declares that the investment is contrary to the national interest).

Which foreign investors are affected?

FATA applies to investors who are natural persons or corporations. Natural persons fall under the Act if they are 'not ordinarily resident' in Australia. A person is 'ordinarily resident' if they were in Australia for at least 200 days in the 12 months preceding the transaction. Investments by corporations fall under the Act if: (i) a single non-resident controls at least 15 percent of the voting power in the corporation; or (ii) total non-resident voting power in the corporation is at least 40 percent; or (iii) a single foreign corporation controls at least 15 percent; or (iv) total foreign corporation voting power in the corporation is at least 40 percent.

What is notifiable?

FATA has two notification and review

regimes. One covers the acquisition of real estate in Australia. The other, the subject of this article, covers foreign investments in Australian businesses. Legally, there are two broad categories of notifications: those required by the Act and those required by policy. In practical terms, this means that the following transactions by foreign interests must be notified. First, acquisitions of a substantial holding in an Australian corporation where the acquisition involves more than a statutory threshold dollar amount. A substantial holding is 15 percent of the voting shares in the corporation (if controlled by a single person) or 40 percent if controlled by two or more associates. Broad anti-avoidance provisions extend the Act to arrangements which deliver de facto, rather than legal, voting control. Second, the establishment of a new business involving a total investment of AU$10m or more. The establishment of new businesses by US investors, except an entity controlled by a US government, do not require notification. Third, takeovers of offshore companies whose Australian subsidiaries or gross assets exceed the statutory thresholds. Finally, direct investments by foreign governments and their agencies irrespective of size.

Industry-specific foreign investment rules in Australia

There are a number of industry- or company-specific foreign investment regimes in Australia. Some of these arise under FATA policy; others are the result of specific statutes:

Media. Portfolio investments in the media of 5 percent or more and all non-portfolio investments irrespective of size must be notified under FATA.

Domestic aviation. Foreign persons (including foreign airlines) can generally expect approval to acquire up to 100 percent of the equity in an Australian domestic airline (other than Qantas), unless this is contrary to the national interest.

International aviation. Foreign persons (including foreign airlines) can generally expect approval to acquire up to 49 percent of an Australian international carrier (other than Qantas) individually or in aggregate, provided the proposal is not contrary to the national interest. In the case of Qantas, total foreign ownership is restricted to a maximum of 49 percent in aggregate, with individual holdings limited to 25 percent and aggregate ownership by foreign airlines limited to 35 percent; a number of national interest criteria must also be satisfied for Qantas, relating to the nationality of board members and operational location of the enterprise.

Operators of major airports. There is a 49 percent foreign ownership limit, a 5 percent airline ownership limit and cross ownership limits between Sydney airport and Melbourne, Brisbane and Perth airports.

Shipping. Under the Shipping Registration Act 1981 a ship registered in Australia must be majority Australian-owned, unless the ship is designated as chartered by an Australian operator.

Telecommunications. Australia's largest telecommunications company, Telstra, was progressively transferred to private ownership over the last decade; part of the sale process involved the imposition of limitations in foreign ownership of the company: aggregate foreign ownership is restricted to 35 percent and individual foreign investors are limited to a holding of no more than 5 percent.

What are the statutory monetary thresholds?

The monetary thresholds above which notification is required depend upon the type of acquisition and the nationality of the acquirer. As a result of the Australia-USA Free Trade Agreement, many US investors enjoy higher thresholds than other nationals (although there is provision for these higher thresholds to be extended to other countries as Australia enters other free trade agreements).

For non-US investors, US investors in prescribed sensitive sectors and US investors which are controlled by a US government, the current thresholds for notification are set as follows: (i) for the acquisition of substantial interests in an Australian corporation, the value of the corporation's gross assets is $100m (non-US investors) or $105m (US investors); (ii) for the takeover of offshore companies with Australian subsidiaries that account for less than 50 percent of the offshore company's assets, the threshold value of the Australian subsidiaries' gross assets is $200m for non-US investors and $210m for US investors; and (iii) for the takeover of offshore companies with Australian subsidiaries that account for more than 50 percent of the offshore company's assets, the threshold value of the offshore target company's gross assets is $100m for non-US investors and $105m for US investors. For other US investors, the dollar threshold is $913m. US thresholds are indexed annually.

Foreign government investment

As mentioned above, all investments by foreign governments and their agencies are notifiable. In September 2007, the Australian Government reportedly raised the issue of investments by sovereign wealth funds with FIRB. Subsequently, in February 2008, the government announced new guidelines that would be applied to the examination of investments by foreign government agencies such as state-owned enterprises (whether or not partly privatised) and sovereign wealth funds. The guidelines focus on the separation of the commercial objectives of the investor from the policy objectives of its government. The greater the separation between the two, the less likely it is that the proposed investment would raise national interest concerns for Australia.

What happens when a notification is made?

Although very few business acquisitions fall foul of FATA, the process of compliance must be taken into account when planning a transaction. When a notification of a proposed acquisition is lodged, the government has 30 days in which to reach a decision on whether to approve it (this can be extended by up to 90 days). The government's power under FATA is on a 'use it or lose it' basis. If, by the end of the 30 days or extended period, the government has not prohibited the acquisition or approved it subject to conditions, the government loses the power to make orders in relation to the acquisition.

As a matter of commercial reality, few major commercial transactions can go into stasis for up to four months while the Australian Government decides whether to approve them. This problem is addressed by two procedures. In the initial planning stages of an acquisition, FIRB can be contacted directly to discuss the impact of FATA and policy on a specific proposal. Later, when an acquisition is announced, the parties will usually state that it is conditional upon FATA approval. Where the acquisition is by private contract, this condition is necessary to avoid a breach of the Act through the acquirer's signing of the contract (and hence making the acquisition) before the lodgement of notification. Such a condition also allows the acquirer or bidder to walk away if its deal is ultimately ruled to be against the national interest.

Conclusion

Regardless of the fact that foreign takeovers are only rarely prohibited, Australian Governments of all political persuasions have retained the FATA process, largely unaltered, for over 30 years. Nor has the relative paucity of prohibitions resulted in any lessening of the rigour that FIRB applies to the evaluation process. Although they have developed considerable expertise in lodging notifications and negotiating with FIRB, Australian commercial lawyers know that each business proposal and notification is unique and that the FATA outcome cannot be treated as a forgone conclusion.

Rod Halstead is chair of Mergers & Acquisitions, and John Elliott and Michael Parshall are joint heads of Mergers & Acquisitions, at Clayton Utz.

M&A in emerging Asia

BY NICHOLAS ASSEF

Although China captures much of the world attention, other Asian nations also present incredible opportunities. In India, for example, the Telecom & Regulatory Authority released statistics in January 2008 which revealed that mobile phone subscribers in that country grew by around 84 million in 2007, with growth in the later part of the year ramping up to around 8 million a month. Unsurprisingly, telco executives are keen on the prospect of entering such a high growth market.

Conducting business in the Asian region presents unique and ever evolving challenges. In addition to the mature markets of Australia, South Korea and Singapore, there is growing activity in the emerging markets of Vietnam, India, Malaysia, Indonesia, Thailand, the Philippines and Cambodia. We believe the opportunities in these explosive growth economies justify the investment of time and capital that needs to be dedicated in order to establish and develop a presence in what are undoubtedly the markets of tomorrow.

Traditional M&A. Taking the traditional, highly structured, strict approach to a transaction rarely wins the day in developing Asia. There are a couple of fundamental reasons. First, many of the Tiger economies are not places where deep experience in M&A has evolved among either corporates or the professional community.

Second, many of the economies, such as Vietnam, have been under political regimes where state ownership of businesses has been the norm. Therefore, the ability to even transact has been effectively non-existent.

An acquirer entering a Tiger economy for the first time must be patient. They must be quiet in their approach, and invest the time to understand the cultural subtleties that each nation possesses. CEOs need to get to know the market intimately and avoid making assumptions. Approaching Asia as 'one nation' is a sure-fire path to failure. Despite the fact that borders are often shared, nations are incredibly unique.

Legal frameworks. The first thing for the CEO to appreciate is that a legal contract is generally cold comfort in an emerging Asian economy. Any acquirer that believes it will be able to enforce warranty claims, contractual rights and so on, will often be disappointed.

This is a key a reason why Westerners regularly fail. Rather than having a fundamental acceptance of a collaborative approach to taking a business forward, the typical 'us and them' approach is applied at the outset of a potential corporate transaction. Many deals simply stall and wither as a result of a failure to accept a quieter, and in many ways a more sophisticated, approach to doing business.

The CEO should also become familiar

with the 'licensing' regimes of conducting business in each market. There are often requirements (such as in Vietnam) for every company to be licensed to conduct business. This is before one considers the requirement of local joint venture partners. Often these issues are not complicated, just time consuming.

Political and environmental landscapes. Another matter that Westeners need to gain comfort with is the ever changing political landscape that typifies many jurisdictions. Such 'instability', however, is not new to the region. Political change at either the government or the individual bureaucratic level can materially disrupt business activities.

The associated matter is environmental stability. Over the last decade there have been a number of potential health 'pandemics' across the Asian region – including SARS and avian flu. The potential for such occurrences needs to be accepted by any potential market entrant. Their reoccurrence may have a devastating impact on operations and demand in the short term across a wide range of industries. And of course, they cannot be modelled.

Due diligence. Another point of frustration for Westeners is the due diligence process. Material from business plans to financial data is not typically produced on a day to day basis in hardened form by many Asian companies. Therefore the process of due diligence needs to be flexible and tailored to the individual case.

Associated with this is credible market and sector data, which is unavailable in most emerging Asian countries. The data to support an acquisition business case typically needs to be built up by the acquirer and its advisory team – which can be a difficult and drawn out process in itself. Even government data can lag by considerable time periods.

Although a traditional due diligence framework provides parameters by which any opportunity can be investigated, the commercial drivers of where a business can be taken in the future should be the priority of any assessment, rather than focusing on yesterday's risks.

Financial data. One challenge that has to be pointed out is the difficulty in reconciling the financial data of a target. This happens for a variety of reasons, many of which are widely publicised, although often with a touch of urban myth around them. A simple explanation relates to the maturity of markets and the fact that most businesses are private. Yes, there are often multiple 'sets of books'. To overcome this, the CEO must build enough trust with the target company to understand the real potential of the opportunity.

The job for the acquirer will often involve building a robust financial model to such an extent that the acquirer may think that it is drafting the business plan and associated financials for the target, which in reality it often is.

Can the business scale? During the financial and commercial assessment CEOs should critically analyse the ability of any target company to leverage its operational base, more so in developing Asia than mature economies.

In particular, the quality of the physical assets that may be purchased must be assessed. This is because in most Asian jurisdictions entrepreneurs will favour second hand equipment to reduce costs, and maintenance can be lacking. The useful life of this equipment may be less than expected – which means that capex and opex might be materially higher just a few short years following the acquisition's completion.

Again, these issues are not unique. But more time should be spent investigating the business case for scalability of operations.

Support and control. Flowing on from the need to build financial data is the requirement to effectively control matters such as cashflow following completion of an acquisition. Seasoned acquirers will often seek to interpose an intermediary if they have no permanent local management in place. This intermediary can control all aspects of cashflow and reporting of KPIs.

Young teams. Many entrepreneurs are young and highly ambitious, but they are not particularly experienced. This can mean a certain amount of almost irrational behaviour from time to time – which is a natural result of believing one is more experienced that one is. In particular, this can affect the time it takes to do a deal. Founders have a habit of regularly changing their minds, for example.

Acquirers need patience and a level head. This also links into the requirement of having earn outs. Without 'golden handcuffs' attaching the individual to the target there is little chance they will be there post acquisition. Many will invariably be off doing another deal, if they don't have multiple deals underway already.

Despite the immaturity of economic factors in these markets, the entrepreneurs themselves are generally highly educated, academically or commercially. The internet has educated them about the potential wealth that can be derived from having a successful business.

Wary of professionals. Many emerging markets (such as Vietnam and Indonesia) have a reasonable mistrust of professional advisers, often stemming from the fact that the use of such professionals is not all that common for facilitating corporate transactions. For this reason it is important that the bidder aligns itself with groups that understand the framework of any marketplace. The use of a senior local figure can also be useful in smoothing over potential bumps in deals.

Valuation. Rapid growth markets pose a great challenge in establishing the value of acquisition candidates – particularly when an educated entrepreneur believes the potential value the company may reach tomorrow is what should be paid today. Seasoned CEOs should agree to a value based upon specific milestones being achieved over periods of up to five years. Although a structured transaction is nothing new, the levels of structures used in emerging Asia can be highly beneficial for the acquirer.

Skill shortages. Enthusiasm in business does not replace experience. Many rapidly expanding Asian companies hit a major hurdle in the recruitment of skilled and experienced professionals. A basic issue is that experienced Asian executives are themselves opting for the path of growing their own businesses rather than being employees.

Therefore, a key attractor that a bigger offshore player can give is the infrastructure and systems by which the entrepreneur can quickly expand in a controlled fashion. In the media sector in particular, the winning factor in a deal is often the career opportunities that the acquirer can offer. Although Asian entrepreneurs are typically happy growing their businesses to a certain level, they often acknowledge that there is a real attraction to being part of a larger organisation.

Opportunity exists. These markets are big. They are growing rapidly but are still immature by many western standards. Consumers are enjoying increasing standards of living. Technology is assisting in driving both consumer demand and the maturing of these markets. In the event an acquirer can adapt its business model to deal with such a fluid environment, it may open itself up to opportunities which have the prospect of delivering exceptional shareholder value.

Nicholas Assef is an executive chairman at Lincoln Crowne & Company.

How to speed up M&A deals in China

BY FEI GUOPING

A foreign acquirer entering the Chinese market needs to know how to conduct efficient negotiations, understand China's legal system and familiarise itself with the various due diligence requirements.

Conducting an efficient negotiation in China

Foreign investors often complain that transactions with Chinese companies will take them more time than similar transactions with European and US companies. But the length of time should not be blamed solely on Chinese companies or the government's complicated scrutiny procedure; in most cases the foreign investor must share the blame. When doing business in China, investors are always carrying out their M&A plans according to some fixed code without paying attention to what their Chinese partners are really concerned about. It follows, unsurprisingly, that the Chinese sellers are always slow to nod their heads at the negotiation table. As a result, it takes more time to conclude a deal.

When negotiating, a Chinese entrepreneur is always taking several issues into consideration. What benefit can he get from a deal? Is it imperative to take part? After the takeover, will the acquired company be turned into a SOFE? Unless all these issues are agreed by both parties, it will be difficult to proceed with the deal. If foreign buyers carry out the deal as they planned, and close their eyes to such concerns, they are likely to suffer communication problems and may be unable to complete the transaction.

To overcome this, an acquirer should build trust, tell its Chinese partner how they will benefit, and grant its team freedom to manage the deal.

Build trust

Chinese entrepreneurs have a saying which advises them to 'conduct oneself first before running the business', meaning that in a deal they need to assure themselves that their potential business partner is reliable. After this confirmation, they will tend to take a more active role in forthcoming negotiations. It is therefore strongly recommended that acquirers make the effort to establish trust. The widespread notion that an acquirer cannot make a deal without having a personal relationship with government officials has substantially distorted the importance of the Chinese philosophy on relationships. The underlining essence of the relationship structure is the trust among people in China.

Chinese culture stresses that individuals should 'listen to his words and watch his deeds'. It means, when building trust, people should not only listen to what others say, but take note of what they do, because their actions are just as important. So how is it possible to judge whether a potential business partner is reliable before cooperating? Clever Chinese businessmen find the answer at the dinner table (one more thing a foreign party may complain about). The Chinese entrepreneur will invite his potential partner for lunch or dinner, and during this period, listen carefully to what the potential partner says and watch closely what he does at the table. From that, the Chinese businessman will assess his trustworthiness. Foreign investors have a tendency to ignore China's profound wine and food culture when they complain that the dinner process take too much time. In fact, it is at the dinner table that the parties will get to know each other and build trust. Of course, there are also other Chinese ways to built trust.

It is only partly true to say that the relationship comes before the deal; more accurately, if there is no trust, there will be no deal.

Tell the Chinese partner how they will benefit

Chinese managers and shareholders are born experts at weighing options. They are also acutely aware of the saying 'lose at sunrise and gain at sunset'. Hence, when they are going to sell their companies, they are considering what they will get in the deal. It is natural that in an M&A negotiation, a Chinese manager will care about nothing but 'the essence of the deal' – the actual value and benefit he will gain.

He may also express concerns about whether the deal will harm his vested interest or have an adverse effect on his future rewards. Unless this material matter has been agreed by both parties, Chinese managers and shareholders cannot turn their attention to other issues.

On this matter, financial investors tend to be considerate. When negotiating, they usually inform their prospective partners of their intentions and interests at the outset. That way, they can always easily catch the attention of Chinese businessmen. It is wise for a foreign investor to explain early and in detail their future profit estimates, which will accelerate the transaction process.

Grant the team freedom to manage the deal

To conduct a deal which strictly conforms to norms is never wrong. However, as far as the value of a merger is concerned, the key is to maximise the shareholders' benefits. It is therefore important to grant your team the necessary right to conduct the M&A in a feasible way, which normally shortens the time needed to complete the transaction.

It is only partly true to say that the relationship comes before the deal; more accurately, if there is no trust, there will be no deal.

An enterprise which made numerous global deals once imposed a rule that it would never participate in cross-regional or cross-cultural M&A markets. But it moved into China's M&A market two years ago, and has surprisingly completed three acquisitions successfully. Not only did the transactions themselves go smoothly, their post-merger integration turned out favourably. One of the reasons for this success was that the enterprise had every confidence in the M&A team and gave them the right to make quick and feasible responses according to the specific context of a deal as long as it benefited the M&A value. Such a team need not be restricted by the fixed processes and procedures of M&A.

Understanding China's legal system

Foreign investors often complain that they did not receive fair treatment in China. They investigate China's law carefully to comply with the procedures. They also grasp the most authoritative and latest detailed M&A strategies supplied by international advisory agents. However, when dealing with relevant PRC regulatory authorities, many find China's legal environment highly confusing. An acquirer's inadequate grasp of PRC laws and regulations is often a greater weakness than its M&A strategy.

In line with the findings of some foreign investors, even if an acquirer stays in line with all laws and regulations, the transaction may not be conducted as scheduled. One reason is that the principle of 'no prohibition in law means admission' was not followed entirely in China, and whether a law can be carried into execution will be decided by a definitive rule concerning the details of implementation. Another important reason is that when PRC authorities are supervising deals, they will not only follow the law but also the definitive rules or directive principles called 'Red-Title Documents'. Furthermore, the Chinese Government allows these regulatory agencies to draft supervising rules by themselves. There are other documents which an acquirer should pay attention to, including speeches made by senior officials of the governing party. Even though these documents are not followed directly by regulatory agencies, their contents exert influence on regulators' interpretation and enforcement of the law. To understand such a legal system, not only is legal knowledge required, but also the knowledge of Chinese culture and rich social practice in China.

The long-delayed Carlyle and Xugong deal is just one example. In that deal, the parties have failed to get the approval document in over two years. The most significant reason for this is that the acquirers have failed to fully understand China's legal system and regulatory mechanism, and as a result they have drafted a legal structure to the deal which does not conform to the laws and regulative rules in China.

Therefore, foreign investors need to understand fully the construction of the PRC legal system. They should not only pay attention to the documents officially termed 'law' or 'regulation', but also to those polices or documents that help them to understand the application of the law.

Due diligence in China

When it comes to the due diligence process, there are three main issues: (i) the problem of non-transparent information, (ii) the complexity of China's tax, labour and IPR problems; and (iii) the problem of oversimplified Chinese contract clauses.

The problem of non-transparent information

In the due diligence investigation, it is difficult to investigate the legality, integrity and veracity of information on a target company in China. This is because Chinese courts cannot supply such investigative services when needed and some information is difficult to obtain, such as details on the target company's underlying litigation, arbitration and execution. Furthermore, it is difficult to collect desired information on the target's management because the social trust mechanism described above has not been completely established. A typical example is that when commercial banks in China provide a loan, in addition to the pledges they always ask for the other companies to guarantee the credit of the borrowing corporations as guarantor. The inter-processing of a credit guarantee may combine several corporations together in one area by mutual guarantee. Banks often fail to register such information timely and correctly, which means the acquirer cannot obtain and thus is unable to forecast the contingent pledge risk. The situation becomes even worse when a company provides credit guarantee for others without recording it.

The complexity of China's tax, labour and IPR problems

When buyers excitedly agree on a cooperative intention and start to review the details of the target company, they will be concerned by China's tax and labour problems, which exist in Chinese corporations universally but with varying degrees of severity. These problems are connected with the legal system and social environment of China. The universal irregularity, as well as the abuse of administrative power, means that the costs of compliance are higher than that of infraction. Therefore, in order to reduce costs, companies will take action which more or less amounts to breaches in tax and labour laws.

In China, addressing the labour problem is not as difficult as that of tax. One just has to draft the labour contract and undergo all the employment procedures according to related laws, such as labour contract law. A violation, if serious, could mean a risk of administrative punishment but seldom will it constitute a crime.

Because of the irregularities, some companies with tax problems do not want regulatory authorities or others to have access to their information, afraid that exposure will subject them to an economic fine or even criminal liability.

Addressing tax problems is slightly complicated. For tax problems in due diligence, buyers will ask for patching-submittance or accrued preparations, even re-valuation, which seems reasonable to them, but not to Chinese companies, which understand the realities in China and do not believe they are at risk of being punished. As a result, they cannot accept the condition to pay tax owed or do accrued preparations and lower the deal value. Indeed, because of the irregularities, some companies with tax problems do not want regulatory authorities or others to have access to their information, afraid that exposure will subject them to an economic fine or even criminal liability. Many companies in China will therefore choose to avoid M&A opportunities. However, if these problems are tackled appropriately, it will help to conclude a deal more smoothly, and more M&A candidates will emerge.

Another common problem in M&A due diligence is the infringement of IP rights. Although the Chinese Government has struggled to tackle the continued infringement of IPRs in recent years, there are still numerous IPR infringements in most Chinese enterprises. If the target company is the victim, it is easy to handle – just leave that issue to legal action. If the acquirer is working with a capable legal team, it may also manage to recover any loss, which will add share value. But if the target company infringes others' IPRs, the situation is more complicated. In any event, this should be dealt with tactfully to avoid harming the interests of the target company's shareholders and managers.

The problem of oversimplified Chinese contract clauses

When foreign investors investigate a Chinese company's contracts, they will often find that the contract clauses are oversimplified. This has much to do with China's culture and stage of development.

As mentioned earlier, under Chinese culture, people prefer dealing with those they can trust and are not accustomed to consider a business partner untrustworthy. When negotiating, they are reluctant to raise questions because they believe it will harm their friendship.

In addition, China's young market and its less developed commercial culture make it difficult for enterprisers to forecast potential risks buried in simple contracts. For example, one reason for the conflict between the French company Danone and the Chinese company Wahaha in 2007 was oversimplified contract clauses. In the joint venture contract, Wahaha was bound to an anti-competition clause, while Danone was not. The situation in China's underdeveloped market economy leads some companies to start up without attempting a thorough forecast of the future, which would probably explain why Wahaha took the view that nothing was more important than cooperation with Danone.

It is hard to obtain the necessary information for complete due diligence. It is even more difficult to forecast its effect on the transaction and take pertinent countermeasures. If an acquirer and its advisory team want a satisfying outcome from M&A, they need a thorough understanding of Chinese law and its market, backed up by extensive practical experience in China.

Fei Guoping is vice chairman of China M&A Association and partner of Long&Field, the M&A Department of Grandall Legal Group.

Will cross-border buyouts in China ever be feasible?

BY MARCIA ELLIS AND JAY C.S. TAI

Every week it seems a new buyout fund is opening an office in China or announcing a new Asia-focused initiative. In the last couple of years, smaller funds and the funds of international investment banks that are well-established in Asia have been joined by larger buyout funds such as KKR, Bain and Blackstone, which have opened offices in Hong Kong in the last few years from which they plan to source and manage China and other Asian investments.

The numbers tell the story. In 2006, eight Asia-focused buyout funds raised a total of US$6.44bn, while in 2007 18 Asia-focused buyout funds raised a total of US$15.67bn. Despite the subprime crisis and the resultant dampening of buyout activity in the US and Europe, 2008 already promises to be a boom year for buyout activity in Asia. Blue Ridge Partners already has announced it has raised a US$1.45bn buyout fund focused on Asia and JP Morgan Asia Partners has announced it has raised a US$750m fund to invest in mid-market buyouts in Asia. In fact, there is every indication that buyout funds are shifting greater attention to the Asian markets as the types of LBOs that they have been accustomed to doing in the US and Europe have become more difficult to accomplish.

A question still remains, however: how much of this money will they be able to be put to work in China? Inbound private equity deal flow to China is still a tiny fraction of that in most other countries by any measure, and inbound buyouts continue to be very difficult if not impossible for private equity investors. Several recent inbound China buyouts, most famously the Carlyle Xugong deal, have been announced but never closed due to difficulties in obtaining required government approvals. In general, buyout shops have had to content themselves with significant minority stake investments (for example, KKR's investment last year in Tianrui Cement), and even these investments have become increasingly difficult due to regulatory changes.

Impediments to private equity investments

The last few years have presented a rocky and ever-changing regulatory landscape for inbound private equity investments in China. In some ways, China has come a long way in constructing a framework for acquisitions by foreign investors of interests in Chinese companies, a framework that did not exist before 2003. Unfortunately, regulations on foreign M&A that came into effect in September 2006 have created a major impediment to inbound private equity transactions.

Prior to September 2006, the primary means used by private equity funds to invest in non-state-owned Chinese companies was for the individuals who owned the companies to incorporate a special purpose vehicle in an offshore tax haven such as the Cayman Islands and for that special purpose vehicle then to acquire the equity of the Chinese target company. After that, the fund would subscribe for shares of the offshore special purpose vehicle.

This structure, commonly referred to as roundtrip investing or red chip restructuring, offered many advantages to both the fund and the Chinese investors. Funds generally prefer to hold shares in an offshore company in which their agreements with the Chinese founders can be governed by law other than that of China. Unlike in a Chinese company, in which equity comes in only one class, funds can hold preferred shares in an offshore special purpose vehicle. This permits the fund to receive any and all preferred rights that it is able to negotiate and to put in place a value adjustment mechanism that would be triggered if the Chinese company does not meet certain specified metrics. This structure also provides the advantage to the fund of making it possible for the fund to be granted a pledge of the shares of the Chinese founders in the special purpose vehicle as security for all of the obligations of the Chinese founders. Finally, the greatest advantage of this structure for both the fund and the Chinese founders is that it provides a ready-made means of exit that does not require Chinese governmental approval. The shares of the special purpose vehicle can be listed on an offshore stock exchange or sold in a trade sale with (in most cases) no Chinese governmental approval.

However, after gradually chipping away at this structure for a number of years with legislation that made it increasingly difficult to implement, in August 2006 China issued regulations that all but put a complete stop to implementation of this structure. The 'Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors' – or M&A rules – require that a roundtrip investment be approved by the Ministry of Commerce at the central level and, thus far, since 8 September 2006 when the M&A rules came into effect many have applied for such approval and apparently none have received it.

The government has many concerns with this structure, but the fundamental factor at the core of all these concerns is control. The funds and the founders like this structure as it effectively situates their relationship and any future exit outside of the control of the Chinese government; the Chinese government does not like this structure for the very same reason. In addition, this structure raises tax and currency control issues with respect to the Chinese founders. Finally, the government dislikes the structure because it facilitates offshore listings at a time when the government is promoting listings on China's stock exchanges.

Impediments to buyouts

Buyouts and control transactions might at first glance appear to be shielded from the issues surrounding roundtrip investments. That is because they do not necessarily entail bringing the Chinese founders offshore as investors in an offshore special purpose vehicle and thus do not fit under the definition of roundtrip investment in the M&A rules. However, despite the fact that most buyout and control transactions do not require Ministry of Commerce approval at the central level as roundtrip investments, they often require such approval under separate provisions of the M&A rules that govern foreign investor control transactions which may impact the economic security of China or involve a target company in a key industry. Foreign acquisitions of control in companies that own a well-known trademark or an established Chinese trade name also require central level approval.

These provisions (and similar provisions that appear in China's recently enacted Anti-Monopoly Law) appear to be modelled on the so-called Exon Florio provisions pursuant to which the Committee on Foreign Investment in the United States (CFIUS) reviews proposed acquisitions by foreign investors of US assets to determine whether the foreign investor might take actions that threaten the national security of the United States. As is the case of the Exon-Florio provisions (and the implementing regulations promulgated thereunder), the relevant provisions in the M&A rules provide for the parties to the transaction to notify the relevant authorities (the Ministry of Commerce, in the case of China) if they believe their proposed transaction may be subject to review under these provisions and if they fail to do so leaves the transaction open indefinitely to the requirement of divestment or other remedy.

The factors that would trigger a notice requirement under the M&A rules are sufficiently broad and the potential impact of failing to notify the Ministry of Commerce is sufficiently onerous that few buyout funds would risk proceeding with a significant transaction without notifying the Ministry of Commerce. Unfortunately for buyout funds, the consideration of foreign control transactions has become enmeshed in a debate that is going on within China about whether economic reforms have been beneficial for Chinese in general in light of the increasing gap between the well off and the poor and the rural and the urban inhabitants of China and about China assuming its appropriate place on the world economic stage. In addition, in some cases, the internet has allowed domestic competitors of target companies to use the serious and emotionally charged concerns reflected in these debates to increase public and official sentiment against foreign acquisitions in order to eliminate foreign acquirers from the playing field.

In addition, there is certainly some sense in which the security-related review provisions in the M&A Rules and the Anti-Monopoly Law and their use against primarily US-based funds are a legislative tit-for-tat, aimed at paying the US back for its CFIUS review of the proposed acquisition of Unocal by China National Offshore Oil Corp. (CNOOC) and most recently the proposed acquisition of 3Com by Huawei, a Chinese telecommunications equipment company, and Bain Capital. China has learned from the US that in a post-WTO accession framework the permitted ways to control certain types of foreign investment are through anti-monopoly control and national security review.

Finally, beyond the regulatory impediments to foreign control transactions, there are cultural factors that limit such transactions. In China, fundamentally, most founders of private companies and even CEOs of state-owned enterprises regard trade sales of their companies, even at what objectively would be viewed as a very good valuation, as a less attractive exit option than an IPO. This position partially stems from the desire for the prestige that the founders/CEOs believe they will only achieve if they complete any IPO, and partially stems from the relatively underdeveloped level of understanding of valuations in China. Because founders/CEOs have a very unclear idea of the actual market value of their companies and the inflated valuations being achieved in IPOs, they almost inevitably believe that any offer made in a trade sale is too low.

Financial investors are good for China

The main task of financial investors in the next couple of years should be to work with the Chinese government to convince policymakers that financial investors are good for China and in fact, in many cases, better for China than strategic investors. Whereas strategic investors are primarily interested in rolling up Chinese businesses into their existing global operations and imposing their internationally recognised brand on Chinese businesses, financial investors are more often than not merely concerned about restructuring and rationalising Chinese enterprises so that these companies – which employ millions of Chinese workers and are important forces in the local economy – are realising their ultimate value under their existing brands. Financial investors could be key to ensuring that companies from China take what Chinese regard as their rightful positions on the global economic stage and make their brands into internationally recognised and respected names.

Financial investors, and particularly buyout funds, need to get better at structuring their investments and their investment-related lobbying and positioning of their investment proposals to ensure that they are appealing to all the right interest groups related to the transactions. China has become significantly more complicated than it used to be. Investors must not only worry about pleasing an effectively monolithic local government but must lobby at both the local and central levels at various agencies that will have a say in whether a particular transaction receives all required approvals – and may have markedly different views on fundamental issues regarding foreign investment in China. In addition, investors must consider how their proposals will be viewed by the management of the target companies, how they will impact the employees of the target companies, how they will be viewed by opponents of reform, how they will impact competitors of the target companies and how those competitors can be convinced to support the proposed acquisitions. The financial investors must grapple with the issue of how the proposed acquisition can be structured so that it is good for the financial investors but also clearly good for China.

Convincing all the relevant players that financial investors in general and the current investment being proposed by the relevant financial investor is good for China, good for the target company and good for the current owners of the target company is not something that is going to happen overnight. However, it is a task that financial investors must undertake if they intend to continue to make investments in China.

Marcia Ellis is a partner and Jay C.S. Tai is a senior associate at Morrison & Foerster LLP.

Rules and issues surrounding M&A with Chinese companies

BY STEPHEN CHAN

On 7 January 2008, the China Mergers and Acquisitions Association released the top 10 most influential cross-border M&A bids in 2007. Among the bids, the Chinese corporations benchmarked the emerging significance of the Chinese financial industry players in the global M&A market. Chinese financial institutions played a major role – half the top 10 cross-border M&A bids related to Chinese banks and insurance companies in the outbound M&A market as US economy slowed due to the subprime crisis and global credit crunch. Unlike outbound M&A deals transacted previously, Chinese corporations, especially stated-owned enterprises in the financial industry sector, are interested in any opportunities in the developing countries.

During the fiscal year ended 31 December 2007, foreign direct investments in China rose 13.8 percent to US$82.7bn (including foreign investments in banks and securities totalling $7.9bn), as reported by the Ministry of Commerce (MOFCOM). This is despite Beijing authorities executing certain measures to cool down the boom, especially the spending on real estate and other assets.

The growth of foreign direct investments in the real estate sector is tremendous and is expected to continue. In 2006, it reached $8.2bn compared with $5.4bn in 2005. Overseas property funds (REITs, etc.) were the 'hot money' providers, driven by the rise of China's property market and the appreciation of the Renminbi.

Foreign investors are also pursuing assets despite restrictions imposed by the MOFCOM. Arcelor Mittal, the largest iron and steel manufacturer which accounted for 10 percent of the world steel output in 2006, acquired a 28 percent equity stake in China Oriental Group Company Limited, a Hong Kong listed company, through its subsidiary, Mittal Steel Holdings AG, for a consideration of HK$5.02bn in November 2007.

However, not all foreign investments go smoothly in the M&A market.

Group Danone, a Global Fortune 500 company, has developed its foods and beverages business in China since 1987, selling its products not only in China but also exporting them to other countries. Group Danone has formed joint ventures under certain operating and licensing agreements with Wahaha Group and became the majority shareholder of the joint venture in 1996. Wahaha, one of its four leading brands, is also the most popular in China. In April 2007, Group Danone has planned an acquisition of Wahaha Group's remaining assets for RMB 4bn. Unfortunately, the planned acquisition is opposed firmly by the Chinese parties of Wahaha Group. Since then, Group Danone and Wahaha Group have been engaged in a series of disputes and lawsuits. Foreign investors should be aware that some Chinese lawyers might call for protection to avoid any loss of controls of major brands when cooperating with foreign investors.

Another mega bid in May 2007 came from Singapore Airlines Limited and its parent Temasek Holdings Pte Limited, which offered US$930m for a 24 percent equity stake in China Eastern Airlines Corporation. They are struggling to get an equity stake since China National Aviation Corporation proposed a counterbid to strengthen its presence in the market on 6 January 2008 – one day before the shareholder vote. The deal was rejected by substantial votes in the shareholders' meetings.

Approval of M&A transactions

The Chinese government has offered a number of different ways to facilitate foreign direct investments. Acquiring a domestic company is the quickest way to enter China's market. Foreign investors have recently expanded into China by accelerating their M&A transactions in accordance with the rules and regulations stipulated in the Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors since 8 September 2006. The Chinese authorities play a substantial role in M&A transactions, especially in terms of examination, approval and supervision. Foreign investors should be aware that the completion of M&A deal might require the approval of several Chinese authorities, depending on different circumstances. It may take considerable time and effort to reach completion.

In accordance with the present Provisions on Mergers and Acquisitions, MOFCOM is the approval authority, the State Administration for Industry and Commerce (SAIC) is the registration administrative authority and the State Administration of Foreign Exchange is the foreign exchange administrative authority.
Under certain exceptional circumstances, approvals from the National Development and Reform Commission and the State-owned Assets Supervision and Administration Commission of the State Council are required in respect of M&A and restructuring of state-owned enterprises. In the event that the target company is operating in a regulated industry or market, the approval of the relevant industry-specific regulator should be obtained. For instance, if the target company is a listed Chinese bank, the approval of both the China Securities Regulatory Commission and the China Banking Regulatory Commission will also be required.

Restrictions by industry sector

The Chinese government issued the first version of the Catalogue for Guidance of Foreign Investment in Industry in 1995. Since then, it has been revised several times. The latest version of the Catalogue became effective on 1 December 2007. The Catalogue classifies industries into a number of categories. Industries which are not specified as 'encouraged', 'restricted' or 'prohibited' by default fall under the 'permitted' category. The classification affects the regulatory approval process and also the tax and other incentives available.

Structuring M&A transactions

An offshore M&A transaction is the most efficient method. The change of ownership is simpler if the investment in China is held by a special purpose vehicle in an overseas country. This does not technically trigger any approval of M&A transactions in China, other than those straightforward changes of any items under the Articles of the investment in China.

In the past few years, foreign direct

investments have entered China directly through onshore M&A of domestic Chinese companies, typically via an equity acquisition, an asset acquisition or a statutory merger. Of these methods, equity acquisition is the quickest. Upon signing the equity acquisition agreement or new equity subscription agreement, the target company will be transformed into a foreign-invested enterprise (FIE) subject to the China's approval process. Foreign investors should be aware that foreign investors will acquire the rights and assume the obligations of the domestic company.

Unlike equity acquisitions, asset acquisitions are time consuming. Through the 'peel off' process, foreign investors acquire the ownership of the assets from the target companies and leave the obligations, unusual and potential liabilities with the target companies. Unfortunately, foreign investors cannot directly operate the acquired assets without having an establishment in China. Foreign investors must establish a FIE for the purpose of asset acquisition.

In accordance with the Regulations on Merger and Division of FIE issued by the Ministry of Foreign Trade and Economic Cooperation and SAIC, FIEs are allowed to merge with each other. This may take the form of either absorption or new establishment, subject to multi-stage approval processes.

Some practical issues

Due diligence. Often the public records of domestic Chinese companies are unavailable or unreliable. Yet foreign investors need such information to determine the legal titles of assets, potential or pending litigation, priority of liabilities and so on. Records and financial information is also kept in different languages. All this make legal, financial and commercial due diligence impractical. Foreign investors therefore seek comprehensive representations, warranties and indemnities from the vendors or owners of domestic companies, but it takes time to negotiate terms and conditions acceptable to the relevant parties.

Financing arrangements. Banks are often unwilling to finance onshore M&A of domestic Chinese companies, subject to a statutory leverage ratio and provision of sufficient security. Foreign investors may consider bringing in offshore funds for the purpose of M&A. Further, foreign investors should be aware that once the new offshore funds registers in the capital account of FIEs, repatriation of funds will need to be dealt with.

Taxes. The Unified Enterprise Income Tax Law was introduced on 1 January 2008. It unifies the income tax rates for domestic companies and FIEs at 25 percent, but retains a low tax rate of 15 percent applicable to new and high technology companies. More tax incentives are provided to venture capital investments and to certain industries in environmental protection and infrastructure. Foreign investors should be aware that tax holidays of two-year tax exemption, followed by a three-year 50 percent reduction, are gradually being eliminated, except in western China where reduced tax rates are still available. The law also contains transfer pricing considerations. Foreign investors should also evaluate the impacts on contingent liabilities in respect of business operations of the acquired company.

Closing. Simultaneously closing the

acquisition of a domestic Chinese company is almost impossible. The transfer of ownership is effected when an approval certificate is granted by the Chinese approval authorities. Both M&A parties will not fulfil their obligations in accordance with the acquisition agreements until the legal transfers of ownership of assets are effected. Foreign investors may be eager to take the associated risks. Some foreign practicable measurements and arrangements are expected to fill in the gap, however the existing laws governing these are not well established.

Anti-monopoly review. The anti-monopoly review clauses are stipulated in the Provisions on Mergers and Acquisitions to stabilise the economic activities of the domestic market. MOFCOM and SAIC have responsibility for discretionary examination and approval, but with no clear guidance on the impact of a deal, regardless of size, on competition or welfare in China. Foreign investors should evaluate the exemption clauses in anti-monopoly examination when planning M&A deals.

On 30 August 2007, China passed the Anti-Monopoly Law which will come into effect on 1 August 2008. The law stipulates that MOFCOM will need to approve M&A of domestic companies which may affect national economic security in China. Foreign investors should review the list of strategic sectors of which the Chinese government will retain control.

The Danone-Wahaha disputes and Singapore Airlines' struggle for a stake in China Eastern Airlines – the two mega M&A bids of 2007 – triggered the two critical areas that impact customer welfare and national economic security in China. It seems the Chinese government will prevent traditional private equity giants from acquiring its major brands outright.

Stephen Chan is a partner at LehmanBrown.

Necessities in a cross-border Indian deal

BY BIJESH THAKKER

India registered more than US$55bn worth of M&A transactions in 2007, the most ever. The nature of M&A has undergone drastic change. Cross-border deals have become a common feature in the Indian M&A market. Although issues involved in a cross-border deal are not very dissimilar to those in a domestic transaction, it is the complexity of issues that is both interesting and surprising. The essential difference between an internal merger and a cross-border transaction is that the evaluation process in a cross-border transaction involves a detailed analysis of the target's country (its economic, cultural and political situation). Moreover, a cross-border deal requires familiarity with new procedures and frameworks involving regulatory bodies, tax authorities and new accounting practices.

Increasing cross-border M&A has helped make the Indian market more sophisticated and the Indian seller more flexible in adapting to the global business culture. However, India is a sub-continent in itself with 29 distinct languages and culture, customs, traditions and habits varying (almost) every few kilometres. Hence, India adds special complexities to a cross-border transaction. In this article, we have highlighted potential areas for a foreign acquirer to monitor.

Understanding the regulatory environment

Understanding and knowing the regulatory environment is a key starting point. India has exchange control regulations. Moreover, although the foreign investment norms are substantially liberalised, approvals could be required in certain cases (e.g., where a company has an existing trademark licence agreement or a technical collaboration in the same field). The evolving competition law and its impact should also be assessed. Highlighted below are three key legal issues.

Deciding the structure. In the process of identifying the target, it is important for the acquirer to decide the main objective of the transaction, i.e., whether it is to acquire an existing business completely or whether it is to buy into an existing business and run it as a joint venture with the existing promoters. This would help determine matters such as the seller's expectation. Moreover, the nature of the transaction, such as an asset sale or share transfer, would be dependent on this fundamental question.

Structuring the transaction from a tax perspective. When structuring an M&A transaction, tax plays a crucial role. Although most equity investments (whether by private equity funds or venture capital funds) are being made through investments by Mauritius based entities, we find that most M&A acquisitions are being made directly from the country of origin. This is because the objective of M&A is long term synergy and business development, not short term exit. Hence, finding an investment route which is tax efficient at the time of exit may not be essential or important to a strategic buyer. However, if the objectives are more short term and exit driven, finding an investment route which is tax efficient at time of exit is of immense importance.

Any changes should not overwhelm, or create insecurity in, either the local management or the employees.

Exchange control implications. India has exchange control regulations, and foreign direct investment, although substantially liberalised, is still regulated. Prior Central Government approval may be required if an acquirer is investing above the prescribed sectoral caps in certain regulated sectors (such as insurance, single brand retail, telecom, etc.) or if you have an existing joint venture or technical collaboration in the same field in which investment is proposed. Further, matters such as price at which the shares of the Indian company could be bought as well as the instrument of investment may also be regulated (e.g., whereas a convertible preference share is considered as share capital from a corporate perspective, it is considered as debt under exchange control regulations).

Cultural issues

Cultural issues are one of the most commonly cited factors for failure of an M&A deal. India's vastness, population and years of history make it culturally unique. Indians are deeply religious and connected to their historical and cultural roots. A multinational corporation entering India must recognise this. For example, in many jurisdictions the position of director may not be rated as the highest, but in India, a director is on top of the corporate ladder whether or not in actuality he has any powers. The work environment in Indian businesses, especially those run by families, is still very traditional, conservative and centred around the promoter. Employees are often treated as family and hence, implementing new ideas like a hire-fire policy or a 'modern professional work environment,' has to be handled subtly and carefully. Any changes should not overwhelm, or create insecurity in, either the local management or the employees.

Due diligence

Very often a deal has failed to deliver the value envisaged due to failure to conduct thorough due diligence. A careful and elaborate due diligence process helps to ensure that there are no surprises later. For a good due diligence to be conducted, it is imperative to have an experienced team with a proper understanding of the market and regulations – and with sufficient time to do a thorough job.

Integration

How to transition the target into the multinational company's fold, attune it to its business practices, work culture and environment, and teach its people reporting and information requirements, is a question management of the acquirer must ask before the acquisition. Acquisition by a foreign multinational is not always seen as a positive step and hence, management must have a transition plan in place prior to deal closing and executed immediately upon closing.

There are no secret formulae for successful M&A. Each situation is unique and presents its own set of potential problems and solutions. However, a better understanding of each legal issue could mitigate the risks posed in both the transaction process as well as the integration process. Acquisition of the Indian company should be seen not as the final destination, merely a step along the road.

Bijesh Thakker is a managing partner at Thakker & Thakker.

Mergers under India's new antitrust laws – challenges ahead for enterprises

BY FARHAD SORABJEE

Now highly visible on the global corporate scene, India has become a hotbed of both cross-border and domestic corporate mergers and acquisitions. Starting with information technology, it has made rapid and often surprising strides in biosciences, pharmaceuticals, telecommunications, aviation, minerals and a host of other sectors. 2006 and 2007 have signalled a terminal departure from the hitherto stately pace of Indian corporate expansion. Cross-border transactions increased from 40 in 2002 to more than 180 in 2006. Last year topped the lot with the total value of cross-border M&A standing at roughly $55bn, including some of the highest profile global deals.

One of the basic economic reasons for the spurt in cross-border and internal consolidation is the pressure of increased competition from new and nimble Indian enterprises and the fact that foreign players are finally able to enter and play in the Indian market with relative ease.

Every rose has its thorn though, and India needs an effective competition law to curb the possible adverse effects of this economic explosion on competition within its markets. But the old shibboleths first need to be vanquished. Dominant enterprises are no longer bad news, only the abuse of their position is. At the same time, a proper competition law enforcement regime needs to signal to enterprises that alliances and structures that are motivated by the eventual abuse of a dominant position will be unacceptable. Competition agencies have very limited scope to ban mergers outright, but a merger, acquisition or takeover could be prohibited if it is likely to substantially lessen competition or prevent access to a market.

The Competition Act 2002 is poised for implementation around late spring in 2008. So enterprises, both existing and prospective, will now have to negotiate with a competition watchdog: a prospect that sends shudders down the spines of many old India hands who are aware of the track record of its existing watchdogs.

The new regime

The Act provides for the regulation of combinations and provides for the financial limits of thresholds which parties to 'combinations' would require to consider before notifying the transactions to the Competition Commission of India. Combinations which are likely to attract the scrutiny of the Commission under the Act are mergers, amalgamations and acquisitions. Joint ventures could also be investigated.

Regarding thresholds, companies with global assets of more than US$2bn or sales of more than $6bn, and assets in India of more than $125m (Rs 500 crores) or sales in India of more than $375m (Rs 1500 crores), would be required to notify the Commission.

The new law may consider combinations to be void only if they are found to cause or be likely to cause an 'appreciable adverse effect on competition' in the relevant market.

Compulsory notification to the Commission and application for approval must be made within 30 days from the date of proposal to combine. Failure to notify may result in the imposition of a penalty up to 1 percent of the total turnover or assets of the combination, whichever is higher. Where the parties to the combination include a foreign acquirer, it is necessary to notify the Commission if the parties or group crosses the asset or turnover threshold jointly.

Unnerved by many provisions of the new law, various industry associations, foreign trade commissions, and even the International and American Bar Association have represented variously to government that several provisions of the new law raise serious cause for concern.

Thereafter, the Commission is required to decide within a maximum of 210 days whether or not the merger has any appreciable adverse effect on competition, else the merger will be deemed to have been approved. The Commission's draft regulations for combinations indicate that it would approve simple cases of mergers within a period of 30 to 60 days from receipt of the application, and only in mergers requiring more detailed investigation would the Commission utilise the entire 210 day limit.

The Commission is empowered to allow, modify or reject a transaction or combination and to impose penalties for non-compliance of its orders or the furnishing of false information. The Act does not seek to eliminate combinations, only their harmful effects. The Commission also has the general power to enquire into and pass orders in relation to anti-competitive practices taking place beyond India, which may affect the Indian market.

Challenge or chaos?

Unnerved by many provisions of the new law, various industry associations, foreign trade commissions, and even the International and American Bar Association have represented variously to government that several provisions of the new law raise serious cause for concern.

There is an inordinately long waiting period of 210 days for clearance. Breaking this into two phases (Phase I for simple clearances in say 30-45 days, and Phase II potentially utilising the whole 210 days for more complex situations) has to some extent been addressed in the Commission's regulations, though there is more than a hint of a suggestion that legally this needs to be embodied in the Act itself and cannot be done by regulation. Add to this the possibility of an appeal to the Competition Tribunal, and days could easily turn into years.

The introduction of the mandatory notification of transactions in the recent amendment to the law, coupled with the low thresholds for local (Indian) assets and turnover involved is another concern. In theory, mergers and acquisitions that have no or *de minimis* connection with India could require Indian clearance from the Commission. The fact that the new law as it stands requires compulsory filing even if just one of the parties has a threshold interest in India is also a cause for concern, though the regulations now clarify that a two party interest minimum requirement would be required. Add to this the absence of any provision for pre-merger consultations, and the situation becomes even more rigid and opaque.

The regulations also appear to require the filing of excessively detailed information that may be redundant and in fact cause unnecessary harassment at the procedural level. Serious concern also exists as to the level of protection of confidential information that may be filed. The prescribed filing fees of up to $150,000 are among the highest in the world, and a payment is to be made in stages, which could incentivise protraction of the clearance process.

Then again, the effective implementation of merger control requires the availability of sophisticated and reliable economic data concerning products and geographic markets, market structure and shares, and likely effects. Much of this is only rudimentary as yet in India.

And what of the existing regulators and indeed, the common law courts? For instance, the power, oil & gas, and telecommunications sectors all have their regulators. Who does one go to? Or do both exercise jurisdiction? And is that legally suspect? What would be the division of powers between the two? The relationship between the competition agency and the individual sector regulators is likely to be a complex and uneven one, and a rollercoaster of uncertainty looms, at least in the near future.

There is no doubting the commitment and integrity of the current Commission or of the government to the establishment of an effective competition regime, but there is already talk of a further delay in the implementation of the law due to hiccups in the selection process for new members of the Commission.

The law itself is adequate if not elegant, and will evolve with judicial interpretation. But any law is only as good as its implementers, and there is no guaranteeing the quality of future enforcers. The reliance upon transferable civil servants to man the Commission is a cause of concern. And then there is the possibility of protracted legal challenges to the provisions of the Act and the regulations framed.

Interesting times, uncertain times. The present Commission has made it clear that it will principally adopt a light touch, but go in hard where necessary. An admirable approach, if maintained.

Farhad Sorabjee is a partner at J Sagar Associates.

US-bound acquisitions by Indian companies

BY ANIL KUMAR

Companies such as Nirma, Wipro, Gitanjali, GHCL and Hindalco not only represent the changing economic face of India, they represent a new league of Indian companies going global. Each of these companies acquired large companies in the US in their quest to become truly global.

With 83 US-bound transactions worth over $10bn in 2007, India has suddenly emerged as a serious contender in the cross-border M&A space. Neither the global credit crunch and or economic slowdown in the US seems to have impacted this trend.

Increasing competitive pressures, emerging global opportunities and the decline in overseas trade and investment barriers are encouraging Indian companies to seek acquisitions in the US. Factors supporting this trend are strong balance sheets, easy access to capital, business confidence and a relatively stable economic and political regime.

Developed economies like the US are attractive to Indian companies because of their large consumer markets, transparent business processes, robust legal environment, advanced technologies, skills and knowledge capital. Moreover, as the markets in these economies tend to be mature and saturated, it often proves difficult for Indian companies to gain market share without acquisitions.

Highlights in 2007

2007 raised a number of highlights. Indian companies accounted for a total of 83 US-bound acquisitions with a cumulative transaction value of over $10bn. This represents a 73 percent increase over the 48 transactions of 2006. The mega deals comprised Hindalco's acquisition of Novelis for $6bn, Rain Calcining's acquisition of CII Carbon for $595m, Wipro's acquisition of Infocrossing for $568m and Firstsource's acquisition of MedAssist for $330m. IT/ITES was the most acquisitive industry capturing over 51 percent share of the total US-bound transactions by volume, followed by healthcare (11 percent); chemicals, textiles, and automotive (5 percent each); metals & mining, jewelry, travel, and media (4 percent each). Other industries accounted for less than 2 percent each in terms of volume.

Deal sizes of less than $25m accounted for 76 percent of US-bound acquisitions volume, followed by transactions in the $25-$50m range (8 percent). This reflects the increasing pressure to gain scale among smaller companies. Deal sizes in the $50-$100m; $100-$500m, and greater $500m range each accounted for less than 6 percent of the 2007 transactions. Most transactions involved the acquisition of 100 percent stock for cash consideration. These transactions generally had an earn-out structure, where a portion of the deal value is paid on future milestones.

Factors fuelling US-based acquisitions by Indian companies

Although the strategic rationale for US-based acquisitions varies by industry and the individual company, there are a few common drivers. US-based acquisitions provide easy access to the world's largest market and customer base through marketing and distribution channels of the acquired company. Indian companies are able to acquire well-established brands, a wider product portfolio, and readymade distribution networks, thus, globalising and augmenting their competitive asset base. An organic approach to building customer base and gaining market access in the US could otherwise take many years. In addition, many Indian companies are seeking to expand their distinctive capabilities by acquiring specific skills, knowledge and technology abroad that are either unavailable or of a lower quality at home. Indian companies are able to identify foreign firms with value-added offerings, which complement their own low cost products and services to create an efficient integrated global business model.

Due to the lowering of import tariffs, Indian companies are facing increased competition within the domestic market. In order to compete effectively, these companies are under pressure to access global markets and operating synergies. US companies provide one of the best global platforms in the world. In addition, low interest rates and tariffs coupled with easy access to external commercial borrowings provide Indian companies with sufficient liquidity for global acquisitions. Sustained growth in corporate earnings has improved their profitability and strengthened balance sheets. This has, in turn, strengthened their credit ratings and ability to raise funds overseas. In addition, with the rupee rising against the dollar, Indian companies are required to spend less to acquire overseas.

Meanwhile, regulatory changes in India have made it easier for Indian firms to become more global in their operations. As foreign exchange reserves have grown, the Reserve Bank of India has progressively relaxed the controls on outbound investments, making it easier for Indian companies to acquire or invest abroad.

Analysis by sector

Information technology / ITES. With 42 US-bound acquisitions in 2007, information technology is the most acquisitive industry in India. The IT industry accounts for over 51 percent of US-bound transactions from India. Within this industry, the sub-segments focused on healthcare and financial services are most attractive for acquisitions, given their untapped opportunities in the US market. While large-size companies such as Wipro and Firstsource are seeking to add new service capabilities through US-bound acquisitions, mid-size companies such as Logix Microsystems and Cranes Software are seeking to strengthen their current capabilities.

The high rate of US-bound acquisition activity in India is being propelled by the need to gain scale in terms of size, product offerings and geography. This, coupled with the availability of acquisition targets, sufficient liquidity, favourable exchange rate and competitive pressures is pushing Indian companies to pursue an inorganic path to building scale.

Healthcare. The healthcare industry captured 11 percent of the transaction volume with nine US-bound acquisitions in 2007. Jubilant's acquisition of Hollister Stier Laboratories for $122m and Wockhardt's acquisition of Morton Grove for $38m was not only about gaining market access in the US but also accessing firm-specific strategic assets like internationally certified manufacturing facilities, new products, research capability, brands, etc. and benefiting from operating synergies.

As a target location, the US has traditionally lagged behind Europe in pharmaceutical outbound acquisitions from India. But this could change based on the upcoming generic opportunities and the size of the US market. Relying on third party marketing agents may not be a good strategy in the long run, thus, Indian companies are expected to acquire export-supporting networks in the US.

Consumer goods. In consumer goods, the need to acquire US companies is driven by the desire to acquire new supplier relationships and distribution channels and not for manufacturing capacities. Front-end distribution is a common theme in many of these deals.

In recent years, Indian textile and jewellery companies have built new manufacturing facilities and special economic zones (SEZs). These companies are looking to acquire distribution and retail channels to utilise the additional capacity; Himatsingka Seide's acquisition of Divatex follows commissioning of a facility in Hassan SEZ and Gitanjali Gems' acquisition of Samuels Jewelers and Rogers Jewelers follows commissioning of their SEZ factory in Hyderabad.

Automotive & manufacturing. The key transactions in the automotive & manufacturing space were Ashok Leyland's acquisition of Defiance Testing for $17m and Sintex's acquisition of Wasaukee for $20m. Higher valuation of available acquisition targets and a general industry compression in the US has forced Indian automotive & manufacturing companies to be slow on the acquisition trail. However, as demonstrated by Ashok Leyland and Sintex, there are certain sub-sectors such as engineering design and plastic product manufacturing which remain attractive. With US companies moving their basic auto-component production to China and India, assemblies and finishing sub-industries represent the interesting segments.

Others. The largest transaction in 2007 was Hindalco's acquisition of Novelis for $6bn. This acquisition was driven by Hindalco's desire to access global markets and gain complete integration of its value chain. Calcined petroleum coke maker Rain Calcining's acquisition of US-based CII Carbon for $595m has enabled the company to become the largest manufacturer of calcined petroleum coke in the world. As seen last year, the metals and specialty chemicals industries continue to demonstrate the potential for billion-dollar transactions.

Key considerations

Typically in these deals, the Indian companies have paid for their US acquisitions in cash, for a variety of reasons. Because most Indian companies are still owned and managed by the families who founded them, they are often reluctant to bring other parties into the shareholding structure. Moreover, regulatory issues make it difficult to issue stock to foreigners for considerations other than cash, while the capital markets in India may require onerous lock-in periods when new stock is issued. With respect to financing, a combination of internal accruals and debt / equity financing is generally used. Of the multiple factors that need to be considered for determining the acquisition structure, jurisdiction, tax incidence, accounting, access to funds and local regulations are the most important. Generally, US-bound acquisition structures include an earn-out clause where a portion of the enterprise value is to be paid over a period of time based on achieving milestones.

Indian companies looking at the US market for acquisitions are generally advised to know the market, the culture and quality of the management. Understanding the culture, regulations, legal framework, and tax consequences of the target country are fundamental considerations. There certainly are pitfalls but these are becoming less serious as Indian companies gain more experience in making foreign acquisitions. India's accomplishments in liberalising regulation, modernising the business environment and boosting the country's growth over the past decade has created a self-sustaining pace. And this bodes well for Indian companies looking to go global and innovate.

Anil Kumar is a managing director at Virtus Global Partners.

Legal issues and regulatory issues in Indonesia's M&A market

BY TASDIKIAH SIREGAR AND SETIA NADIA SORAYA

Indonesia's M&A activity has recently increased. Factors contributing to this include the global resources boom and the single presence rules of Bank Indonesia prohibiting a controlling stake in more than one bank. Below are some general observations and advice on certain Indonesian legal and regulatory matters concerning M&A.

Regulatory matters

The legal framework covering M&A is provided primarily in the new Company Law that came into force in August 2007 and legislation on takeovers, mergers and foreign investment. Specific regulations apply to M&A in certain sectors.

No single government agency is presently responsible for the supervision of all M&A activity. Rather, different government departments are involved in M&A of banks, finance companies, foreign investment companies and public companies. M&A involving foreign investment companies are subject to approval from the Capital Investment Coordinating Board. For M&A in the financial and insurance sector, approval from the Ministry of Finance is required. The Capital Markets and Financial Institutions Supervisory Board (BAPEPAM-LK) must be consulted when the target is a public company. M&A of banks is subject to approval from Bank Indonesia. The Minister of State Owned Enterprises is involved in M&A of state enterprises.

At the initial stage, foreign investors need to observe which businesses are open or restricted for foreign investment as set out in the negative list and other rules of the technical departments. For example, the maximum foreign shareholding in a bank is 99 percent, while in a finance company it is 85 percent. In some cases, although certain businesses are not restricted under the negative list or other rules, by policy, the authorities may impose certain restrictions.

M&A must satisfy certain regulatory requirements including preparation of an M&A plan, corporate approvals and announcements. Acquisition can be through purchasing shares directly from existing shareholders or by approaching the management of the target. The latter involves a lengthier procedure than the former. The former bypasses the acquisition plans jointly prepared by the management of the target and investors for approval by the supervisory boards of the target and the investors. The acquisition requirements under the Indonesian Company Law will also apply to a capital increase resulting in a change of control of the company. However, the applicability of the acquisition requirements to the capital increase remains unclear.

As a general rule, M&A should not be detrimental to the interests of the target, minority shareholders, employees, creditors or the public, or lead to monopolistic practices or unfair business competition.

Minority shareholders. M&A must not prejudice the right of minority shareholders to sell their shares at a reasonable price. While the Company Law does not specifically regulate how the "reasonable price" is determined, in practice it can be based on the market value of shares or determined by independent appraisals.

Employment. Investors should take proper measures to deal with employees as they have the option to discontinue their employment with the target following a share acquisition and to claim severance. Severance is payable by investors unless otherwise agreed in the acquisition documents. Although there are conflicting views among the authorities on the applicability of the option, if the acquisition will not result in a change in the terms and conditions of employment, in most cases, the option still remains applicable. The monetary value of the overall benefit received by employees following the acquisition should not be less than the existing overall benefits package. There have been frequent occasions where employees have 'lobbied' for 'ex-gratia' entitlements even where there was no termination of employment upon the acquisition. Although there is no legal basis for these demands, employees make these overtures for a payment as a 'sweetener' simply because their acceptance of the acquisition is considered necessary. Employees may hint that without their acceptance, they may consider initiating termination or withdrawing cooperation with management. The employees usually treat these entitlements as an appreciation from the employer for their willingness to continue their work with the new management. The 'transfer' of employment in an asset or business acquisition may also give certain severance compensation entitlements to employees.

Creditors. Investors also need to consider creditors' rights to object to M&A within a certain time limit. Creditors include all parties having receivables payable by the target regardless of value. As a result, suppliers of the target can also be classified as creditors. The target needs to reach a settlement with objecting creditors, otherwise M&A cannot go ahead. No specific settlement method is determined by law. It is reasonable to assume that settlement will involve payment of debts by the target.

Antimonopoly. Other than in the banking sector, there are no clear guidelines to assess monopolies resulting from M&A in Indonesia. The Antimonopoly Law prohibits M&A if it will lead to monopolistic practices or unfair business competition. M&A resulting in the target's assets or sales turnover exceeding a certain value must be reported to the Supervisory Commission on Business Competition. Unfortunately, the value threshold remains unclear as the expected implementing regulation on antimonopoly has not yet been issued. The implementation of laws in Indonesia often requires implementing regulations to give full effect to the laws.

A party is no longer able to have control in more than one bank as a result of Bank Indonesia's 'single presence rules' of 2006. Certain controlling stakes are exempt from the rules inter alia controlling stakes in two banks with a different banking business basis. The rules force existing controlling parties to take certain options, including to transfer their shares or merge or consolidate the banks or establish a holding company.

Fit and proper test. Investors in banks must pass the Bank Indonesia fit and proper test before the acquisition. Bank Indonesia will assess the investors up to their ultimate shareholders. Bank Indonesia has wide latitude in any circumstances to examine the investors and their controlling stakes. Bank Indonesia does not allow the funds for the acquisition to be sourced from loans or other forms of financing originating from Indonesia, or from crimes. The fit and proper test may also apply to a new controlling party of the existing controlling shareholders. Investors in insurance companies are also subject to the fit and proper test conducted by the Ministry of Finance.

Capital market rules. Additional rules under capital market regulations apply to M&A involving public companies. A report on the negotiation of the acquisition must be made by the investors to BAPEPAM-LK, the Indonesia Stock Exchange, the target and the public. The acquisition of at least 25 percent of a public company will require the investors to conduct a tender offer for the remaining shares. Even if the acquisition is less than 25 percent of the shares, the investor will also be subject to a mandatory tender offer if it results in investors having direct or indirect control, such as ability to control amendments to the target's articles of association or over the management and supervisory board of the target. Certain acquisitions are exempt from the mandatory tender offer, inter alia, the acquisition of shares owned by governmental institutions in the target and the acquisition of up to 5 percent of shares issued by a publicly listed company within a period of 12 months. The tender offer rules also apply to acquisition at the controlling stake level. Consultation with BAPEPAM-LK is recommended throughout the tender offer process.

Privatisation. The acquisition of state owned limited liability companies (known as *Persero*) for privatisation is subject to prior approval from the House of Representatives. Investors must comply with guidelines for privatisation determined by a privatisation committee established by the government. The Minister of State Owned Enterprises has authority to cancel or postpone the acquisition on certain, including commercial, grounds.

Investors in banks must pass the Bank Indonesia fit and proper test before the acquisition.

Searches. It is not practicable to conduct searches to ensure there is no pending or threatened litigation against the target, its assets or its ability to continue business.

In Indonesia, claimants may submit claims against another party in the District Court having jurisdiction over the domicile agreed in an agreement, or the District Court where the party is domiciled or the District Court where the party's assets are located. There is no centralised filing system for the judicial process in Indonesia. Rather, each District Court manually maintains its own filing system. A power of attorney from the target is required for a court search.

Currently, there is no effective public

registration of corporate information. Indonesia presently also lacks any registry of security interests with the exception of land mortgages, fiduciary securities and vessel hypothecs. Searches over real property can be undertaken at the relevant Land Office. However, in most cases, that Land Office will not grant access to records without a power of attorney from the registered owner of the property.

Other Matters

Consultation with the authorities is always recommended prior to M&A. Investors should take into account certain peculiarities of the Indonesian legal system, how matters are interpreted by the authorities as a matter of written or unwritten policy and also be aware of what competitors are doing in practice.

In acquisitions, almost inevitably foreign investors will want to obtain comfort from methods other than a normal due diligence enquiry. For example, warranties and representations in the acquisition documents may be more detailed and other enquiries, such as with lenders, clients or customers of the target may also be undertaken. Indemnities from sellers and certain officers against the target's past liabilities (particularly unrecorded liabilities) and security in the form of guarantees or purchase price retention may also need to be obtained.

Finally, it may not be easy to give precise forecast of how long a deal may take in Indonesia. It is not uncommon in the Indonesian context for M&A to take longer than similar procedures in other jurisdictions. This should be taken into consideration if a multi-jurisdictional M&A is being considered.

Tasdikiah Siregar is a partner and Setia Nadia Soraya is a senior associate at Makarim & Taira S.

CHAPTER THIRTEEN:

Regional view – Middle East

The Middle East as an emerging market

BY ELEANOR KWAK, ANTONY TURTON AND PHIL O'RIORDAN

In the restaurants and *shisha* cafes of Dubai, conversations among the ever growing expatriate population almost inevitably turn to the topic of sky rocketing property prices and the latest announcement for a mega project. While such individuals often tend to get carried away (as in Hong Kong in the 1980s) it does seem that something quite remarkable is occurring in the Middle East. In turn, certain Middle Eastern countries seem to exude confidence at the moment and are keen to play a larger role on the world stage, as economic powerhouses. This article considers legal, procedural and socio-economic factors that should be considered in M&A transactions in the Middle East.

The Middle East in this context quite often means the countries that are members of the Cooperation Council for the Arab States of the Gulf (GCC), namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

There is no doubt that in many respects the traditional way of life in GCC countries has changed dramatically since the discovery of energy deposits. It is estimated that these countries hold 55 percent of the world's known oil reserves and are producing just under one-third of the world's daily output. In addition to oil reserves, the region is rich in natural gas and it is estimated that the region houses 40 percent of the world's known natural gas reserves, according to the United States Energy Information Administration. External political interventions and the world's increasing demand for energy resources has ushered unprecedented growth and change across the region.

In many countries, increased wealth has sparked investment in major infrastructure projects to upgrade facilities, and coupled with this has been a shift towards diversification of economies and fostering growth and development of various industries through state investments. The overall result is that for many countries across the GCC, the modernisation process has been compressed into decades rather than centuries.

Some examples of recent mega projects in the GCC include the World Islands and the Palm Jumeirah off the coast of Dubai in the United Arab Emirates, King Abdullah Economic City in Saudi Arabia, Dubai International Financial Centre, Qatar Financial Centre, and Bahrain Financial Harbour.

The revenue generated via the sale of energy resources, investment in infrastructure and economic diversification initiatives has procured unprecedented economic and population growth in the GCC and broader Middle East region. For example, in the United Arab Emirates, the 2005 government census found that the population had grown by 74.8 percent in the years 1995 to 2005. This is accompanied by estimated economic growth of 7.8 percent in 2007 and predicted growth of 6.6 percent in 2008, according to the Central Bank of the United Arab Emirates.

Recently, the international media has focused on massive outward investment from sovereign wealth funds based in the GCC region. With investment markets such as Wall Street hunting instant capital, GCC sovereign wealth funds are seen as a much needed source of liquidity. A recent example of a sovereign wealth fund acquisition is the Abu Dhabi Investment Authority's purchase of a $7.5bn stake in Citigroup.

Investment is also flowing the other way, and on an enormous scale. Rising economies in the Middle East, particularly in the GCC countries, have spurred interest from a broader class of international investors and others seeking to establish a presence in these emerging markets. In many countries, diversification of the economy and investment has been encouraged by favourable government policies and initiatives, such as those relating to free trade initiatives, taxation laws and import duties.

Ownership and structuring. Although there are exceptions, for example in the UAE's free zones and in respect of certain business sectors in Saudi Arabia, any investment into the GCC countries (whether in the form of an acquisition, start-up joint venture or otherwise) will need to account for the requirement that most local companies must have a majority of their shares held by a national of that country or (in some circumstances) the GCC. Where a foreign investor is seeking to control more than 49 percent of a local subsidiary, it is usually possible to put in place arrangements which effectively assign rights to control and profits in a company from the local partner. However, it is essential that careful thought is given to the drafting of these arrangements, as there are often criminal penalties for transgressing the law in this regard. In the case of local acquisitions, any existing schemes to assign control and profits need to be carefully reviewed to ensure that they are compliant with the law and also that they may be effectively assigned to the new investor.

Licensing and consents. Business in the GCC countries generally operates within a culture of consents. Whereas in western jurisdictions, most acts are permitted unless expressly prohibited, the assumption in the GCC should be that an act must be expressly permitted.

For many foreign investors, it comes as a shock to learn that a number of official consents are required for such things as an acquisition of shares, a change of directors or the establishment of a joint venture. The red tape and delays that result from the requirement for these consents can also be frustrating and bewildering for foreign investors, although most will conclude that the rewards outweigh the headaches.

Careful planning can minimise these problems. In particular, completion of acquisitions should always be conditional on the obtaining of official consents, and the flow of funds should reflect this. Escrow arrangements are frequently the preferred route.

In most cases, companies operating in the GCC will need to obtain a trade licence permitting them to carry out their specific business. Generally it is not possible to operate a 'general objects' commercial company, and there are frequently complications on the transfer of a licence, for example in the case of an acquisition.

Financing. Where an acquisition or joint venture is to be financed, local law issues may arise. These mainly relate to the taking of security, especially in relation to shares and more general charges over a company's assets.

The law and practices in the region relating to enforcement of security are largely untested. Generally, enforcement of security must be pursued solely through the courts. This contrasts with the position in jurisdictions such as England and the United States where the financier has a wider range of self help remedies available, together with more certainty in relation to the types of security available.

Although it is possible to have financing and sometimes security documents governed by foreign laws more favourable to a lender, in practice the enforcement of foreign law provisions before the local courts is often problematic. Courts in many GCC countries will frequently seek to apply local laws notwithstanding a choice of foreign law, and the court process can be slow and costly.

A growing trend is the use of Islamic financing and given the complex nature of this type of financing it will be necessary to consult both Islamic scholars in addition to obtaining specialised legal advice.

Taxation. Taxation requirements vary across the region. However, generally it is considered that countries in the GCC region host favourable taxation regimes.

In the UAE, while there are income tax decrees in the Emirates of Dubai, Abu Dhabi and Sharjah, in practice at the date of publication these decrees are not enforced and with exception of banks and oil companies there are currently no direct taxes levied on the profits or incomes or individuals or businesses. In the free zones, a tax-free environment is guaranteed for a defined period.

Law and practice. Another crucial difference between the GCC region and many western jurisdictions is the degree to which the current practice of the authorities (for example, in relation to the criteria for the granting of consents) may be just as important as written laws. Entrants to the market need to thoroughly research the current practice and, where necessary, seek pre-approval for their proposed investment before committing extensive time and resources to implementing plans.

Conclusion

The GCC is enjoying an unprecedented boom and represents an enormous opportunity for foreign investors. However, the region does have a distinct business culture which presents challenges but also great opportunities for growth. It is vital that any plan accounts for complications which may arise as a result of the local business law and practice, and that sufficient time and resources are dedicated to ensuring that any investment may be safe, secure, legal and profitable going forward.

Eleanor Kwak and Antony Turton are associates, and Phil O'Riordan is a partner, at Clyde & Co.

The growth of IT investments in UAE and the wider region – an improving legal infrastructure

BY NASSER ALI KHASAWNEH

Real estate has always been the investment vehicle of choice for the Arab investor. Whether it is the individual investor who puts all his savings into buying land, no matter how small, or the large investment funds that are fuelling the towers of dizzying heights in the Gulf, land has always had its special allure in this region. A fund manager who specialised in information technology recently spoke of an impatient investor who wished he had bought a piece of land instead of a stake in a software company.

But that mentality is gradually, though slowly, changing. It is driven by a growing number of young and technology literate entrepreneurs. M&A, and private investment funds focused on the IT sector, are on the rise. And while the aforementioned investor is right to suggest that real estate in the Gulf and the rest of the Arab world can secure fast and huge returns, there is a deepening understanding of the long term benefits of investing in other sectors, particularly in new technologies.

Behind this growth is an ever expanding IT industry in the region. According to the industry research company IDC, IT spending in the Gulf region will grow by 11.6 percent to US$8.56bn in 2008. The largest market is in Saudi Arabia where IT spending will reach $3.76bn in 2008 (an 11.28 percent growth), and the UAE's spending will grow from $2.66bn in 2007 to $2.99bn. Also, while internet usage remains disappointing compared to some other regions, it is catching up. In the UAE, more than one-third of the population is now connected online.

A law firm's role in an IT-related acquisition is pivotal. Typically, a law firm's involvement starts just before the due diligence exercise. Ideally, a lawyer should be involved at the very beginning of the negotiations between the parties in order to make sure that contractual arrangements are set in place in a well defined and orderly manner. Unfortunately, in many cases, a lawyer will only get involved after the parties had exchanged a number of important communications or signed an overrated piece of legal documentation: the Memorandum of Understanding (MOU) or Letter of Intent (LOI). Arab businessmen have an extremely intense, often inexplicable, passion for MOUs and LOIs. Many entrepreneurs in the region feel that the first step must be an MOU. When faced with a request for an MOU or LOI, it is important to clarify that an MOU is inherently a legally non-binding agreement. They should not be trusted implicitly. What is the point of spending hours and days negotiating a document that is non-binding? Parties are much better off investing that time in exploring all the major issues with a view to agreeing the final and binding agreement, or including all the initial points for discussion in a binding Non-Disclosure Agreement (NDA) or other such contract.

The due diligence process in an IT investment must be conducted in a particularly careful and measured manner. The DD exercise must of course cover all the usual areas, such as corporate, commercial and financial matters, properties, employees, and litigation. However, in most IT deals, the most crucial element of the DD is intellectual property. The DD exercise must include a detailed analysis of all the IP that resides with the company. A careful analysis must be conducted of the patents and trademarks that are owned by the target company, as well as any copyright that resides therewith. Therefore, the lawyer must compile a diligent list of all trademarks, patents and/or copyrightable subject matter that is owned by the company under review. In this regard, a list of IP owned by the company cannot be sufficient to satisfy the lawyer and, more importantly, the client that is making the investment. It is of paramount importance to insist on viewing documents such as trademark registration certificates confirming the completion of the registration process. If a trademark is still in process, evidence should be presented confirming the submission of the application and its acceptance or approval by the trademark office.

While software and other IT products are subject to patent protection, copyright law is also relied upon to provide protection. This makes the DD exercise particularly difficult in IT transactions. Copyright protection, unlike patent and trademarks, is not conditional upon any registration. In fact, according to the Berne Convention (the underlying treaty on copyright first adopted in 1886) and TRIPS Agreement of the World Trade Organization (Agreement on Trade-Related Aspects of Intellectual Property Rights), copyright protection is automatic and registration cannot be a condition for protection. Copyright is defined as any expression on any tangible medium of expression, and once a work is expressed it immediately gains protection as copyright. Therefore, when reviewing the copyright owned by the target company, it is important to form a clear understanding of the subject matter that constitutes the copyright in question. This usually requires meetings with the target company's employees who deal with R&D and the technical side of the operations. There is no definitive formula for identifying, for example, the copyrightable software. The key is to analyse the elements of the program developed by the target company with a view to determining whether this has indeed originated from the company and has been properly expressed in a tangible format.

In this regard, it is important to note that the legislative infrastructure around IP in the region has been constantly improving over the last 10 years, particularly in the area of copyright laws. As countries in the region joined the WTO, they were required to meet their obligations under the TRIPS Agreement. Furthermore, countries that have adopted, or are in the process of negotiating, free trade agreements with the United States have had to upgrade their IP legislation and enforcement practices. This has led to new and improved IP laws in countries such as the UAE, Saudi Arabia, Egypt and Jordan. Furthermore, key players in the IT industry, particularly the software industry, actively enforced their rights throughout the region. This has led to a maturing process whereby rates of IP infringement and piracy have steadily dropped in the region.

Another aspect of the legislative

infrastructure that bodes well for the future of IT investments in the region is the growing focus on legislation regarding electronic commerce and signatures. Laws that give legal effect and value to electronic transactions are crucial to the growth of a viable industry based on e-solutions and other forms of e-commerce. Most countries in the region do not yet have laws or regulations in this regard but countries such as the UAE and Jordan are taking the lead. The Emirate of Dubai was one of the very first counties in the region to adopt such a law, with the Electronic Transactions and Commerce Law (Law No. 2 of 2002) making it to the Statute book in 2002. This law gave substantial legal effect to electronic communications and transactions. In principle, it enshrined various principles that support electronic commerce. For example, Article 7 states that "an electronic mail does not lose its legal effect or its capacity for enforcement purely because it was in electronic format".

Dubai's Electronic Transactions Law fast became a model in the region, with the report of efforts aimed at adopting such a law through a treaty at the level of the Arab League. Furthermore, a similar law, Federal Law No. 1 of 2006 concerning Electronic Transactions and Commerce Law, was adopted by the United Arab Emirates at the Federal Level in January 2006. Another related development is the growth in improving laws around issues of cybercrime. It goes without saying that those who invest in IT / e-commerce solutions need to know that they can protect their rights against the growing threat of hacking, phishing and other internet-based crimes. Once again, the UAE has shown strong leadership with the passing of a law against cybercrimes (Federal Law No. 2 of 2006).

While the improving IP and e-commerce legal infrastructure is laying solid foundations for an IT industry boom, there are of course additional challenges in this field that are common to all sectors. In structuring an IT transaction in the UAE, an ever-present issue is the ownership limitation imposed by the UAE's Commercial Companies Law (Law No. 8 of 1984). This law stipulates that any company must have a local majority stakeholding, i.e., a UAE national must own 51 percent of a company that is established in the UAE. Therefore, any acquisition of shares in a UAE company must be structured on this requirement. Furthermore, in the UAE, there is no developed concept of preferential shares. Therefore, in most cases, any acquisition would involve a complex agreement that would spell in detail the relationships between the parties. For example, in terms of limited liability companies, the UAE Companies' Law allows the shareholders to distribute profit in a way that does not reflect the stakeholding, and it allows the parties to nominate the general manager (hence, if there is agreement, the minority shareholder can nominate the general manager). Therefore, an agreement between the parties is always necessary to define the rights within the confines of the Companies Law.

A feature that is particularly relevant in the Gulf is the proliferation of free zones. Usually, a free zone is an area in which certain exemptions are allowed from various aspects of local law. Using Dubai as an example, there are tens of free zones in which companies are exempted from the local ownership requirement laid down in the Companies Law. Consequently, non-UAE nationals are free to own 100 percent of companies formed in the various free zones, such as the Jebel Ali Free Zone and the Dubai Airport Free Zone. The Dubai Internet City is a particularly attractive option for IT companies. However, companies in free zones do not have the right per se to conduct business in mainland UAE. Free zone companies are a good option for a regional operational centre that will manage business in the whole region. If the purpose is to set up an entity focused on UAE business, then a UAE company must be formed that respects the 51 percent rule.

Finally, in the years ahead, particular attention must be paid to the Common Market of the Gulf Cooperation Council (GCC), the union of the Gulf states of Saudi Arabia, Bahrain, UAE, Qatar, Kuwait and Oman. The growing economic ties between the Gulf countries are fast approaching the levels of economic cooperation in the European Union. The GCC Common Market is predicated upon the GCC Economic Agreement which stipulated inter alia that "The council countries' natural and legal citizens are treated in any country of member countries with the same treatment of their citizens without any differentiation or discrimination in all economic fields especially … practice of all economic, investment, and service activities." This means that companies in the GCC and nationals thereof will be able to operate freely within all the countries of the Common Market and that all ownership restrictions for such nationals will be removed. While the Common Market came into effect on 1 January 2008, the necessary implementing laws and regulations are not yet all in place. However, the reality of the Common Market will be reflected in all aspects of the legislative framework in the region.

The years to come will prove pivotal in the IT sector in the region. As highlighted above, the legal infrastructure is constantly improving in the region, and this provides a foundation for further growth. Or will the attraction of sky piercing towers overwhelm the growing belief that investment in ideas is the cornerstone of a new and vibrant Arab market?

Nasser Ali Khasawneh is a partner at Khasawneh & Associates Legal Consultants.

CHAPTER FOURTEEN:

Contributor glossary

A.T. Kearney

Vikram Chakravarty
Navin Nathani

Acclaro Growth Partners

Christopher 'Kit' Lisle

Advokatfirman Hammarskiöld & Co.

Philip Heilbrunn
Peter Sarkia
Erik Swartling

Advokatfirman NorelidHolm

Christer A. Holm
Susanna Norelid

Advokatfirmaet Steenstrup Stordrange DA

Terje Gulbrandsen

Alvarez & Marsal

Eric Benedict
Shepard Spink
George Varughese

Amarchand & Mangaldas & Suresh A Shroff & Co.

Shardul S. Shroff

Aperian Global

David Eaton

AppLabs

Graham Smith

Arthur D. Little

Oliver Lux
Christian Niegel
Evgeny Shibanov
Dr. Karim Taga

Atos Consulting

Samantha Barklam
Sean Wells

Bates White, LLC

Boris J. Steffen

BBK

Christoph M. Schindler

BearingPoint

Matthieu Baudouin
Stephane Cohen-Ganouna
Natalia Danon-Boileau
Olivier Sibenaler

Begbies Global Network

Nick Hood

Beiten Burkhardt

Bogdan Borovyk
Cameron Hall
Ekaterina Katerinchuk

Berwin Leighton Paisner LLP

Rachel Cuff
David Harrison

Blake, Cassels & Graydon LLP

Frank P. Arnone

Booz Allen Hamilton

Justin Pettit
Dr. Jürgen Ringbeck

Borenius & Kemppinen Ltd

Andreas Doepel
Jyrki Tähtinen

Bracewell & Giuliani

John Brantley
Amauri Costa
Martin Hunt

Clayton Utz

John Elliott
Rod Halstead
Michael Parshall

Clifford Chance

Paul O'Regan

Clyde & Co.

Eleanor Kwak
Phil O'Riordan
Antony Turton

Dealogic

Salim Mohammed

ERM

William Butterworth
Jaideep Das
John Simonson

Eversheds

Robin Johnson

Garrigues, Abogados y Asesores Tributarios

Fernando Vives

GE Commercial Finance

Christoph Reimnitz

Gibbons P.C.

Robert Coyne
Kevin Evans

Grasty Quintana Majlis & Cía

Eduardo de la Maza

Heenan Blaikie LLP

Subrata Bhattacharjee

Homburger

Frank Gerhard

King & Spalding International LLP

Mark Thompson

Kroll

Phil Antoon

J Sagar Associates

Farhad Sorabjee

Jennings, Strouss & Salmon, PLC

Richard Lieberman

Jones Day

Matthew Latham
Weyinmi Popo

Kate Lye (independent consultant)

Kate Lye

Katzenbach Partners, LCC

Timothy Galpin

Kaye Scholer LLP

Derek Stoldt

Khasawneh & Associates Legal Consultants

Nasser Ali Khasawneh

Kirkland & Ellis International LLP

Frank Becker
Dr Jörn Schnigula

LehmanBrown

Stephen Chan

Lincoln Crowne & Company

Nicholas Assef

Lincoln International, LLC

Darren N. Redmayne
Saurin Y. Mehta

Liniya Prava

Tatiana Kachalina
Svetlana Dubinchina

Linklaters

Matthew Middleditch

Long&Field

Fei Guoping

Makarim & Taira S

Tasdikiah Siregar
Setia Nadia Soraya

MAQS Law Firm

Jacob Strandgaard Andersen
Veikko Toomere

Mazars LLP

Oliver Hoffman

McDermott Will & Emery LLP

Nick Azis
Patrice Corbiau
Abigail Reed
Jeffrey Rothschild
Dennis White

McKenna Long & Aldridge LLP

Chris G. Baugher
Anthony M. Balloon
Wayne N. Bradley
Michael J. Cochran
Marc C. D'Annunzio
Gary W. Marsh
Ann-Marie McGaughey
Richard R. Willis

Middletons

Murray Landis
Greg McConnell

Milbank, Tweed, Hadley & McCloy LLP

Drew S. Fine
Alexander M. Kaye

Morgan Joseph & Co. Inc.

Frank A. McGrew IV
Dunn Mileham

Morrison & Foerster LLP

Marcia Ellis
Jay C.S. Tai

MVision

Mounir Guen

NautaDutilh N.V.

Willem Calkoen
Harm Kerstholt
Miriam van Ee

Nishimura & Asahi

Masakazu Iwakura
Yoshiaki Sakurai
Juan L. Ramirez

Patton Boggs LLP

Walt Lemanski

PricewaterhouseCoopers

Will Bryan
Mike Burwell
Ian Coleman
Denise Cutrone
Richard Fuchs
Oleg Mikhailovsky
Greg Peterson

Projectfusion

Angus Bradley

Sheppard, Mullin, Richter & Hampton LLP

Tom Hopkins
Jason Northcutt

Sorainen

Raminta Karlonaitė

SummitPoint Management

Michael Sarlitto
David Soley

Taylor-DeJongh

Terry A. Newendorp
Nicole Weygandt

Thakker & Thakker

Bijesh Thakker

Uría Menéndez

Christian Hoedl
Javier Ruiz-Cámara

Virtus Global Partners

Anil Kumar

Waselius & Wist

Niklas Thibblin

WSP Environment & Energy

Tim Clare

Zamfirescu Racoţi Predoiu Law Partnership

Nicolae Hariuc
Cătălin Micu

FINANCIER
WORLDWIDE corporatefinanceintelligence

FW
E-BOOK