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INDUSTRY OVERVIEW

When the lights go out

BY CLAIRE SPENCER

At the beginning of 2007, the outlook was bright for the global M&A market. Dealogic figures for Q1 show a 28.5 percent rise in deal value compared to the same period in 2006. The number of transactions actually dropped by 920, which reflects the boom in mega-deals. The largest deal completed during this period was the spin-off of an 88.1 percent stake in Kraft Foods Inc. to Altria shareholders for $56.2bn – the second-largest deal in 2007 so far. Things looked even better in Q2 when $1.03 trillion worth of deals was completed; an increase of 38.6 percent and 670 more deals than the previous year.

It was during Q3 that crisis struck. While the US subprime mortgage industry started to see an upswing in the number of foreclosures in late 2006, it did not become significant until July 2007, when the combination of rising interest rates and freefalling property prices resulted in a credit crunch. There was cause for concern, but not enough to impact deals that were already in the pipeline. Deal figures exceeded 2006 by 30.6 percent in value and 7.8 percent in volume. Two of the year's top ten deals went through in this quarter. Fund managers still had plenty of cash in their coffers, and there was no immediate evidence that the crunch would be prolonged. But investor enthusiasm for leveraged loans, and large deals in general, had been dampened, which led to August 2007 posting the lowest monthly deal value since 2004.

Halfway through the final quarter, the market is still ticking over, but fewer deals are moving into the pipeline. Banks are fully aware of the difficulty of syndicating debt. They are demanding that leveraged buyouts are financed with more equity, and lowering their debt to EBITDA multiples. The market is still seeing strategic mega-deals, such as the $95.6bn takeover of the Dutch bank ABN Amro by a consortium of three European banks – Royal Bank of Scotland Group, Fortis and Banco Santander. But the vast majority of private equity firms have turned their attention to the mid-market, and huge buyouts are likely to be scarce or non-existent in 2008.

M&A roundup: The Americas

US

Trends in the US M&A market in the first half of 2007 mirror those seen across the globe. In Q1, deal value was up 27.4 percent while volume declined by 26.1 percent as mega-deals soared. During Q2, deal value was up 19 percent on 2006, and volume had risen by 11.4 percent. By this stage, M&A was at an unprecedented level – but it turned quickly. Although deal value continued to climb in Q3, volume dropped by 8.2 percent. The dip looks set to continue in Q4, but the market has not ground to a halt. Transactions are possible but they are being conducted differently. "Since the summer, the pace has slowed, but we continue to see brisk activity, especially in the middle market," observes Wayne Bradley, co-chair of the Corporate Department at McKenna Long & Aldridge. "Recent trends include a renewed focus on robust due diligence, lower purchase price multiples, deal terms that are more balanced as between buyer and seller, continued standardisation of the M&A process across markets and borders, and continued growth in the number of cross-border transactions."

Corporate and financial buyers still demonstrate a desire to complete deals. "Strategic buyers need to grow globally, both as a result of the desire to increase market share and access new customers, as well as the need to diversify geographically to hedge risk," says Mr Bradley. "PE buyers remain driven by the huge piles of cash they must deploy. Generally, businesses are doing well, and that means many are attractive targets. In less fortunate industries, a cadre of well-funded distress-focused buyers is becoming more active. This should make-up for at least a portion of the overall slowdown in M&A activity." Acquirers are trying to remain optimistic, believing that a conservative, long-term outlook will see them through the coming months.

Recent market volatility has shifted the balance of power towards strategic buyers, as financial buyers struggle to raise cheap debt. The current climate also makes it impossible to negotiate the sort of borrowing terms that private equity enjoyed for the 18-24 months before July 2007. But financial buyers are not out of the picture. Greg Wolski, a partner at Ernst & Young, notes that although changing debt markets have slowed many buyers, especially in private equity, they are still actively seeking good deals. "Private equity fundraising is at historic highs, most significantly in Europe. Increasingly, buyers see deals that pose the greatest potential opportunity – and risk – to be in Brazil, Russia, India and China. Continued high levels of private fundraising in the US and Europe point to continuing acquisitions," he says. These firms are currently most active in the mid-market.

Capital structures are also changing. In the last couple of years they became highly complex, with mezzanine, second lien and other subordinated instruments acting as a bridge between equity and senior debt. But as mega-deals dry up, there is less need for multiple tranches. Also, higher equity contributions reduce the total debt requirement.

Now that the frenetic pace of acquisitions seems to have calmed, the trend in M&A is clearly towards reducing risk. As part of this phase, acquirers are enhancing due diligence processes – particularly for cross-border deals. "In any transaction, what you don't know will hurt you," says Mr Wolski. "Due diligence allows buyers to understand deal dynamics, structure favourable deals, and plan post-close to ensure success. In emerging markets, where fraud, corruption, and compliance issues can destroy acquisition value, forensic due diligence allows a buyer to evaluate potential future losses from inappropriate or illegal business practices. As companies reassess their business and carve out non-core holdings, effective sell-side due diligence should be strongly considered." Due diligence is a tool that promotes deal success, and any findings should be incorporated into the strategic plan.

Acquirers are also reducing risk by exerting more influence in their negotiations with sellers. According to Mr Bradley, in private deals, indemnification-related issues are still the most discussed and negotiated issues. "These include caps, baskets, escrows, and survival periods," he says. "During the seller's market, up to this past June, buyers were taking whatever they could get on these points in the interest of getting a deal done. Recently, however, more time has gone into arriving at solutions that are acceptable to both buyers and sellers. In acquisitions of public companies by private equity buyers, the parameters of 'go-shop' and break-up provisions have become prominent and are much debated."

Private equity firms in particular cannot afford to take an overly-speculative approach to their deals. The financial model must be supported by operational acumen. "Mega-deals will continue but awareness of risk is now higher and the appetite for it less," explains Mr. Wolski. "At the same time, financial engineering is no longer the single strategy for success in acquisitions. Private investors need specific industry and business knowledge to be successful. That also applies in the middle market, where value will increasingly depend on specialised industry expertise and strategic execution," he says. In the current market, it will be harder to gloss over mistakes with a little financial creativity.

There is no reason to expect that PE firms will retreat entirely. They will need to search for high quality, financeable deals, and agree to tougher lending terms.

Latin America

Further south, the credit squeeze has not gone unnoticed, but the situation is quite different. The developing markets of Latin America have not felt the shockwaves as acutely as elsewhere. Sergio Galvis, a partner at Sullivan & Cromwell, highlights two trends that have contributed to this. "First is the rise of Latin American multinational companies, such as CVRD and Tenaris, which have shown that they are in a position to make strategic acquisitions in North America and other regions beyond Latin America. A second important trend is the inward investment into the region, especially in the natural resources and infrastructure sectors," he says. Further, the region's M&A structures do not rely as heavily on leverage, so, in the current environment, it may be less susceptible to contraction.

Latin America also has another M&A driver: high commodity prices. Sectors based on natural resources – such as metals & mining, utilities and oil & gas – are thriving. Many of the region's major deals have occurred in these sectors, such as Anglo America's investment into the Minas Rio iron ore project. There is a lot of potential in Latin America for strategic and financial acquirers. Corporates are traditional investors in natural resources and private equity firms are keen to satisfy the region's need for improved infrastructure and to stay in for the long haul.

Capital structures remain largely unchanged, although complex hybrid securities are becoming more prevalent. Deal terms are shifting towards risk reduction for buyers. "Changes in the credit markets are still working their way through transaction documentation," says Mr Galvis. "Certainly, market participants are vigorously negotiating closing conditions, material adverse change clauses and other contractual provisions. Market participants have recognised for a long time that due diligence plays a central role, both in public company deals and in private transactions. That isn't changing anytime soon." Of course, wise buyers will always tread carefully in emerging markets. Cross-border M&A can be a minefield, and acquirers should remain aware of foreign investor protection laws. It may be the case that domestic laws will need to be supplemented by international arbitration clauses, for example, to resolve potential post-transaction disputes.

Although Latin America has become more resilient, the region is by no means immune to global developments. Over the next few months it is likely to display the same symptoms as the rest of the international market. "There may be some slowdown on deal volume, at least in the short run for new mega-deals involving financial players where leverage is a key factor," observes Mr Galvis. "But with respect to Latin America I remain cautiously optimistic, especially in some of the stronger markets like Brazil, Mexico, Colombia and Peru. Deal size, while significant, doesn't tend to be as large in Latin American M&A as in the US, which may ameliorate the financing impact of credit market disruptions." Unless the credit crunch is prolonged, or intensifies, the disruption alone is not expected to be a key driver for the region.

M&A roundup: Europe

At the beginning of 2007, the story in Europe was much the same as elsewhere. Peter Sarkia, a partner at Hammarskiöld & Co, highlights a number of trends prior to the subprime fallout, especially in private equity related transactions. "Opportunities for thorough due diligence were very limited," he says. "Especially in secondary buyouts, very few reps and warranties were provided by vendors and in many cases the reps 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."

Europe has experienced a similar, although not identical, pattern to the US and the global market as a whole throughout 2007. Q1 saw deal value increase by 39.6 percent on 2006, but with a drop of 466 in deal volume. Q2 saw a larger jump of 60.6 percent in deal volume, but spread over 355 fewer deals than the same period in 2006. Thomas Sacher, a partner at Beiten Burkhardt and co-head of the firm's M&A practice group, suggests the German market reflected this trend. "The first half of 2007 was obviously a record year as global M&A activity is concerned, and we think that this holds true for the German M&A market as well," he says. "When the credit crunch emerged in summer, we were unsure at the very outset of how adversely it would affect the M&A industry. Fortunately, most of our initial concerns proved unfounded. In fact, we feel that beyond the highly leveraged PE transactions there is still a thriving M&A environment." M&A has continued unabated, ▸▸

but things have not remained the same. As the subprime crash hit across the Atlantic, the total value of European deals only climbed by 1.1 percent, and deal volume saw a small increase of 4.2 percent.

As is the case elsewhere, strategic buyers in Europe are infused with renewed vigor as PE firms are forced to rethink their investment strategies. Valuations have also become more conservative, giving corporates more opportunity to shine. "Clearly, strategic parties have more access to the market and we have seen bidding consortia being formed by private equity players with large strategic parties as a partner," observes Ferdinand Mason, a partner at Boekel De Nerée. "This facilitates the debt-provider and makes the transaction more deliverable. However, competition law aspects need to be taken into account to avoid any hindrance." Prior to the crunch, liquidity was the main driver of M&A in Europe and although it has not dried up, the fear that it might is keeping financial players on their toes. Of course, other major drivers, such as consolidation, ensure that dealflow is available for acquirers that can finance deals.

Yet there is no reason to expect that PE firms will retreat entirely. They will need to search for high quality, financeable deals, and agree to tougher lending terms. Lending appetites have altered European capital structures. At the beginning of the year, it would have been no problem to take out a €500m loan at up to six times EBITDA, whereas now the multiple would be more like two or three. It is also likely that we have seen the end of covenant-lite deals, as banks are insisting on more restrictive terms for corporate loans. They are also reluctant to take large loans into their portfolios due to syndication problems. "We expect banks to increase risk provisioning, to more closely monitor their lending and to insist on more restrictive loan agreements," predicts Mr Sacher. "This could result in lower valuations and less competition among buyers, which in turn could benefit the strategic buyers. Recent developments will probably affect the market for large transactions more than the mid-size deal market."

Across Europe, practitioners agree that due diligence should be part of every deal. However, there is a still a tendency to treat it as a box ticking exercise rather than a process which informs the acquirer's strategy. It is crucial for both parties that due diligence is thorough, as it has a direct impact on the valuation of the target. Disputes tend to crop up on a case-by-case basis, but warranties and indemnities tend to be hotly contested, according to Mr Mason. "In the Netherlands, auctions are very aggressive and most transactions will have a cap between 10 and 25 percent of the consideration," he says. Mr Sarkia outlines several negotiation issues that frequently arise in Nordic M&A transactions. These include the purchase price and the mechanism for establishing a purchase price, the level of reps, warranties and covenants to be provided by the vendor, competition restrictions for the vendor in industrial buyouts, conditions precedent for closing, and consequences in the event of a break-up.

Going forward, Europe will have the same problems as the rest of the world, but advisers are generally upbeat about mid-market prospects and the ability of corporates to shore up the market. Mr Sacher has high hopes for German M&A in 2008. "Apart from high-end transactions, we expect the M&A market to remain strong," he says. "This is particularly true for German mid-sized companies, which are known to be the backbone of the country's reinvigorated economy and which will benefit from the fact that smaller loan financing in amounts of up to €500m is still relatively easy to obtain." Mr Sarkia believes that Scandinavia will follow the same pattern. "In the mega-deal bracket, the subprime fallout has already had a substantial effect. These deals have problems getting necessary financing on satisfactory terms. The mid-market is not, at least not yet, affected to the same extent, but there is a tendency towards demands for more creditor friendly terms and conditions. Leverage levels are also declining," he says. Mr Mason believes that the shifting roles of strategic and financial buyers will be more important in the Netherlands. "More opportunities exist for strategic parties. Also, private equity firms may need to consider carve outs to service the loans on their heavily leveraged transactions."

M&A roundup: Asia-Pacific

The Asia-Pacific region held up relatively well immediately after the subprime crash, but final-quarter figures to date suggest the fallout has reached these shores. In the first half of 2007, Asia Pacific deal value climbed 39.4 percent over the previous year, with 704 more deals. Q3 figures demonstrated, as with other regions, that the consequences of the credit crunch took some time to filter through the deal pipeline. In the meantime, deal flow continues at a more reserved pace, until buyers can be sure that a more severe correction is not on the way.

Australia

In Australia, deal value increased by 80 percent in 2007, although the number of deals remained fairly stable. Private equity took an interest in large Australian brands such as Qantas. "In the first half of the year, the regional influence of private equity was the most noticeable trend," says Nicola Wakefield Evans, a managing partner a Mallesons Stephen Jaques. "That trend is now subdued as a result of the subprime crisis and in the second half of 2007, the cost of capital has increased as a result. However, there is a lot of uninvested money in funds targeted towards this region, so the medium term outlook looks positive."

Attention to detail is crucial if due diligence is to be used effectively throughout the M&A process.

Abundant liquidity drove buyout firms into new markets in search of deals, and Australia offered attractive assets. The country has also seen consolidation across several sectors, such as financial services, media/internet, aged care, and transport/logistics. Both of these drivers have since declined – credit has been squeezed and consolidation opportunities are drying up. "The credit market uncertainty has caused a throttling back of M&A activity, however, the prevailing economic conditions in Australia remain positive and the capital is still there if the deal stacks up. A good example is the recent A$2.2bn leveraged acquisition of Coates Hire – a post-August transaction. Of course, investment banks also continue to play a major role in facilitating large scale transactions which have the potential to generate significant fees from advisory, debt financing and ECM services," notes Ross Grant, chairman of Grant Samuel Group. Many Australian acquirers have been looking overseas for M&A deals, but there are still domestic prospects. High share prices have also encouraged strategic buyers to pursue M&A and diversify their holdings.

But financial buyers still have a role to play. They have cash to deploy, and will continue to invest in unsaturated markets that welcome their contribution. However, it is likely that Australia, and the whole Asia-Pacific region, will shy away from mega-deals for the same reasons as the rest of the world. Regional credit markets are already healthier, but strategics will probably continue to snap up assets for the next six months in a more traditional investment climate.

Lending habits have become more conservative in Australia. "For highly leveraged transactions we are seeing a swing away from 'covenant-lite' to 'full strength'," says Mr Grant. "Proportionately larger amortising components (incorporating cash sweep mechanisms) and mezzanine tranches are becoming more common as senior debt multiples reduce and tighter cash control measures are put in place. Traditional underwriting is being replaced by 'clubbed' deals with greater degrees of control for senior lenders over mezzanine/subordinated holders in the event of default," he says. As in other regions, banks are keen to underwrite senior debt, as long as the risk profile is structured appropriately.

Any acquirers that were tempted to skip the due diligence stage will now revert to thorough practices. "Due diligence remains important to all investors, whether they be a corporate strategic purchaser, financial sponsor or credit provider," says Ms Evans. "The key issues remain the same. The level of due diligence needs to be considered as public companies may be reluctant to provide too much information. Given the number of acquirers being trade buyers, the release of competitive information is a concern. When the private equity market returns in force, there are likely to be ongoing issues relating to the equality of disclosure which were not fully tested in the previous private equity boom which lasted until June 2007."

Attention to detail is crucial if due diligence is to be used effectively throughout the M&A process. This is true of anywhere, not just Australia or the Asia-Pacific region. The major due diligence issues tend to be relatively generic. "Price, of course, is always the major issue," says Mr Grant. "However, with the prevalence of schemes of arrangements as the mechanism of choice for private equity-led transactions or those involving complex consideration structures, boards are under increased pressure to ensure that what they put forward to shareholders provides a high degree of certainty of outcome. This has led to increased emphasis on negotiations around funding certainty and out-clauses." In the public markets, buyers are also becoming more focused on exclusivity. No-shop, go-shop, and no-talk clauses are fast becoming commonplace in public-to-private deals.

The credit squeeze continues, and mega-deals may not feature in PE-led M&A for some time. "The current issues in the global capital markets are affecting the large private equity transactions. That means that the financial sponsors are moving to the more mid-market deals in the medium term. Consequently, credit issues should not be a great deterrent for investment grade purchasers in the medium term," says Ms Evans. As in other parts of the world, Australian dealmakers will focus their energies on adapting to the new credit environment. Reducing risk, lowering expectations and pursuing smaller deals will be key trends going into 2008. ■

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