

# TMT in Central and Eastern Europe

A mergermarket report on Technology, Media and Telecoms activity



In association with



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# Foreword

**Deal flow in the Central & Eastern European (CEE) Technology, Media and Telecommunications (TMT) space has grown steadily over the past couple of years, with 309 deals worth a combined €37.4bn being completed since the beginning of 2005. Yet what particular subsectors and countries are dominating regional M&A activity? And is the credit crunch likely to affect potential deal flow? In order to shed some light on TMT activity in the region, CMS commissioned mergermarket to publish this report, and provide a combination of editorial articles, deal flow analysis and market research.**

The findings from our straw poll certainly make for an interesting read. Respondents are broadly positive on TMT prospects in the region, with 63% believing deal flow will increase in the TMT sector over the next year. Respondents also believe that the credit crunch is unlikely to affect acquisitions in the sector, with over 70% believing that current market volatility will not lead to a decrease in M&A flows.

Russia has surfaced as the country which is most likely to witness the majority of TMT activity in the region according to respondents, scoring four points out of a possible five in the straw poll. Computer software is also the most likely subsector to witness the bulk of TMT M&A activity – respondents give this sector a rating of just over four out of a possible five.

The survey also uncovers sentiment regarding the issues of outsourcing and IP auditing of TMT transactions in the region. 20% of respondents will consider outsourcing a recently-acquired operation, while 80% think that IP auditing is an

important issue. 63% believe that they would utilise such an audit in future deals. A sizeable 36% note that they have already undertaken an IP audit, with 60% of them stating that the process was beneficial.

CMS is proud to present TMT in Central & Eastern Europe, which aims to provide readers with an in-depth insight into Central & Eastern European M&A activity in the TMT sector, as well as deal makers' views on TMT outsourcings and IP audits.

Our CEE TMT group has developed a great reputation in the region's evolving TMT sector and has provided strategic advice to many of the international players in the region. If after reading this report you would like to discuss any aspects of TMT in CEE and CIS we would love to hear from you.

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# Historical Data and Analysis

## Top 20 CEE/CIS TMT transactions, 2007 - H1 2008

**Topping the TMT deal chart in 2007 was the €3bn purchase of Golden Telecom, the Russian telecoms company, by Vimpel Communications, the NYSE-listed Russian mobile operator. In 2008, the Golden Telecom deal remains the highest transaction since January 2007. The largest deal this year to date took place in Russia with Inure Enterprise selling its remaining 49% stake in Corbina Telecom to VimpelCom for €262m.**

The valuation was at a bid premium close to 5% above Golden Telecom's closing price before the offer was announced. Vimpel Communications' acquisition of Golden Telecom is expected to facilitate telecom expansion outside its core consumer cellular offering, which is growing rapidly. The bid was one of nine Russian targets out of the region's top twenty deals by value, the majority of which were either in the Internet/ecommerce or telecommunication carrier subsectors. In addition, of these nine Russian targets, 89% were acquired by Russian bidders, the remaining company going to a Turkish media company.

The second highest deal since the beginning of 2007 was the €1.6bn private equity secondary buyout of a 90% stake in the Bulgarian Telecommunications Company, the country's telecoms provider, by AIG Capital Partners, the US private equity firm, in May. AIG purchased the stake from its Austrian counterpart, Viva Ventures, fighting off competing offers from private equity houses Warburg Pincus, Texas Pacific Group, Mid-Europa Partners, as well as corporate bidders such as Turkcell Illetisim Hizmetleri, the Turkish telecommunications company and Oger Telecom, the Dubai-based telecommunications firm. AIG Capital Partners strengthened their grip on the region's TMT sector in the same month by supporting the management buyout of SC Digital Cable Systems, the Romanian provider of video re-transmission services for €113m (not listed in the top deals table).

Nor were AIG the only Western private equity fund taking an active interest in the sector. Mid-Europa Partners were also acquisitive in 2007, completing two buyouts worth a total of €620m. Mid-Europa's first purchase in 2007 was worth €450m and saw the UK private equity group buy Bite Group, the Lithuanian telecommunications company in January. Six months later, the firm acquired a substantial controlling stake in SBB Srpske Kablovske Mreze, the Serbian cable TV and broadband Internet service provider, in a secondary buyout worth €170m. The deal represented an exit for Bedminster Capital Management, the US private equity firm.

Meanwhile, the largest deal by value so far in 2008 was VimpelCom's €262m purchase of a remaining 49% stake in Corbina Telecom, the Russian telecommunications operator in early June. VimpelCom purchased the minority stake from Russian businessman Alexander Mamut. The successful bid means that VimpelCom now owns 100% of Corbina Telecom, which will allow the company to strengthen their presence in the regional broadband market.

# Historical Data and Analysis

## Top 20 TMT deals, 2007 - H1 2008

Announced	Status	Target Company	Target Sector	Target Country	Bidder Company	Bidder Country	Seller Company	Seller Country	Deal Value EUR (m)
21-Dec-07	C	Golden Telecom Inc	Internet/ecommerce Telecommunications: Carriers, Telecommunications: Hardware	Russia,USA	VimpelCom	Russia			3,022
3-May-07	C	Bulgarian Telecommunications Company (90% stake)	Telecommunications: Carriers	Bulgaria	AIG Capital Partners Incorporated	USA	Viva Ventures GmbH	Austria	1,644
9-Oct-07	C	Istrabenz	Computer software	Slovenia	Petrol d.d. Ljubljana	Slovenia			570
30-Sep-07	C	Prokom Software SA	Computer software	Poland	Asseco Poland SA	Poland	Prokom Investments SA	Poland	543
9-Jan-07	C	Invitel Tavkozlesi Szolgaltato Rt	Telecommunications: Carriers	Hungary	Hungarian Telephone and Cable Corp	USA	GMT Communications Partners Limited; Mid Europa Partners LLP	United Kingdom	470
4-Jan-07	C	Trader Media East Limited	Media	Netherlands, Russia, Channel Islands	Hurriyet Invest B.V.	Turkey			468
19-Jan-07	C	Bite Group AS	Telecommunications: Carriers	Lithuania, Latvia	Mid Europa Partners LLP	United Kingdom	TDC A/S	Denmark	450
9-May-07	C	Antenna Hungaria Rt	Media	Hungary	Telediffusion de France	France	Swisscom AG	Switzerland	330
10-Jul-07	C	JSC Telecominvest (15% stake)	Internet/ecommerce Telecommunications: Carriers	Russia	AF Telecom Holding	Russia	North-West Telecom OJSC	Russia	298
4-May-07	C	Wayfarer Media Ltd	Media	Russia	Esterna Ltd	Russia	European Bank for Reconstruction and Development; MTV Networks International; Russia Partners Management LLC	United Kingdom; USA; Russia	267
3-Jun-08	P	Corbina Telecom (49.00% stake)	Internet/ecommerce Telecommunications: Carriers, Telecommunications: Hardware	Russia	VimpelCom	Russia	Inure Enterprises Ltd	Cyprus	262
11-Mar-08	P	DTV Group	Media	Russia	CTC Media Inc	Russia	Modern Times Group MTG AB	Sweden	258
13-Aug-07	C	Corporation Severnaya Korona	Telecommunications: Carriers	Russia	VimpelCom	Russia	Tele2 Sverige AB	Sweden	172
27-Jun-07	C	SBB Srpske Kablovske Mreze (controlling stake)	Internet/ecommerce Media	Serbia & Montenegro	Mid Europa Partners LLP	United Kingdom	Southeast Europe Equity Fund I	USA	170
5-Feb-08	P	Studio 1+1 (30.00% stake)	Media	Ukraine	Central European Media Enterprises Ltd.	Bermuda			150

# Historical Data and Analysis

## Top 20 TMT deals, 2007 – H1 2008: continued

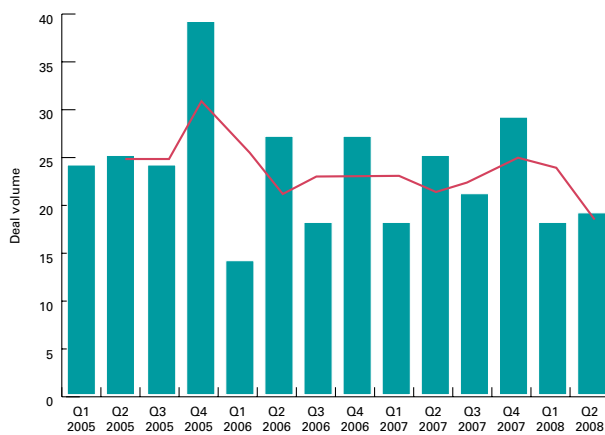
Announced	Status	Target Company	Target Sector	Target Country	Bidder Company	Bidder Country	Seller Company	Seller Country	Deal Value EUR (m)
5-Oct-07	C	NTN Channel (60% stake)	Media	Ukraine	U.A. Inter Media Group Limited	Ukraine	OOO Capitalinvest	Ukraine	149
28-Feb-08	C	Interros Company	Agriculture, Financial Services, Industrial Products & Services, Leisure, Media	Russia	Vladimir Potanin (Private investor)	Russia	KM Invest ZAO	Russia	145
3-Dec-07	C	Volia Cable (undisclosed stake)	Media	Ukraine	Providence Equity Partners Inc	USA	SigmaBleyzer	Ukraine	136
22-Feb-08	P	P4 Sp. z o.o. (23.40% stake)	Telecommunications: Carriers	Poland	Novator Telecom Poland S.a.r.l.; Tollerton Investments Ltd	Luxembourg; Cyprus	Netia Spolka Akcyjna UMTS SKA (formerly Netia Mobile sp. z o.o.)	Poland	130
27-May-08	C	OAo ARCTEL	Telecommunications: Carriers, Telecommunications: Hardware	Russia	Rosweb Telecom	Russia	Flex Welt Finance Limited; Leader Asset Management	United Kingdom; Russia	127

C = Completed P = Pending

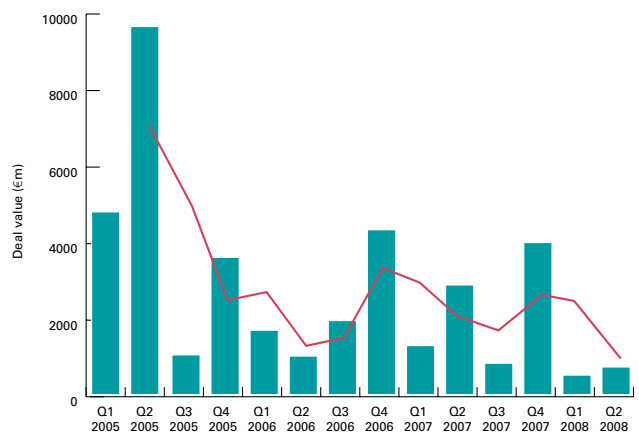
# Historical Data and Analysis

## M&A activity in the CEE/CIS TMT sector

CEE/CIS TMT deal volume



CEE/CIS TMT deal value

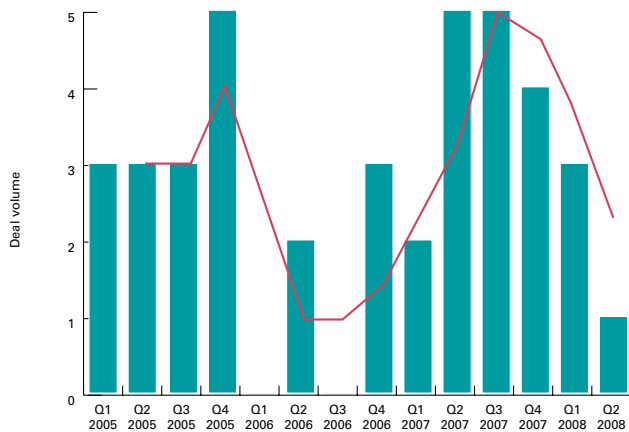


- TMT M&A deal volume in the CEE/CIS region since the beginning of 2005 has averaged 20-25 deals a quarter, with a spike in deal flow in Q4 2005, where quarterly M&A volumes hit 39 deals.
- Despite the rise in volume, quarterly deal values have generally fallen over the period from a quarterly high of nearly \$10bn in Q2 2005 to the long-term average, which is around \$1-3bn worth of transactions per quarter.

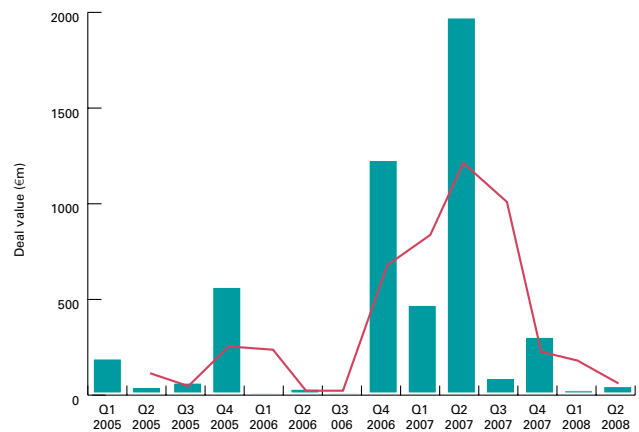
# Historical Data and Analysis

## Private equity activity in CEE/CIS TMT sector

CEE/CIS TMT private equity deal volume



CEE/CIS TMT private equity deal value



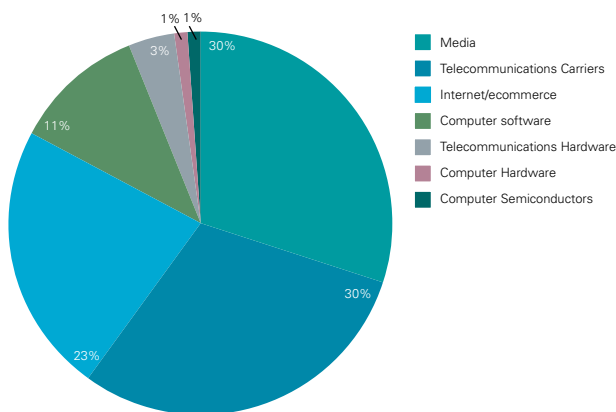
- Private equity activity in the region comprises a small but vital component of overall TMT deal flow. Since the beginning of 2005, private equity deal volumes have, on average, accounted for 12% of overall M&A flow in the sector, while private equity deal values have averaged 14% of total deal values over the period. Over the past four quarters however, private equity transactions have fallen from an average of five per quarter to just two, with just four such deals having taken place in the first half of 2008.
- Three TMT private equity buyouts typically occur per quarter in the CEE/CIS region, generally worth around \$375m in total. However, private equity has crowded the market on two occasions in the past three years – once in the Q4 2005 and then again in Q2/Q3 2007. However, values and volumes have fallen of late, with the number of announced deals dropping for the past three consecutive quarters and quarterly values falling from nearly \$2bn in Q2 2007 to just \$28m in Q2 2008.



# Historical Data and Analysis

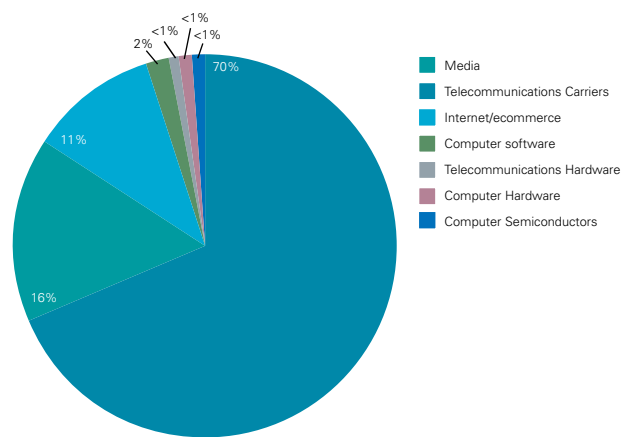
## TMT Subsector deal flow

**TMT subsector split by volume, 2007 - H1 2008**



- Transactions involving telecommunications carriers and media firms have proved significant in the CEE/CIS region in 2007 and H1 2008, with the two sectors accounting for a combined 60% of overall TMT M&A volume. Internet/e-commerce and computer software transactions also made up a sizeable proportion off overall volumes, accounting for 23% and 11% respectively.

**TMT subsector split by value, 2007 - H1 2008**

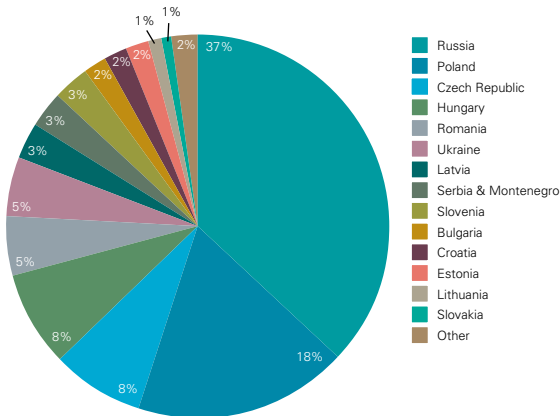


- Again, in terms of deal value, telecommunications carriers took a sizable slice of the pie at 70%.
- Computer software transactions accounted for 9% of volume and just 1% of value. Meanwhile, there were hardly any M&A deals involving either telecommunications hardware, computer hardware or computer semiconductor assets.

# Historical Data and Analysis

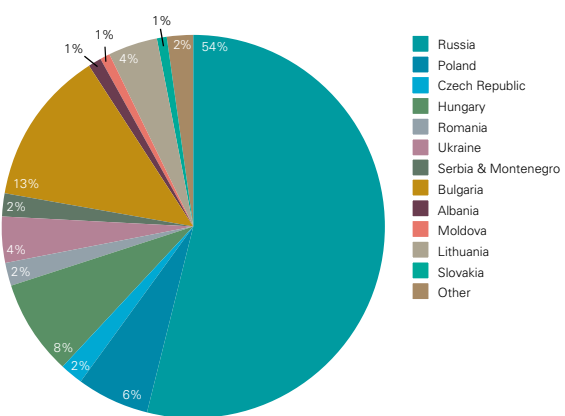
## Country splits

**Country split by volume, 2007 - H1 2008**



- Unsurprisingly perhaps, Russia comprised the largest share of TMT deal flow by country, accounting for 37% of the region's overall volume in 2007 and the first half of 2008. Poland accounted for a further 18% while Hungarian and Czech deal flow both made up 8%.

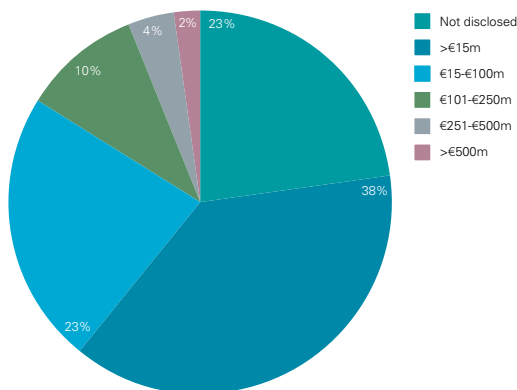
**Country split by value (€m), 2007 - H1 2008**



- Similarly, overall Russian deal value accounted for over half (54%) the market total. The value of transactions with a Bulgarian component made up a further 13% while Hungarian deal valuations comprised 8% of total regional pricings.

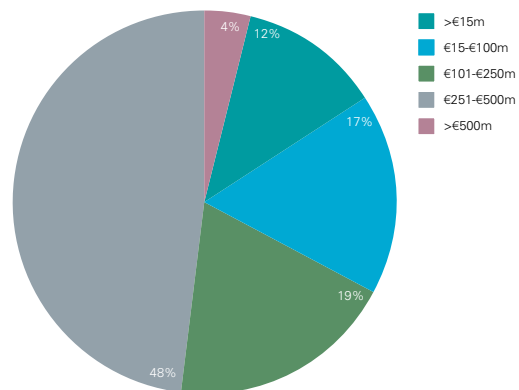
## Deal value splits

**TMT deal value split (€m) by volume, 2007 - H1 2008**



- It is worth underlining that 71% of 2007 TMT M&A deals in the CEE/CIS region were in the mid-market (€0-250m) space, with the bulk of this proportion (38%) being in the <€15m range. Only 2% of deals were worth more than €500m.

**TMT deal value split (€m) by value, 2007 - H1 2008**



- As expected, however, deals worth more than €500m lead the share of deal value, accounting for a 48% share. By contrast, mid-market deal flow accounted for 33% of aggregate values between 2007-H1 2008.

# Deal Prospects

**While TMT deal values and volumes in H1 2008 look somewhat weak, the wider economic downturn is unlikely to have a catastrophic impact on the industry. Despite this, the European Bank for Reconstruction and Development recently revised the CEE/CIS region's 2008 GDP growth rate downwards from 7.3% last year to 6%.**

In addition, since June 2007, the spread on five-year credit default swaps (a measure of risk) widened by 26 basis points for the Czech Republic, 44 basis points for Poland and a massive 151 basis points for Serbia and Ukraine.

The doom-mongering sentiment which has been reported in the media recently is unlikely to put off bread-and-butter M&A activity – in some cases, it might even promote it. Goldbach Media, the Swiss media house, is planning further acquisitions in Eastern Europe following the acquisition of Croatian firm A.D. Projekti in March 2008. Goldbach chief, Klaus Kappeler, reportedly stated that he intends to make further acquisitions in Eastern Europe this year and has noticed prices coming down in some countries recently.

Other corporates that have taken an interest in CEE/CIS include Vodafone, the UK mobile telecoms network operator, which is looking to double its stake holding in Polkomtel, its Polish counterpart, from 19.6% to 39.2%. Meanwhile, Level 3 Communications, the US Internet communications company, and BT Global Services are also looking to expand into Europe. Their joint venture has already ensured that there is a fully equipped 2,400km fibreoptic network in place within the region, enabling Level 3 to further expand its fibre-based network, offering full services in the existing markets of Prague and Vienna while adding new points of presence in Budapest, Bratislava and Ivancice.

In the lower mid-market space, a company to watch in Eastern Europe is Elomobile, the French mobility solutions provider for the transport and logistics industries. The company is planning to expand through acquisitions at the end of 2008. Chief Executive Roland de la Chapelle said in an interview he was seeking several targets in a number of European countries, such as Poland, that generate revenues of around €10m.

Overseas players are not the only ones picking targets – there is also significant likelihood of outbound activity from CEE/CIS TMT firms keen to expand globally. AFK Sistema, the Russian conglomerate with an interest in telecommunications, is reportedly planning to invest up to \$1bn to provide cellular and fixed-line telecommunication services in 21 Indian states, as well as examining a potential purchase in France. Furthermore, the firm is looking to borrow up to \$10bn to invest in foreign acquisitions. Centrum.cz and Atlas.cz, the newly merged Czech internet portals, also want to make acquisitions abroad, reported Czech daily Hospodarske Noviny. The head of the merged portal noted that the company was interested in Central Europe, with Slovakia and Poland being particularly attractive.

The region's telecom market can look to benefit from a host of privatisations coming to market. Following in the Albanian government's footsteps to sell a 76% stake in the state-owned telecommunications operator Albtelecom for €120m to a Turkish player, the Latvian government has indicated that it will support a stake swap, handing over a 40% stake in mobile phone operator LMT for a 49% holding in fixed line operator Latttelcom. It is understood that the government's newly acquired 49% stake would be sold off immediately to Blackstone, the US private equity firm for an undisclosed sum.

While large deals in the media and telecoms subsectors tend to steal the regional spotlight, the smaller CEE economies – such as Slovenia, Slovakia, Bulgaria and Romania, among others – are also reaping the rewards of their burgeoning technology sectors. At the smaller level, the latter two are to be the recipients of a new fund, the New Europe Venture Equity LP Investment Fund (NEVEQ), which will invest in small and medium-sized enterprises in their respective IT industries. The fund, which opened at the end of 2007, will invest around €40m in between eight to ten IT companies. It is being backed by a mix of US and Swiss investors, as well as the European Bank for Reconstruction and Development.

# Intellectual Property Issues in M&A Transactions in CEE in the TMT sector

## I. Introduction

The countries of Central and Eastern Europe (CEE) offer an educated labor force, skilled professionals, reliable IT infrastructure in certain locations, and relatively low cost of labour. Further, they offer easy access to the European Union countries. As a result, the region is a growing market for software application development, research, development and engineering services.

Many CEE countries have targeted and developed expertise in the IT Sector, including: artificial intelligence, application software development, R&D facilities, product testing, custom application development and IT translation services in a wide range of languages for Europe, and value-added services such as call centers, and other such IT services. It has been suggested that certain countries in the region could become the future European version of India for outsourcing or "nearshoring" for European operations, as a result of competitive labour and property costs, quality of the IT expertise, multilingual labour pool and proximity to Western Europe (see, for example, the Boston Consulting Group publication, the Central and Eastern European Opportunity: Creating Global Advantage in Serving Western Europe, 2005).

For example, Oracle has established a substantial presence in Romania. In 2004 Oracle decided to open its largest European call-center operation in downtown Bucharest. Originally, Oracle entered the market in 1992 by acquiring a local database distributor. Since then, the operation has grown to be one of Oracle's largest in Europe, employing more than 1,300 people, and becoming a key development center. According to the Executive Vice President for Europe, "Oracle aims to help push Romania into becoming the Silicon Valley of Central and Eastern Europe."

There are many more examples of major foreign investors entering the region by acquisition are similar in the Czech Republic, Hungary, Poland, Bulgaria, the Ukraine and Russia.

Taking Poland as just one other example, many major international players have decided to invest in Polish TMT companies. These investments include: First Data, International, the US-based provider of electronic commerce and payment solutions and a subsidiary of First Data, acquired PolCard, a Polish card payment processing provider, from GTECH, a listed US-based information technology company and Innova Capital (IC), a Polish private equity firm, for cash consideration of \$325m; Bauer Media Invest, the Germany-based media and advertising company, and a subsidiary of Heinrich Bauer Verlag, a German publishing group, acquired Broker FM, the listed Poland-based media company, for consideration of PLN477.84m (€122.81m); Mid Europa Partners, a UK-based private equity firm, backed the management in a buyout of Aster City Cable, a Polish provider of media and communication services, from Hicks Muse Tate & Furst, a US-based private equity firm, for €412m. Further examples include: Google opening an office in Poland in 2005 and subsequently establishing an R&D center in Kraków and an innovation center in Wrocław, and IBM opening an IBM Software Laboratory in Kraków, which is the first facility of that kind in CEE.

# Intellectual Property Issues in M&A Transactions in CEE in the TMT sector

In addition to greenfield investments, as can be seen from the examples above, many strategic investors seek to acquire a target in the region, and build their operations around that target. Many local companies have focused on software development as they can rapidly develop and export their services with limited capital investment. A significant number of these companies have become successful partners with large software companies located in the USA, Europe or Israel. There is a growing trend of these companies being acquired by their foreign partners (see for example, Consolidation in Eastern Europe: Who is Still in the Outsourcing Game?, in the February 2008 issue of Outsourcing Journal).

Given the interest of strategic investors, it is no accident that private equity and venture capital investors are interested in acquiring interests in successful TMT companies in the region.

However, there are material risks in the CEE region with respect to the acquisition of technology companies and related outsourced technology development. As the acquired entities can become developers of critical technology or become key aspects of the business of the acquiring company, one of the critical issues in the acquisition process is due diligence with respect to intellectual property rights.

In the region, the legal practices in certain countries with respect to the transfer and protection of intellectual property rights are not well developed, despite the fact that in many countries in the region the *acquis communautaire* with respect to intellectual property has been implemented.

As the issues are vast, and the legal systems of the countries in CEE are varied, the following will provide two case studies relating to intellectual property rights in the M&A context in the region. The final section will provide an overview of the methods investors acquiring local CEE targets can utilize to mitigate the risks from a legal perspective.

## II. Copyright infringement: Toader v. Sharman Case

A key legal concern in the outsourced software development context anywhere, but in particular in the CEE, is confirmation that the company or individual providing the development services has full rights to transfer the developed works to the client, or in the case of an acquisition, that the target owns the intellectual property rights it claims it owns. A very illustrative case is the Sharman Networks dispute with a Romanian freelance software developer who later went to work for Microsoft in the US.

A company acquired by Sharman Networks (Sharman) hired as an independent contractor freelance programmer Fabian Toader (Toader) in Romania to code the user interface portion of the peer-to-peer file-trading program that would later become known as Kazaa Media Desktop (KMD). Toader signed a non-disclosure agreement, but that agreement was silent on the ownership of the works produced. Toader, who subsequently moved to the United States, filed a complaint in the United States District Court, Central District of California, alleging that he neither signed a “work for hire” agreement nor executed any written assignment of his rights in KMD. He claimed that as a joint author, he acquired an undivided ownership interest in the entire work, in addition to his rights in the user interface. The complaint alleged that Sharman infringed Toader’s copyright rights in KMD by making and distributing derivative works of the source code created by Toader.

In short, the complaint sought a declaration that: Sharman is not the sole owner of the source code for KMD; that Toader is the author and owner of the source code for the KMD user interface; and that Toader is a co-owner of the copyright in KMD. Although Toader had not registered a copyright in the United States for KMD, Toader created the program in Romania as a citizen of Romania. As such, Toader argued he was not subject to the registration requirement because KMD is not a United States work. Rather, Toader maintained that his Romanian copyright was protected under Romanian law,

# Intellectual Property Issues in M&A Transactions in CEE in the TMT sector

and is enforceable because Romania is a party to the Berne Convention. Amongst other remedies, Toader sought damages estimated to be in excess of \$25m, as well as an injunction to prohibit Sharman from co-bundling within KMD adware and spyware, as such bundling violated Toader's moral rights under Romanian law in the KMD user interface and was prejudicial to his honour and reputation. (See *Toader v. Sharman Networks Ltd. (Complaint)*, 2004 ILR Web (P&F) 1408 (CD Cal., 2004, Case Number CV04-1469).

This case has a long and complicated procedural background (including actions in state and federal courts in the State of Washington). As such, it is very illustrative of the risk of acquiring targets that have hired freelance programmers in CEE without appropriate invention assignment agreements. Due to the tax advantages, many companies in the region will structure employment contracts as independent contractor arrangements, particularly for key personnel with high income. Further, the practice of entering into well drafted and enforceable invention assignment agreements under local law is not common in the region.

If the target in an M&A transaction in CEE has failed to enter into adequate invention assignment agreements with their current and former employees, as illustrated by the *Sharman v. Toader* case above, the implications can be significant, particularly if the relevant code could become integrated with key products of the acquiring company.

### III. Criminal enforcement of intellectual property rights: case study

A critical aspect in the process of acquiring technology companies in CEE is proper due diligence to confirm that the target has not or does not have a practice of infringing third party intellectual property rights. The following actual case is illustrative of the potential legal and public relations risks.

A US multinational, and a leader in its sector, acquires a company in CEE. The due diligence report indicates that there

may be a practice of infringing third party intellectual property rights in the development of software. The issue does not prevent the acquirer from proceeding with the acquisition. As part of post-acquisition restructuring, certain employees are dismissed. Shortly thereafter, the local CEE entity is raided by police and closed for IP infringement. Criminal complaints are lodged against certain senior individuals in the local entity.

Infringement of IP rights relating to software is still an issue in many countries in the region. For example, in Poland, which is one of the more advanced countries in this regard, the latest data indicate that 57% of software used in Poland is a pirated copy, as compared to 35% in the EU and 38% worldwide (See "Rzeczpospolita" daily, 15 May 2008, B4). This has led to a crack-down on piracy by the police and the public attorney. As a result, public authorities are eager to enforce IP rights, and even to confiscate (for evidence purposes) IT equipment that is even loosely connected with IP rights infringement. There has been extensive lobbying in the region for better enforcement by, for example, the BSA and the Embassies of countries exporting IP (eg the US).

### IV. Mitigating risks

From a business perspective it is key to successful transaction to acquire a reliable target with the knowledge and resources from a technical perspective. However, investors acquiring technology companies in CEE need to consider carefully these partners from an intellectual property perspective, both prior to the completion of the acquisition and subsequent to completion.

# Intellectual Property Issues in M&A Transactions in CEE in the TMT sector

## A. Due diligence

The legal due diligence investigation of the potential partner or target company should be completed by counsel with intellectual property expertise, and any deficiencies with respect to the intellectual property practices of the CEE partner should be addressed in the transaction documents. The following are a few examples of appropriate measures:

- As part of the due diligence investigation, thorough IP due diligence should be conducted, and the CEE partner should be requested to produce copies of invention assignment, confidentiality and non-competition agreements (if appropriate) with all of the employees or consultants of the target providing services to the target;
- If not already in place, invention assignment, confidentiality and non-competition agreements (if applicable) should be entered into with all employees and/or consultants as a condition precedent to the closing of the transaction;
- Detailed and enforceable intellectual property representations, warranties and indemnities should be included in the transaction documents, primarily to motivate the sellers to disclose any potential issues prior to completion and, if an issue arises after completion, to mitigate the financial consequences; and
- Obtaining consent prior to completion from owners of licensed-in intellectual property to the extent that the relevant license has a change of control clause requiring consent.

## B. Post-acquisition

As the practices and discipline that is common in large multinational TMT companies with respect to intellectual property rights is not likely to have been implemented to the same extent in the local CEE target, the acquirer should take measures to ensure that its practices with respect to intellectual property are followed. In particular, after the completion of the acquisition:

- The acquirer should require the local entity to put into place internal policies with respect to intellectual property protection to ensure that the intellectual property developed is appropriately protected from an IP perspective, and pirated software is not embedded into the intellectual property developed by the target; and
- Given that the sellers may not disclose all relevant issues to maximise the sale price or simply out of lack of understanding of the significance of the issue, the acquirer should conduct a full intellectual property audit to find and address any potential intellectual property issues as soon as possible after completion, and to allow for claims prior to the expiration of the acquirer's rights under representations, warranties and indemnities.

# Intellectual Property Issues in M&A Transactions in CEE in the TMT sector

## V. Conclusion

By taking the precautions referenced above and other such protections in the relevant transaction documents, acquiring technology companies in CEE can be very effective, not only from a cost and quality perspective, but also from a legal perspective.

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# Post-M&A Outsourcing of Non-Core Activities

## Introduction

As in more developed markets, strategic and private equity/venture capital investors in Central and Eastern Europe (CEE) are increasingly considering outsourcing certain non-core activities of acquired companies as a catalyst for company integration, to increase efficiency and competitive advantage and to reduce costs.

It is not uncommon in CEE in the case of the acquisition of large companies, particularly former state owned entities, that the non-core activities of the acquired company are outdated, overstaffed and inefficient. In smaller entities, the non-core activities may be understaffed or insufficient to meet business needs. This situation, combined with the increasing availability of competent outsourcing service providers in the region, both multinational and local, makes outsourcing an increasingly viable option post-acquisition.

However, as in more developed markets, the success of any post-M&A outsourcing transaction depends on the type of activity to be outsourced, type of company to be acquired, and the nature and circumstances of the acquirer. Below, we examine each of these issues, and provide a summary of the primary issues to be considered in implementing post-M&A outsourcing of information technology activities.

## (1) Non-core activities

It is critical in a post-M&A outsourcing to identify the right combination of services to outsource, both commodity and specialised. There is strong evidence that the outsourcing of core activities can have a detrimental effect in a strategic acquisition and can negatively impact a sale or reduce the sale price in connection with a resale by a private equity or venture capital investors. As such, the specific scope of the area of activity to be outsourced should be defined carefully.

Typically, the types of non-core activities that are outsourced are:

- information technology outsourcing;
- software Development/R&D outsourcing;
- business process outsourcing (eg payroll; customer support; telemarketing/call center, etc); and
- knowledge process outsourcing (eg accounting; engineering, etc).

As noted above, in CEE, depending on the size of the entity, these areas may be oversized and inefficient in a large target (eg outdated legacy systems that need to be retired) or underdeveloped in a smaller target (eg lack of proper accounting, billing and payroll procedures). Outsourcing may be appropriate to either expeditiously make the non-core activity efficient or expand and improve the capability.

However, what is core and non-core depends on the sector of activity of the target, as outlined in (2) below. If non-core activities are properly identified, then post-M&A outsourcing can lead to significant post-acquisition efficiency and cost savings, without jeopardizing the core activities and competencies of the target.

## (2) Type of company

Evaluating possible outsourcing arrangements in a post-M&A environment is not an easy task. Finding similar functions and auctioning them to the lowest cost service provider to demonstrate cost savings could have a substantial negative effect on the target. As such, a clear and strategic business case for the outsourcing transaction should be evident, taking into consideration the core and non-core activities of the target. The sector and competencies of the target are key to this analysis.

# Post-M&A Outsourcing of Non-Core Activities

To take a more obvious case, information technology and software development/R&D outsourcing would likely not be a high priority for information technology companies, whereas business process outsourcing and knowledge process outsourcing may be appropriate for such companies.

In contrast, certain aspects of information technology and software development/R&D outsourcing are not necessarily core activities to, for example, a bank. Outsourcing of these may be appropriate and efficient in the banking context.

## (3) Type of acquirer

A strategic buyer will have a very different approach to outsourcing than a private equity/venture capital investor, as their long-term goals are typically quite different.

In the case of a strategic investor, capital investment and maintaining capabilities in-house may be the firm's strategy. However, where the target does not have capacity similar to or up to the standards of the acquirer, outsourcing may be a viable alternative to quickly modify the practices of the target by bringing in a reputable international service provider capable of and familiar with the type of services the strategic investor expects of its new affiliate. Such outsourcing may be a cost efficient and expeditious means by which to avoid the difficulty and investment cost of restructuring the relevant activity.

A private equity/venture capital acquirer, particularly where the transaction is leveraged, will typically have an immediate need to restructure, improve and make more efficient (particularly from a cost perspective due to debt service obligations) certain non-core activities of the target (e.g. accounting, payroll, MIS). Outsourcing may be a key tool for the private equity/venture capital acquirer to achieve what is a prime objective of such buyers, the restructuring of the target to focus on its core activities in anticipation of a subsequent sale (e.g. to a strategic investor). However, care must be taken in structuring and negotiating the outsourcing arrangement, as long-term and poorly negotiated outsourcing agreements can end up being an impediment to a subsequent sale.

## (4) IT outsourcing

An activity increasingly targeted in CEE for post-M&A outsourcing is information technology. However, the process and prospects of outsourcing information technology activities are often considered too late in the process of the M&A transaction, which can lead to the outsourcing not being properly implemented post-acquisition by fully negotiated and implemented outsourcing arrangements. The following are certain key issues to be considered in the process of implementing successful post-M&A outsourcing transactions in CEE.

### (a) Pre-acquisition DD

The process of outsourcing information technology activities of a target should start in the due diligence phase. IT systems and processes should be a key element in the due diligence report prepared in connection with the transaction. The acquirer should understand whether there are: legal issues (eg intellectual property infringement requiring major licence costs post-acquisition or potential litigation or criminal actions); major upgrades in process; incompatibles that could cause post-completion integration issues; and/or material issues with the cost and efficiency of the information technology activity. Such due diligence should review a range of issues, including: the current IT inventory; legacy systems; required upgrades that may be necessary for hardware and/or software; legal documentation relating to the rights of use and ownership of IT assets; dependencies on external maintenance and support providers; human resources, including related employment and invention assignment agreements, and potential restructuring and transfer of business issues that could result in substantial cost post-completion in connection with restructuring or outsourcing; the extent to which the system is dependent on in-house bespoke developments; and any large scale IT project that could have significant implications post-completion.

# Post-M&A Outsourcing of Non-Core Activities

These factors should be part of any comprehensive due diligence investigation. However, they are critical to planning post-completion integration and restructuring involving outsourcing. The sooner the planning for the post-completion outsourcing is made, the quicker the solution can be negotiated and implemented.

## **(b) Post-acquisition outsourcing implementation**

As with any outsourcing arrangement, a post-M&A outsourcing transaction in the information technology context should involve a process that identifies a capable partner and establishes a strong agreement with the partner sufficient to achieve and enforce the objectives of the outsourcing transaction. These two issues are particularly important in CEE outsourcing transactions.

### **(i) Partner**

As the level of capability of outsourcing service providers in CEE can be quite varied, it is critical that the providers be evaluated on a competitive basis. Even the largest outsourcing service providers, while having the capacity to market a service in CEE, may not have a team and capacity in the relevant jurisdiction and sector capable of effectively providing the services. As such, a smaller and more local provider may be more effective.

To evaluate the potential providers, a structured and comprehensive request for information and subsequent request for proposal process should be implemented. Without this RFP process, identifying the right provider and maintaining realistic price competitiveness (eg through dual negotiations) in the transaction may be compromised.

### **(ii) Agreement**

The parameters of a detailed outsourcing agreement and the long and sometimes difficult process of negotiating such agreements are well understood in more developed jurisdictions. In CEE, there is a tendency to put into place relatively simple provider friendly service agreements in the outsourcing context, rather than comprehensive and negotiated outsourcing agreements covering in detail: all potential costs; customer obligations, implementation plans, disaster recovery, key performance indicators and appropriate service level agreements, benchmarking, and reasonable penalty, step-in and retransfer provisions allowing the customer to enforce the obligations of the provider in a long-term agreement where the customer has limited opportunity to reintegrate the outsourced service or transfer the outsourced activity to another provider. Without such detailed provisions, customers are at a distinct disadvantage during the term of the outsourcing agreement.

# Post-M&A Outsourcing of Non-Core Activities

## Conclusion

Careful and targeted outsourcing after the completion of an M&A transaction in CEE can result in increased efficiency and cost savings to the acquired company. There is an increasing trend to consider outsourcing certain activities of an acquired company in CEE as the capacity of major outsourcing providers and local providers is improving in the region. However, the type of activity to be outsourced, the type of company and the nature of the acquirer are critical in considering whether and what type of outsourcing is appropriate. Further, pre-acquisition due diligence and planning, evaluation of partners and a comprehensive agreement are critical to the process of implementing a successful outsourcing transaction. As outsourcing practice is not as developed in CEE, attention to these issues can pay dividends once an outsourcing arrangement is put into place after the completion of a successful M&A transaction.

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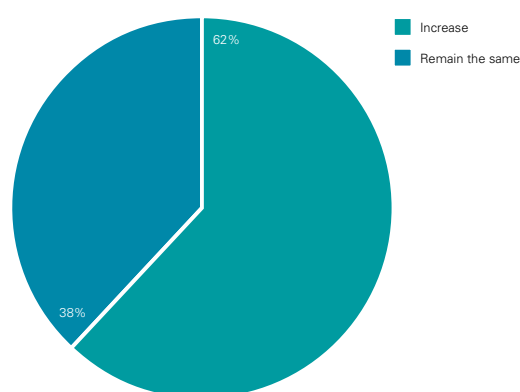
Co-Head of CEE TMT Sector Group

# Straw Poll

## Deal flow expectations

**63% of respondents believe that M&A flows in the CEE/CIS TMT sector will increase in the next year**

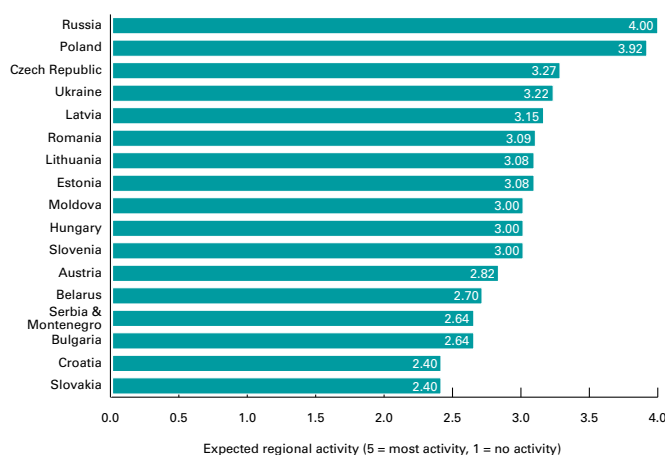
What do you expect will happen to the level of M&A activity in the TMT sector in the CEE/CIS region in the next 12 months?



- The majority of respondents are generally positive about TMT M&A prospects in the CEE/CIS region, with 62% of those surveyed expecting that deal flow will increase. The remaining 38% of respondents believe that the number of transactions will remain the same over the next 12 months.
- Deal flow is also being driven by an “active interest from funds and private equity firms,” claimed one respondent, whilst another respondent said the mid-market space would drive M&A in the sector. One of the core drivers of this M&A activity, as several respondents mention, is an increasing demand for TMT services in the region. One respondent claims that, “companies have to move with haste to snap up opportunities in the region, because many central European firms are ‘going east’.”

**Russia, Poland and Czech Republic are cited as the countries most likely to witness bulk of TMT activity**

In which countries do you expect the majority of the region’s M&A activity to be focused in the next 12 months?



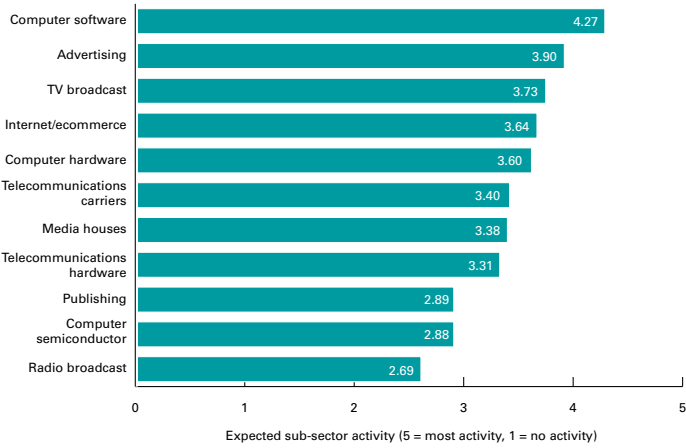
- Respondents cite Russia as the country which will witness the majority of TMT M&A activity over the next 12 months with an average tally of 4 out of a maximum score of 5. Russia is closely followed by Poland (3.92 out of 5) and the Czech Republic (3.27 out of 5). At the opposite end of the spectrum, Croatia and Slovakia are not considered likely to witness the most significant level of TMT M&A activity in the region – respondents ranked the likelihood of both countries doing so at just 2.4.
- One respondent noted that he expected “TMT M&A activity in Belarus to fall – from a strong amount of activity now to no activity in the future,” while another respondent said that in Russia, “market consolidation is an ongoing process,” contributing to its leading position in the region in terms of M&A flow.

# Straw Poll

## Drivers and obstacles of deal flow

### Respondents expect computer software M&A deals to lead TMT subsector deal flow

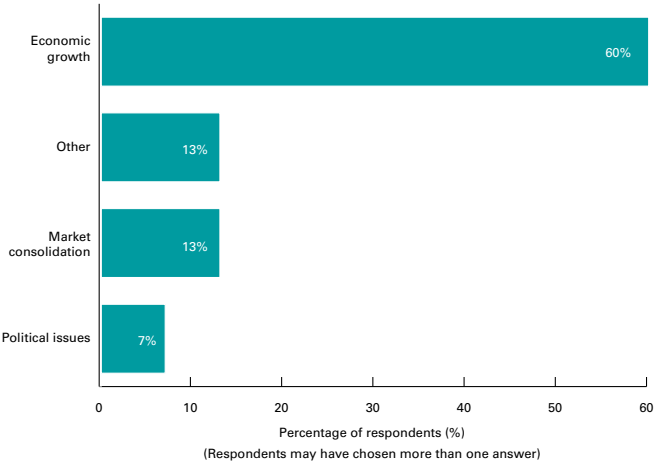
In which subsectors do you expect the majority of CEE/CIS TMT M&A activity to take place in the next year?



- Respondents agree that M&A deals in the emerging European computer software segment will likely see the most M&A activity over the next year, with an overall 4.27 rating out of a maximum of 5. The other hot areas for M&A are advertising and TV broadcasts (ratings of 3.9 and 3.73 respectively). However, respondents were generally less optimistic about activity in the publishing, computer semiconductor and radio broadcast sectors, all of which were graded below 3.

### Economic growth in the CEE/CIS region is driving TMT transactions but regulatory concerns hinder them, say respondents

What are the primary drivers for undertaking TMT transactions in the region?

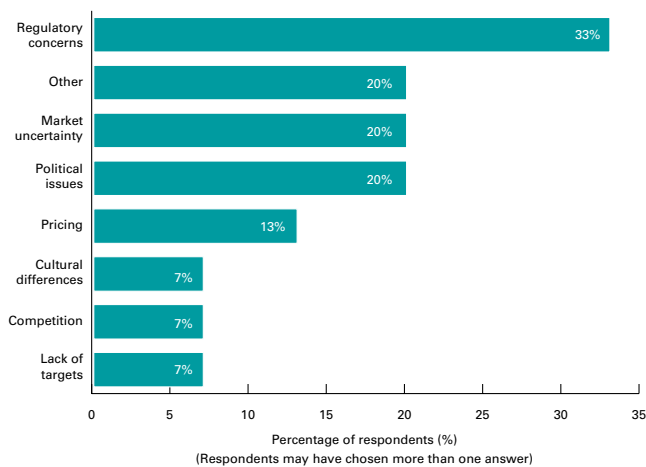


- 60% of respondents believe the region’s economic growth prospects are driving M&A growth, while the current consolidation trend in the market is cited by a further 13% as a positive factor affecting M&A flow. Additionally, respondents generally trust that accelerating economic expansion will have a myriad of positive knock-on effects, such as the “growing demand for complex tech solutions and very strong advertising markets.”

# Straw Poll

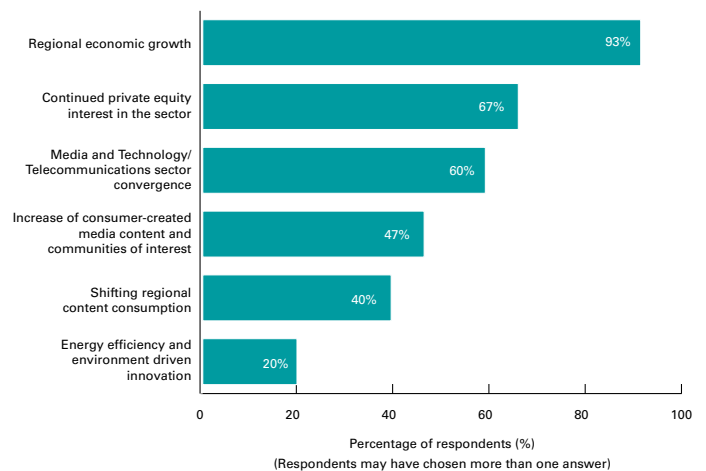
## 93% of respondents believe economic growth will continue driving regional M&A growth in TMT in the future

What are the primary obstacles for undertaking TMT transactions in the region?



- On the other hand, 33% of respondents also believe that regulatory issues are the most significant obstacle to conducting M&A activity in the region, “especially in Russia and the Ukraine,” highlights one respondent. Political issues and uncertainties surrounding the region’s markets are also viewed as hindrances to M&A activity, by 20% of respondents in each case. The survey also revealed that there are additional concerns which one respondent attributed to “corruption and a lack of transparency.”

What macro trends do you think could increase regional M&A opportunities in the TMT sector?

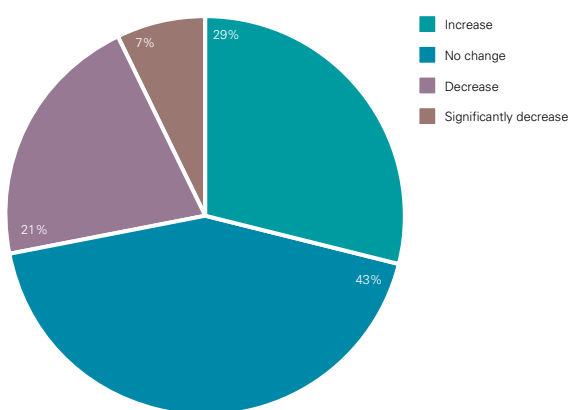


- 93% of respondents believe future regional economic growth will continue to drive M&A opportunities, while 67% believe that private equity interest in the sector will lend itself to M&A activity.
- One respondent feels that “private owners of significant assets wanting to liquidate will positively impact regional M&A opportunities. Generally as prosperity grows and value becomes transparent there will be more involvement in the TMT sector.” However, another respondent questions continued private equity involvement in the sector: “Whether PE interest will continue to drive M&A flow remains to be seen. It depends on the ongoing fallout from the credit crunch.”

## Straw Poll

### The credit crunch is unlikely to have a negative effect say over 70% of respondents

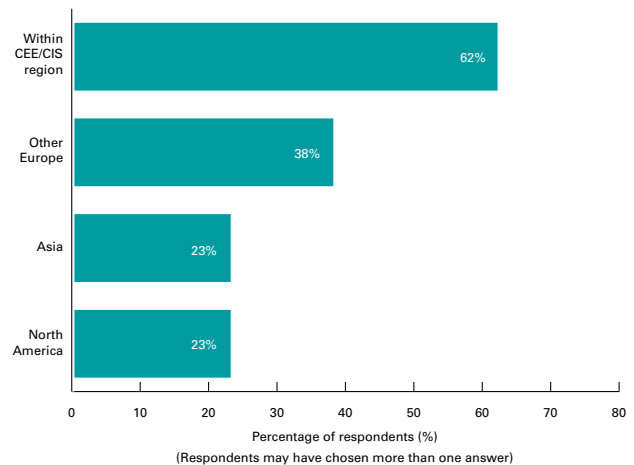
What effect is/will the credit crunch have on regional M&A activity in the TMT sector?



- 72% of those surveyed note that the credit crunch will either have a positive or neutral effect on levels of regional TMT activity, while just 7% believe that the crunch will have a pronounced negative impact.
- One respondent considers that the downturn's effects will be more prominent "in the advertising & media sector, as opposed to telecommunications." However, another respondent is more circumspect about the negative implications of the crunch, saying that "it depends – some analysts think that the 'bad times' in Western economies may actually help boost deal flow in the CEE/CIS region."

### The bulk of future inbound cross-border activity is likely to come from within CEE/CIS region say 62% of respondents

Which regions do you expect to lead inbound cross-border TMT deal flow into Emerging Europe?



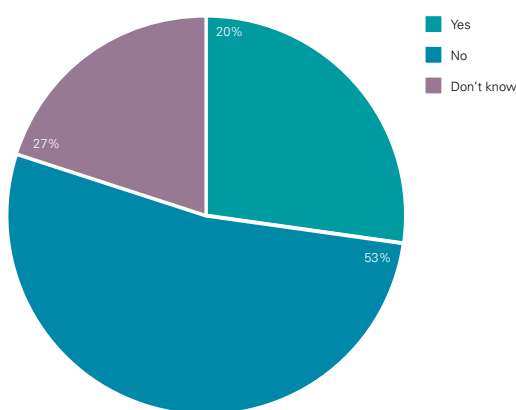
- Strikingly, cross-border TMT activity in the CEE/CIS is mostly expected to originate from buyers that are based within the region, according to 62% of respondents. A lesser 38% of respondents believe that other European bidders will lead cross-border flow.
- Buyers from emerging markets in Asia are viewed as likely by around a quarter of respondents, with one respondent noting: "Western companies are finding it difficult to finance deals at the moment. It would be interesting to see if emerging market sovereign wealth funds will move into the region, as western markets are not showing any activity whereas emerging markets are showing growth."



## Straw Poll

### 53% of respondents have not outsourced/ would not consider outsourcing a recently-acquired operation as part of a post-merger integration measure

Have/would you ever consider outsourcing your target's operations as part of a post-transaction integration measure?

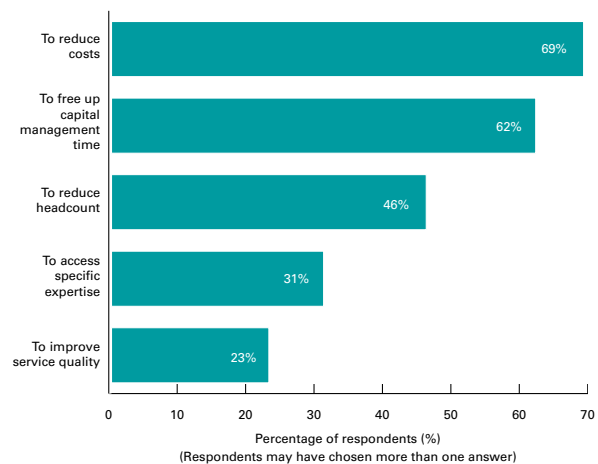


- 53% of respondents either have not or would not consider outsourcing a recently acquired operation as part of a post-merger integration measure. 20% claim they had or would consider outsourcing, while 27% were unsure as to whether they would consider outsourcing.
- Among those who had outsourced a business function post-merger, one respondent notes that his firm had outsourced a telemarketing operation, while another has outsourced the legal services, accounting, PR, IT and HR functions of its target. Generally, these respondents are happy with the end result. When asked to rate the effectiveness of the outsourcing on a scale of one to five, with five being very effective and one being the opposite, the average respondent rating was 4.33.

## Attitudes to outsourcing and IP audits

### Cost reduction is the main driver for outsourcing say 69% of respondents

What do you consider to be the drivers for outsourcing operations following an acquisition?

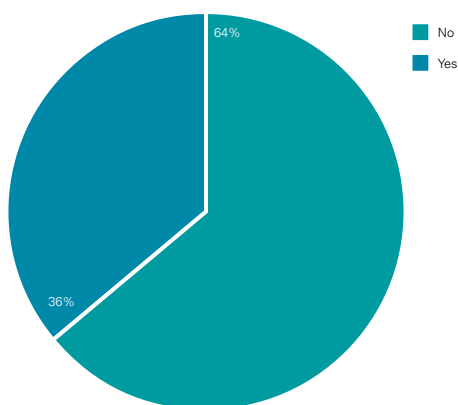


- Reducing costs and freeing up capital/management time are two of the main motives to outsource according to 69% and 62% of respondents respectively. Improving services quality and accessing specific expertise, on the other hand, seem to be the least important drivers – with only 23% and 31% in that order considering it to be a positive factor.

# Straw Poll

## 64% of respondents did not undertake an IP audit following their last transaction

Following your last transaction, did you undertake an IP audit as part of your post-merger integration process?



- The majority of respondents (64%) did not undertake an IP audit following their most recent merger, with one respondent saying that “it was not required.” However, a sizeable 36% did so, with one respondent noting that “the IP audit was part-and-parcel of a general audit.”
- Of the minority that had conducted an IP audit previously, 60% state that they believe the process was beneficial. One respondent notes that his firm conducted an IP audit by “utilising our own staff – with some business synergies occurring almost immediately.”

## Methodology

In March 2008, mergermarket conducted a survey of 15 executives from leading Western and Central & Eastern European Technology, Media and Telecommunications firms as well as private equity practitioners who had undertaken an acquisition in Emerging Europe in the past three years. The survey aimed to uncover leader sentiment on TMT M&A activity in the region, in particular, the experience the surveyed companies have had in respect of IP auditing and outsourcing target operations post-merger.

## The majority of respondents consider IP rights an important issue and would consider conducting an IP audit following an acquisition

- 80% of respondents believe that IP rights are an important issue. Furthermore, 63% of respondents went on to say that they could consider conducting an IP audit in the future following an acquisition.
- One respondent notes that the IP audit process is essential: “In broadcasting, the rights to content are where the business lies and it is essential to commission external objectives and expertise.” Meanwhile, another said he would “conduct an audit to improve efficiency and understand what we are buying, and how to deal with it better.” Another respondent notes, “for software producers an IP audit is always important.”

For the purposes of this survey, mergermarket has defined the CEE region as the following: Albania, Belarus, Bosnia & Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia & Montenegro, Slovakia, Slovenia and Ukraine.

The acronym ‘CIS’ stands for the Commonwealth of Independent States.

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