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CMS European M&A Study 2014

Sixth Edition

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Introduction

We are delighted to present the CMS European M&A Study (the “Study”). This is our sixth annual study which means that we have now reviewed over 2,000 deals for the seven year period of 2007–2013, a period of prosperity, financial crisis, significant geopolitical changes, concerns about the Eurozone and, at last, signs of some sustainable recovery in Europe.

The CMS European M&A Study 2014 provides insight into the legal provisions of mergers & acquisitions (M&A) agreements, makes comparisons across Europe and with the US and identifies market trends. It evaluates private M&A agreements relating to both non-listed public and private companies in Europe for the seven-year period 2007–2013. Of the 2,068 transactions we analyse in the Study, 344 relate to 2013.

Particular highlights in our Study are the CMS Trend Index and Sector Focus described below:

- **CMS Trend Index** – for each of the aspects we report on, we provide a CMS Trend Index to illustrate a current fact or trend.
- **Sector Focus** – CMS has adopted for a number of years a sectoral approach and now we present risk allocation statistics within specific sectors. We provide 2013 sector statistics for a number of areas we report on, namely locked box deals, earn-outs, liability caps, limitation periods and MAC clauses.

The data used in the Study is not publicly available and is based on privately negotiated transactions in which CMS acted as an advisor to either the buyer or the seller. CMS is one of the few legal service providers with the capability to provide a European study of this kind due to its presence and market penetration in a wide range of jurisdictions across Europe.

We do hope that this Study helps you in your day-to-day M&A life. We are of course very interested in any suggestions, and would be more than happy to discuss and share any experiences you may have.

Thomas Meyding
Head of CMS Corporate Group

Executive summary

CMS European M&A Study 2014

2013 was a year in which global M&A flattered, only to deceive. It finished 3% down compared with 2012 in terms of deal value. Deal value in Europe dropped 12% from the previous year and provided a lesser share of global M&A at 28.5%. Q4 was particularly disappointing both globally and in Europe, especially taking into account better economic news in many of the European member states.

Practitioners observe that deals seemed to take longer. Purchasers remain risk averse; internal approvals take longer; many multinational purchasers are particularly concerned about the general regulatory compliance of their targets including observation of anti-bribery and corruption laws.

However, the downbeat results and execution difficulties do not reflect current sentiment as we begin 2014. In the European M&A Outlook, published in October 2013 by CMS and Mergermarket, there were significant indicators that the market is much more optimistic. For instance:

- A significant majority of the survey respondents believed that the prospects for European economic growth up to the end of 2015 are improving
- 90% of respondents believed the European M&A market would improve or at least stay the same up to the end of 2015

Many commentators point to the strong cash position of corporate balance sheets; low funding costs; the fact that private equity firms still have good reserves of “dry powder” for acquisitions; and that many trading companies have disposed of their non-core assets and completed their cost cutting exercises. In short, corporates and institutions are ready to “do something” and take advantage of the early signs of sustained economic recovery. One recent commentator declared that “the animal spirits are stirring” and “stars are aligned” for takeover deals. If so, that will be further stimulus for private mergers and acquisitions.

Meanwhile in some other markets, there is economic resurgence after dark days. Spain has been one of the markets hardest hit by Europe’s financial crisis, but there is renewed optimism as both foreign and domestic investors anticipate recovery building on growth in 2013. The chairman of Santander said recently “Money is

coming in from all sides for Spain” and buoyed by strong external endorsement, Spain has particular reason to feel optimistic about M&A transactions in 2014.

Risk allocation as between seller and buyer in M&A sale and purchase agreements – which is what this Study looks to analyse – has remained stable now for three years. The sharp swings between various deal points shown in pre-2011 CMS European M&A Studies are no longer seen. We have, however, seen subtle developments in 2013. For instance, although there has been no bounce in the number of earn-out transactions, it is noticeable from this year’s Study how the earn-out periods are longer. 30% of relevant transactions had earn-out periods of 3 years or longer. This means that sellers are more prepared to do deals based on a consistent medium to long-term return and seem to have more confidence that there will not be economic troughs or downturns over that period. Similarly, there is a different balance for transactions where some form of security is required for warranty claims. We are seeing that buyers are generally requiring less security than they did in 2012, but that the security that they are negotiating is just as likely to be hold-back or retention of part of the purchase price as it is to be an escrow account. In previous years, it was almost twice as likely that an escrow account would be negotiated rather than a hold-back.

Warranty periods are generally becoming shorter although there are regional differences. MAC clauses are still relatively rare in Europe. Each of the jurisdictions will have its own features. For instance, France has the lowest liability caps but long warranty periods; *de minimis* and basket provisions are absolutely standard in the UK; CEE usually sees the most MAC clauses and arbitration as the most likely dispute resolution mechanism. Yet, we now see growing evidence of greater consistency between European regions and less extremes where custom and practice is significantly different in some regions. Most of the common arguments in M&A transactions are familiar in all of the regions although the outcomes will vary.

Key conclusions

The key conclusions of the CMS European M&A Study 2014 are as follows:

- Purchase price adjustments – the number of deals containing a purchase price adjustment mechanism decreased in 2013, continuing the general trend that was observed last year.
- Locked box – there was little change in the use of locked box mechanisms when compared with 2012 although there were significant regional differences.
- Earn-out – in 2013, 14% of transactions had earn-out clauses which was a marginal decrease in the number of such transactions compared with 2012 whilst there was a marked increase in the proportion of relevant transactions (30%) with earn-out periods exceeding 36 months.
- *De minimis* – there is an ongoing trend for greater use of *de minimis* provisions in every European region.
- Baskets – the upward trend in the use of baskets was maintained in 2013 and recovery on a ‘first dollar’ basis continued to be standard in Europe in 2013 in contrast to the US where once again in the majority of transactions recovery was on an ‘excess only’ basis. Thresholds for baskets are slightly lower with the majority of transactions having a threshold of less than 1% of the purchase price.
- Liability caps – sellers were less successful in limiting their liability to 50% or less of the purchase price in 2013 (47%) as compared with 2012 (54%).
- Warranty & Indemnity insurance – W&I insurance (considered in 9% of the deals in 2013, an increase from 8% in 2011/2012) remains an important option for solving the warranty gap when sellers (e.g. financial sellers) refuse or cannot give warranties.
- Limitation periods – in contrast to 2012, the limitation period of 12–18 months was the most popular in 2013 with notable increases in the use of this particular limitation period in the UK, France and CEE regions.
- Security for warranty claims – the number of buyers looking to obtain some form of security (whether it be use of an escrow account, purchase price retention or bank guarantee) decreased in 2013 but, where applicable, a significantly higher proportion of buyers negotiated retention of part of the purchase price.
- MAC clauses – the proportion of deals with a MAC clause remained unchanged at 14% in 2013 compared

with 2012 and therefore MAC clauses remain relatively rare in Europe in contrast to the US where a large majority of deals (94%) have MAC clauses.

- Non-compete covenants – 49% of deals had non-compete clauses which was an increase from 46% in 2012.
- Arbitration – the number of M&A deals with an arbitration clause increased from 33% (2012) to 37% (2013).

European and US differences

The Study continues to reveal significant cultural and regulatory differences within Europe when compared with the US:

- Earn-out deals are more popular in the US. 25% of US deals had an earn-out component compared with just 14% in Europe in 2013.
- MAC clauses are much more popular in the US than in Europe. MAC clauses were used in 94% of the deals in the US compared with just 14% of deals in Europe.
- Not only are baskets much more prevalent in the US, but the basis of recovery is different. In the US, 61% of relevant deals are based on ‘excess only’ recovery as opposed to ‘first dollar’ recovery compared with only 26% in Europe in 2013 for ‘excess only’ recovery.
- Purchase price adjustments continue to be used in the majority of US deals (85%) while only being used in 43% of European deals in 2013.
- Lower liability caps in US deals are more popular, with 87% of US deals having liability caps of 25% of the purchase price or less, compared with only 34% of European deals.
- Working capital adjustments continue to be by far the most frequently used criteria on a purchase price adjustment in the US, used in 91% of deals as opposed to just 40% in Europe in 2013, where the deal contained a purchase price adjustment.
- Basket thresholds tend to be lower in the US with 88% being less than 1% of the purchase price compared with 51% in Europe.

Differences within Europe

The Study also revealed significant differences in customs and practices within Europe, including:

In Benelux:

- There was a rise in the number of deals with a 'first dollar' recovery mechanism in deals with baskets in 2013 (95% of deals compared with 79% in 2012).
- Deals were the most likely within Europe (43%) to have liability caps of less than 25%.

In Central and Eastern Europe (CEE):

- Deals in CEE were the most likely in Europe to have a MAC clause (28%).
- Arbitration continues to be the main dispute resolution process (71% compared with the European norm of 37%).

In German-speaking countries:

- Deals in German-speaking countries were the most likely to have escrow accounts as a mechanism for securing warranty claims (18%).
- German-speaking countries became the 'European earn-out region' in 2013 with 25% of its transactions containing earn-out provisions.

In France:

- French deals had the highest proportion of liability caps of 50% of the purchase price or less (87% of deals).
- In 67% of transactions with a basket, the basis of recovery was 'excess only' – still the highest proportion in Europe.

In Southern Europe:

- 68% of Southern European deals reveal a liability cap exceeding 50% of the purchase price.
- Southern European deals have the longest warranty periods, exceeding two years in 50% of deals.

In the UK:

- UK deals were the most likely to have 'first dollar' recovery – in 96% of deals with a basket.
- In 44% of deals, the warranty period was 12–18 months.

CMS commentary

- CMS transacted 344 deals in 2013, a slight increase compared with 2012 and 2011.
- 2014 is likely to be much more active than 2013 with all the indicators pointing in that direction. Whilst there still remains a gap between seller price expectation and reality, we expect purchasers to be bridging that gap this year.
- There are inevitably differences year on year between different categories of risk allocation points covered by the Study. These points continue to be heavily negotiated in M&A deals, but overall risk allocation as between sellers and buyers has remained fairly constant for the last three years.
- We expect the most active sectors to be TMT, Financial Services and Energy.

Methodology

The Study includes deals which were structured either as a share sale or an assets sale, including transactions where a seller held less than 100% of the target company's share capital, provided this represented the seller's entire shareholding in the target company. The Study also includes property transactions which involved the sale or acquisition of an operating enterprise such as a hotel, hospital, shopping centre or comparable business, and not merely a piece of land. Internal group transactions were not included in the Study.

The data has been divided for comparative purposes into four European regions. The countries included in each of these regions are as follows:

- Benelux: Belgium, The Netherlands and Luxembourg
- Central and Eastern Europe (CEE): Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia and Ukraine
- German-speaking countries: Austria, Germany and Switzerland
- Southern Europe: Italy, Spain and Portugal

France and the United Kingdom are presented as individual categories.

Transactions included in the Study cover the following sectors:

- Finance & Insurance
- Hotels & Leisure
- Energy & Utilities
- Consumer Products
- Technology, Media & Telecommunications
- Infrastructure & Project Finance
- Lifesciences (Pharmaceutical, medicinal and biotechnical products)
- Real Estate & Construction
- Industry
- Business (Other Services)

Comparative data from the US was derived from the Private Target Mergers & Acquisitions Deal Points Study reporting on transactions completed in 2012 and produced by the Mergers & Acquisitions Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association's Business Law Section.



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