ALLEN & OVERY

New tactics for new times

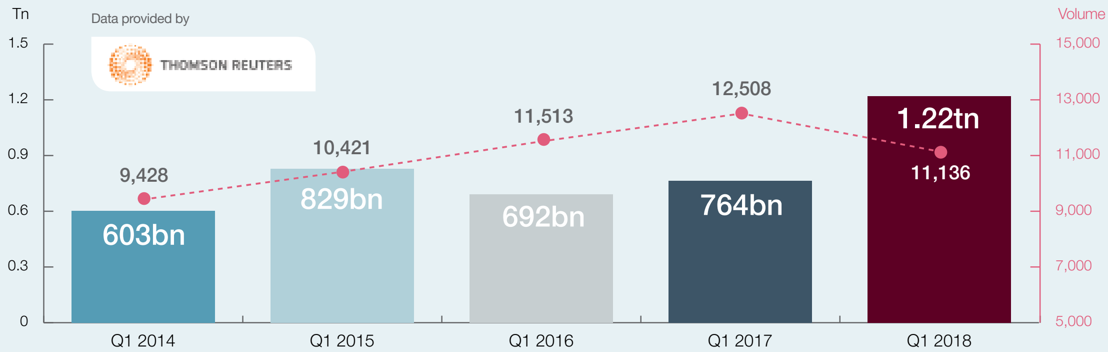
M&A Insights: *In focus* | Q1 2018

Global M&A Q1 2018 snapshot

A record Q1 for value of deals

60% increase in deal value
Q1 2018 vs Q1 2017

225% increase in value of deals
over USD10bn Q1 2018 vs Q1 2017



Global trends in private M&A

Digital strategies and private equity funds drive deals

Allen & Overy's annual study of the private M&A market – based on analysis of over 900 deals we've advised on over the last six years – reveals how, in a buoyant sellers' market, private equity funds' buy-side tactics are paying off and digitalisation is driving deals across sectors.

Our latest analysis shows that dealmakers remain in a confident mood. Despite a range of significant political uncertainties, activity remains buoyant, particularly in the mid-market. It continues to be a strong sellers' market, with a number of key fundamentals remaining in place, including healthy corporate cash balances, record levels of private equity fundraising and ready availability of financing.

The sharp correction in equity prices in January 2018, amid worries about faster than expected increases in interest rates, may test nerves. But there is still little sign that dealmakers are losing their appetite for transactions.

While our 2017 research may appear, at first sight, to reflect a continuation of familiar themes, we are seeing significant new trends in deal tactics and terms as the boom in M&A activity rolls on.

Private equity auction tactics pay off

Several years ago, private equity funds sometimes struggled to make headway against strategic buyers in auction processes, but they have staged something of a fight back in the last three years, using a range of new tactics at a time when auctions have become increasingly popular.

Strategic buyers are often prepared to pay higher prices, reflecting valuable synergies that have not traditionally been available to private equity funds. But the increased use of 'buy and build' – where new businesses are added to existing private equity portfolios – has allowed funds to join the search for synergies and to compete on more equal terms.

There's also been a growth in 'Club' deals where private equity funds, bringing discipline, contacts and access to finance, team up with trade buyers, offering efficiencies, economies of scale and commercial expertise, to create winning combinations.

"Private equity funds have staged something of a fight back in the last three years, using a range of new tactics at a time when auctions have become increasingly popular."

Such tactics appear to be paying off, with private equity funds winning 47% of the auctions in our 2017 sample, compared to just 35% in 2015.

There were further examples of innovation during the year, with some funds opting to take minority (rather than the usual majority) stakes in targets – a particularly common approach in key Asian markets with foreign ownership controls.

We also saw more successful attempts to source assets outside of an auction last year, with sponsors building strong relationships with management and making a bilateral approach.

We expect to see further innovation in the future. Already we are seeing private equity houses raising funds with a 15-year holding period, rather than the usual ten, with the potential to generate higher returns over a longer holding period.

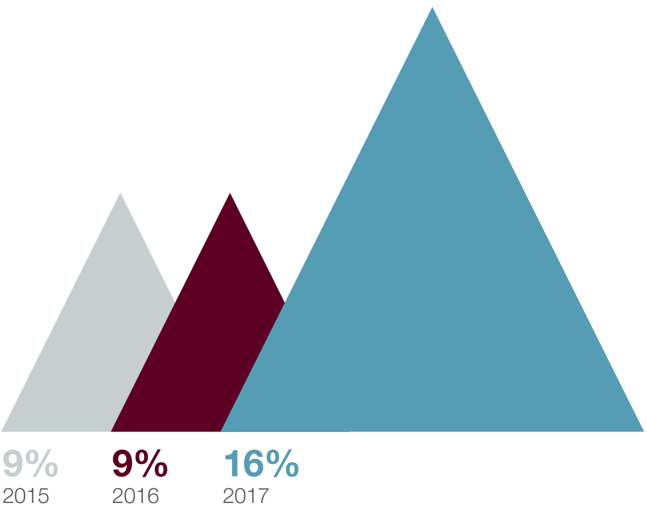
Digital strategies driving deals

A clear trend in the last year was the number of deals driven by digital transformation strategies, with companies across a broad range of sectors seeing M&A as the speediest way to build their digital operations, often aiming to achieve a set proportion of digital revenues within the next few years.

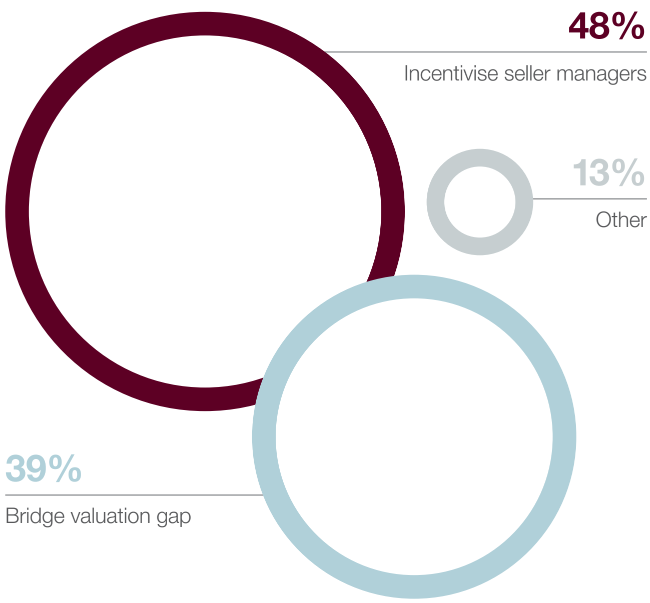
In the tech sector, we've also seen a sharp rise in so-called 'acquihires', where a company is bought for its talent, rather than its products, services or financial performance.

This, along with sellers' high expectations on price, is driving an increasing use of earn-outs, lasting two to three years. Some 48% of the earn-outs in our sample were to incentivise and retain founders or seller managers, while 39% were used to bridge the valuation gap between buyer and seller.

% of deals featuring earn-outs



Reason for earn-out – 2017 deals



Earn-out period – 2017 deals

Data from A&O's Global trends in private M&A study

"In a sellers' market, it is not surprising to see sellers push back on the execution risk that antitrust approval presents."

Antitrust and regulatory risk

Antitrust or regulatory approval was required in 80% of the high value (USD500m+) deals in our sample, and 71% of mid-market transactions. In the current sellers' market it was not surprising, therefore, to see sellers push back hard on the execution risk this presents. For instance, in about a fifth of these deals, sellers insisted on a reverse break fee of up to 10% of deal value (with the average fee being 6% of deal value).

In 24% of deals subject to antitrust conditions, 'hell or high water' provisions were imposed, requiring the buyer to take all action necessary to get the deal cleared. Private equity sellers, in particular, insisted on this.

Reverse break fee
19% of deals

Average fee
6% of deal value

W&I insurance market grows

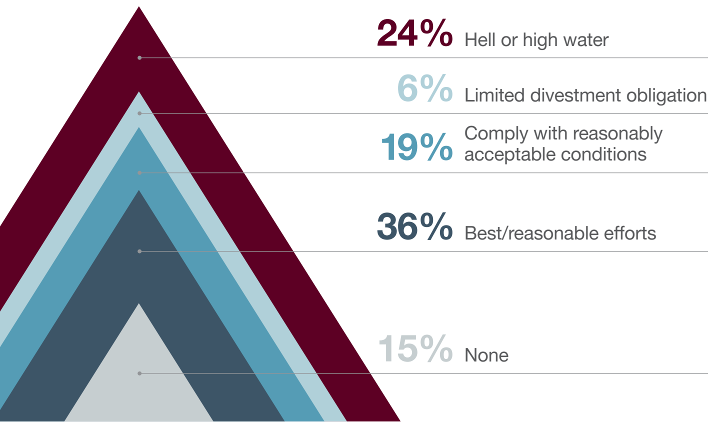
Until recently, we did not see warranty and indemnity insurance used much outside Europe and Australia, but a strong market has now emerged in the U.S., and the product is gaining currency in Asia and the MENA region. We saw a significant increase in the use of W&I insurance globally in 2017, with the product used in 47% of private equity exits we advised on and 27% of all transactions where operational warranties were given.

The growth in W&I insurance is clearly offering buyers an alternative to using an escrow account to provide security for warranty claims. In 2017, escrow accounts still featured in more than a quarter of our deals globally, but they were more often a short-term arrangement used to secure a potential price adjustment, to hold a reverse break fee, or to assist with complicated closing mechanics.

In another clear trend, "locked box" (or fixed price) deals are gaining ground in most markets. The U.S. is the notable exception – here price adjustment mechanisms to take account of changes in value up to closing remain the norm.

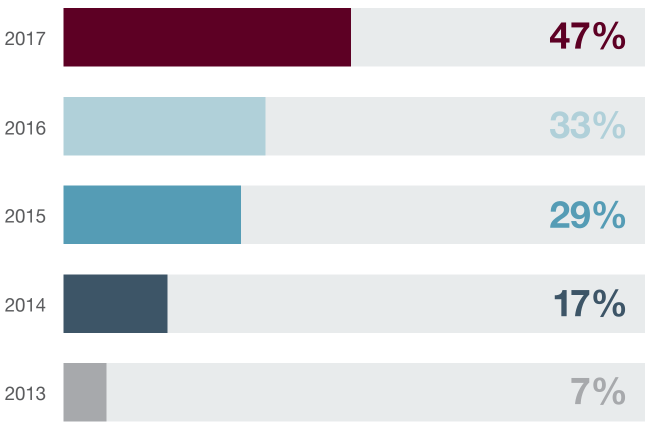
Globally the proportion of our deals based on a locked box rose from 43% in 2015 to 57% last year.

Buyer's obligation to obtain antitrust approval – 2017 deals



Data from A&O's Global trends in private M&A study

W&I insurance in private equity exits



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If you would like a detailed presentation on our analysis of global trends in private M&A, please ask your usual A&O contact.

M&A auction tactics

Preparation and focus – the cornerstones of success

In the current M&A environment, an increasing number of deals are being run as auction processes. To achieve a successful outcome, sellers and buyers alike need to approach auctions with the right strategy. That, argue A&O corporate partners Matthew Appleton and Helge Schäfer, requires both to prepare exhaustively, focusing on five key areas.

Deciding which way to conduct an M&A transaction – whether by bilateral sale or through an auction – can be a fine judgement call.

Bilateral deals offer some clear process advantages to both sellers and buyers. They can be simpler and less costly – and, for the prospective buyer, there is often greater likelihood of taking control of a prized asset when negotiating unopposed.

Auction processes are, by their nature, altogether more involved. For sellers in particular, they are likely to require increased management time and more substantial support from financial and legal advisers. While for potential buyers, the competitive process can lead to wasted time and costs if they turn out not to be successful.

Yet our view is that a properly run, highly competitive auction can deliver meaningfully improved results for sellers – making it an increasingly attractive sale route.

For prospective buyers, a well-navigated auction can also be a successful process, providing a more informed view of the target, especially where extensive vendor due diligence is provided.

Auctions are on the increase

Market research backs up these views. Take Allen & Overy's own annual survey of Global trends in private M&A, a detailed analysis of the deal strategies and tactics used in more than 900 private transactions we have advised on over the past six years in multiple jurisdictions.

This shows that auctions remained an increasingly popular alternative to bilateral deals globally, with 41% of 2017 deals conducted through auction, continuing a steady climb from 2014 when auctions accounted for just 35% of all deals.

There are fundamental macro-economic reasons why we have seen a growth in auction deals in recent years, and particularly why they are an increasingly popular option for sellers.

Chief among these is the relative scarcity of attractive assets at a time when corporate balance sheets are flush with accumulated cash, when private equity houses have raised record levels of fresh financing, and while cheap debt remains readily available to both in a continuing low-interest rate environment.

In addition, shareholders and investors are putting increasing pressure on companies and funds to make acquisitions to accelerate growth and to consider disposals as a way to realise value.

This combination of factors means we are living in a strong sellers' market and it is easy to see why a growing number of sellers, in search of the very best returns, are opting to pit a range of prospective buyers against each other.

The majority of 2017 deals in Allen & Overy's survey (55%) remained highly competitive. In one outstanding case, 100 bidders signed confidentiality terms, 30 submitted indicative bids and at least ten were shortlisted. And as we note on page two, private equity funds are proving increasingly successful in winning auctions.

On the other side of the deal, it doesn't mean that prospective buyers should approach auctions with unnecessary trepidation. It is clear to us from the many transactions we have advised on that well-advised, savvy bidders can successfully navigate the auction to achieve favourable terms and can even disrupt the process as it unfolds, to gain further advantage and emerge as the winning bidder. The inherent risk of the auction process can be significantly reduced if approached with the right negotiation strategy – leading to successful outcomes.

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Preparation is all

Auctions by themselves, of course, do not offer a firm guarantee of success – even for sellers. It is not hard to find evidence of auctions that have been run badly, with all the consequences that go with that. The secret to avoiding that outcome, for buyers and sellers alike, lies, we think, in three simple words – preparation, preparation, preparation.

For sellers, that means doing all the necessary, detailed groundwork well before the process properly kicks off with the issuing of a teaser. They then need to manage the process closely and carefully by selecting a long list of potential buyers, offering them access to the confidential information memorandum (CIM), considering non-binding offers at the end of round one, narrowing down the field into round two and final detailed negotiations (whether in round two or three).

Bidders need to be ready to move quickly from the moment they receive the teaser (or even before) – doing as much preparatory work as they can to inform their pre-process view on the target and, crucially, the auction strategy they will deploy. Heightened competitiveness is manifesting itself in sellers increasingly running "two-round only" auctions, as opposed to the more classic three-round approach – and well-advised bidders need to be ready for, and respond to, this from the outset.

Risks and rewards

Auctions can, as we have seen, offer rewards for both sellers and buyers. But the risks are equally high.

A badly run auction may not only result in a failed sale, but at worst will render an asset so tainted that it takes significant time before it can be brought back to market.

This hazard and many of the other pitfalls we have identified can be avoided, however, if parties on either side of the transaction prepare the ground carefully and run the auction process with a high degree of discipline.

For sellers and buyers alike, time put into getting the preparation right is invariably well spent.

Pitfalls and penalties

M&A auctions are like a game of three-dimensional chess, with multiple players. Deft tactics and psychological game playing go with the territory. Preparation will help both sellers and buyers avoid common pitfalls and the penalties that come with them:

- **Control**: sellers need to set the rules of the game from the start and control them throughout. Buyers will be looking to break the rules so it is vital sellers stay on top of their game – or risk playing endless catch up.
- **Opening shot**: bidders may be tempted to put in a low opening offer, calculating there will be a chance to up the ante later in the game. The danger is that the opening shot will be seen to be too weak and will simply be dismissed.
- **Advantage**: competing bidders will always be looking to gain the advantage, not least as it may even offer them the chance to strike a pre-emptive deal and bring the game to an early close. But there is a danger that bidders can overreach themselves, pushing the seller too far, too fast. In many cases, a seller will re-assert control, forcing over-pushy bidders back into the pack.
- **Movement**: sellers and bidders need to remain nimble and agile, moving quickly to respond to events as they unfold. Slow-footed bidders will quickly get left behind; sluggish sellers will be overtaken by events and lose the initiative.
- **Competitive tension**: creating and maintaining competitive tension will be vital in securing good deal terms for the seller, particularly on price. But for bidders there can be an advantage in being seen to support the seller in creating that tension. It could move the bidder up the pecking order and help it emerge victorious.

Five key areas of focus

Whether a seller or a buyer, there are invariably five key focus areas to deliver in any auction – price, certainty, speed, facilitating a clean break and simplicity.

01 Price

Maintaining high levels of competition throughout the process is essential if the seller is to achieve the best possible return. Scarcity of assets and an excess of capital is currently pushing asset prices higher, but sellers still need to attract the right balance of bidders, strategic and private equity, to increase and maintain that tension.

From a bidder's perspective, it is vital to pitch in at the non-binding offer stage at an appropriate level. Shooting too low may offer scope to increase the offer later, but there is also a risk the offer will be dismissed at the outset. It's also crucial not to rely on price alone, but ensure the bid will deliver across all the focus areas.

02 Certainty

Designing the process to run in a structured and controlled way, from the start right through to closing, is very important for sellers, not least because it will avoid them having to play damaging catch-up as the process unfolds.

But sellers can also create certainty by researching and understanding the prospective bidder universe – and being ready to respond to concerns likely to be raised. Upfront investment in financial and legal vendor due diligence can pay big dividends later as the process later unfolds.

Similarly, bidders can use the time ahead of gaining access to the CIM and submitting a non-binding offer to get ahead of the game. They can, for instance, carry out public due diligence, analyse possible merger control issues and understand how best to structure the deal to meet the likely concerns of the seller around issues such as deal conditionality and financing.

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03 Speed

Speed is clearly of the essence for both sellers and buyers. It is becoming increasingly common for well-prepared sellers to use a pre-trailed process to shorten auction rounds. Another trend is for sellers to require pre-negotiated contracts ahead of binding bids being submitted, a move which often shrinks round three into a few concentrated days of final negotiation. It's an approach that can work well, apart from in the case of complex carve-out deals.

All this puts the onus on bidders to be able to react to events, demanding an ability to marshal key decision-makers and advisers rapidly at all times. By helping to speed up the process, bidders can put themselves on a more favourable footing with sellers, which may offer the chance to disrupt the process with a pre-emptive deal. Pre-empts can offer big rewards, but the risk of misjudging the bid and being quickly rejected are also high.

04 Clean break

Sellers are often looking to make a clean break from the business they are selling, both operationally and from a liability perspective. Sometimes that will not be possible and transitional arrangements need to be put in place. Early research into prospective bidders will clarify what transitional arrangements might be needed.

Bidders also need to be clear about what contractual comfort they may need from the seller but should focus on matters that are essential, rather than just "nice to have."

05 Simplicity

Sellers essentially want simplicity of process, documentation and terms. Bidders are usually best advised to avoid complex price and deal structures. Researching and understanding the seller's commercial objectives, both in and beyond the transaction, will help the bidder structure the offer in a way that supports rather than cuts across those objectives.

If the seller is open to a more complex deal structure, a bidder should think about using a more innovative approach. If it unlocks further value for the seller, that bidder may gain an important advantage over others.

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