Hogan Lovells

M&A Evolution:
Strategies for the New Deal Landscape

FT
FINANCIAL TIMES

CONTENTS

INTRODUCTION

The financial crisis that started in 2007 has changed the M&A landscape profoundly. As global macroeconomic uncertainty continues to prevail, the future of M&A is no longer a global proposition. Instead it is far more company and industry specific.

Rising consumer demand and unpredictable market dynamics have given way to consumer insecurity and extreme volatility in the foreign exchange, equity and debt markets. Banks, while flush with cash from investors seeking stability away from the capital markets, may not be the ready source of funding that they were prior to late 2007. A mismatch between buyer and seller expectations of value, based more on uncertainty than ever before, further erodes deal-making. Despite this, it is clear that there is still appetite to do deals both strategic and opportunistic, whether in support of organic growth, to acquire market share or to enter into new markets.

According to Credit Suisse, it is estimated that there is US$3.5 trillion of cash on corporate balance sheets worldwide. Where there is cash there is a need to invest it, or return it to shareholders. Deal volume levels, however, reflect a degree of caution in valuations, financing challenges, uncertainty and the difficulty in putting together buyers and sellers in this environment.

Those that are able to navigate successfully the waters around regulation, funding and price are those that are getting deals through. Robust negotiation and creative structuring are absolutely essential in bringing complex transactions to close, while a detailed understanding of the relevant industry and how to adapt approaches in different markets is critical.

As part of our focus on understanding these dynamics and testing our own experiences of doing deals in global markets, we commissioned the Financial Times to conduct a global survey of 160 board members and directors of M&A at major corporates on their attitudes to deal-making. We wanted to quantify the changes to the M&A marketplace: What are the key hurdles to doing deals? Where are the best opportunities in terms of geographic markets? How is the landscape changing?

At a time when the prevailing mood is one of uncertainty, this report provides clarity. While we are operating within a constantly-evolving landscape, it is clear that there is still a definite appetite, as well as a strategic need, for M&A.

November 2011

Andrew Skipper and Stuart Stein
Co-leaders, Global Corporate Practice Group, Hogan Lovells

FOREWORD

If you can't create it, buy it.

With growth flat-lining in most parts of the developed world, it's not surprising that CEOs have once again turned their attention to deal-making. While directors of M&A are focused on creating growth organically within their business, most see buying growth through acquisition as an important part of their strategy, according to this year's Financial Times/Hogan Lovells report.

Indeed, the market for M&A in 2011 started off with a bang. Corporate balance sheets are flush with cash and the year began with a rush of corporates snapping up their dream buys at discount prices.

But three years on from the start of a banking crisis that reshaped the world economy and the outlook is still uncertain. This summer, worries about the debt of US and European sovereign nations once again brought a stop to deal-making . Volatility is the enemy of M&A and 2011 is now unlikely, at the current pace, to improve on 2010 for deal-makers.

The risks for the M&A environment are great. In the wake of the financial crisis, M&A is more political than ever. Unsurprising then that over half of those surveyed see regulation as having a significant impact on their ability to complete deals. With share prices depressed, getting targets to agree on price is one of the biggest issues corporates face. Seven out of 10 directors of M&A interviewed saw sellers' expectations as the greatest obstacle in achieving fairly valued acquisitions. And to guard against the pitfalls of overpaying, companies say they are being cautious. With debt markets back at post-Lehman collapse levels, cash remains king and the most vital factor in deal-making today. It is set to remain the preferred source of funding for deals in the next year or two, particularly for US corporates.

Despite M&A activity declining every quarter this year, companies are still working away on plans. Resource sectors such as mining are among those where chief executives are keen to take advantage of cheap market valuations of dream takeover targets.

In the search for growth, the top three geographical markets for investment potential in the next 12-24 months are seen to be China, the US and South East Asia. Technology sectors have provided some of the most high profile deals of the year. This is proof that while the financial crisis may cause deal-making to falter at times, industry continues to evolve, and M&A is re-emerging as a way companies can keep ahead.

November 2011

Anousha Sakoui
M&A Correspondent, Financial Times

HEADLINES

34%

cite **state regulation** and **tax issues** as one of the **major factors** impacting the M&A market

23%

cite **macro economic outlook** as one of the **major factors**

83%

want to pursue **organic growth**

55%

rank **growth through outright acquisition** among their **three most important strategy options**

55%

cite cash on **balance sheet** as the most **favoured source** of funding

71%

cite **sellers' expectations** as the **greatest impediment** to achieving a **fair valuation** for acquisitions

23%

rank **China** as having the **best investment potential**

29%

say **China** is the **most difficult region** for deal-making

EXECUTIVE SUMMARY

Since the start of the global financial crisis the M&A landscape has not only been transformed, it continues to evolve apace. Turmoil in financial markets, recession and the more recent emergence of concern about sovereign indebtedness have caused a great deal of economic uncertainty, which has inevitably affected the M&A environment.

Despite this, the outlook among board members and directors of M&A at major corporations is mixed. Although respondents are clearly worried about macroeconomic instability, few of them seem to think that the current drama over sovereign debt will change their fundamental strategic thinking very much, if at all.

It cannot be overlooked that after a period of relatively little investment, many companies have strong cash balances and have by no means ruled out the possibility of engaging in acquisitions in the next year or two. Most of those whom we interviewed indicated that the pursuit of organic growth is the single most important element in their overall strategy. This suggests that in the first instance their M&A activity is likely to be in support of extending existing business models.

Our findings also indicate that nearly as many respondents believed that there are strategic benefits to acquiring market share or entering into new markets through outright acquisition. Indeed, Boards are pursuing opportunities to do just this, particularly in emerging markets, which remain the geographic priority for most companies' acquisitive investment.

So if it is not just macroeconomic uncertainty, what other issues are of concern to Boards? The additional challenges that our respondents feel that they are facing are centred on the many changes to tax and regulatory regimes post-crisis, as well as continuing difficulties around the availability of acquisition finance and the valuation of acquisitions.

Indeed, concern about the regulatory and tax environment was mentioned by the greatest number of our respondents. It is indisputable that the financial crisis has motivated a great deal of legislative and regulatory innovation, and even some drift in the direction of protectionism. Changes to competition and labour law also continue to muddy the waters, and although 43% of those whom we interviewed commented that such factors have had no significant effect on their ability to complete deals, a majority stated that they have been a major hindrance.

Scepticism surrounding the availability of finance, and in particular equity finance, also remains a leading issue for corporate strategists in the UK and the US, and especially to those whose companies are in weaker balance sheet positions.

Finally, challenges to valuing acquisitions and the related issue of how businesses can protect themselves against the risk of overpayment have become significant concerns amongst potential investors. It is an inevitable consequence of a major financial dislocation, especially in conjunction with the continued volatility of the equity markets, that valuation metrics are distorted and the signposts to appropriate pricing become uncertain.

In spite of all of this, deals are still being done and it would appear that, for a majority of businesses, strategies for M&A are determined over the longer-term. With many companies' balance sheets flush with cash and with credit cheap (although not always easy to obtain), prospects for acquisitive activity in the next year or two are good.

KEY FINDINGS:

- Uncertainty regarding adverse and possibly arbitrary changes in the target company's tax regime or regulatory environment is the greatest issue that was spontaneously mentioned by our respondents, with 34% ranking it first amongst their concerns.
- Unsurprisingly, uncertainty about the economic outlook remained very high amongst our respondents, with 23% mentioning it as an important factor in their strategic thinking. Yet whilst none of them discounted the potential dangers, most respondents did not think it would affect their companies' M&A strategy directly.
- Given economic and financial market uncertainties, the availability of finance – particularly equity finance – was also a leading concern for 28% of our respondents.
- Eighty-three percent of those whom we interviewed indicated that the pursuit of organic growth is one of the most important elements in their business' overall strategy. This suggests that, in the first instance, M&A activity is most likely to be pursued in support of existing core businesses, implying an emphasis on purchases to round out or extend distribution or customer service functions in key geographies.
- However, acquiring market share or entering into new markets remain important to most companies' strategies, with 55% of our respondents ranking this amongst their three most important options for growth.
- Corporate cash flows have accumulated on balance sheets following a period of relatively little investment, so it comes as no surprise that cash on the balance sheet was overwhelmingly the most favoured source of funding for deals in the next year or two, cited by 55% of our respondents.
- Seven-tenths of those whom we interviewed viewed sellers' expectations as the greatest obstacle to achieving a fair valuation for acquisitions.
- Three quarters of our respondents regarded an emphasis on transaction discipline as their best defence against overpayment, and suggested that their companies have adopted a more cautious approach to M&A overall.
- The geographic markets in which our respondents believe there is the greatest potential for M&A investment are (in order of priority) China (23%), the US (15%), Southeast Asia (12%) and Western Europe (11%).
- However, 29% of respondents also deemed China to be the most difficult deal-making environment. Western Europe was ranked as the second most difficult market.
- Over half of those we interviewed considered regulation and other government initiatives as, at least potentially, significant constraints on their ability to complete deals. Regulatory factors are widely believed to delay, prevent or necessitate undesirable changes in the structure of deals.
- Overall, M&A directors retain an appetite for opportunistic deal making, as their M&A strategies are largely set for the long-term and therefore are not necessarily impacted by the current economic condition.

THE NEW DEAL LANDSCAPE

Opportunities in a Changing Market

Several years into the global financial crisis, the outlook among potential acquirers is mixed but seems predominantly to be one of cautious optimism. After a period of relatively little investment spending, many companies have strong cash balances and, in the absence of growth driven by a favourable economic environment, most are willing to at least consider pursuing the expansion of their businesses through opportunistic deal-making.

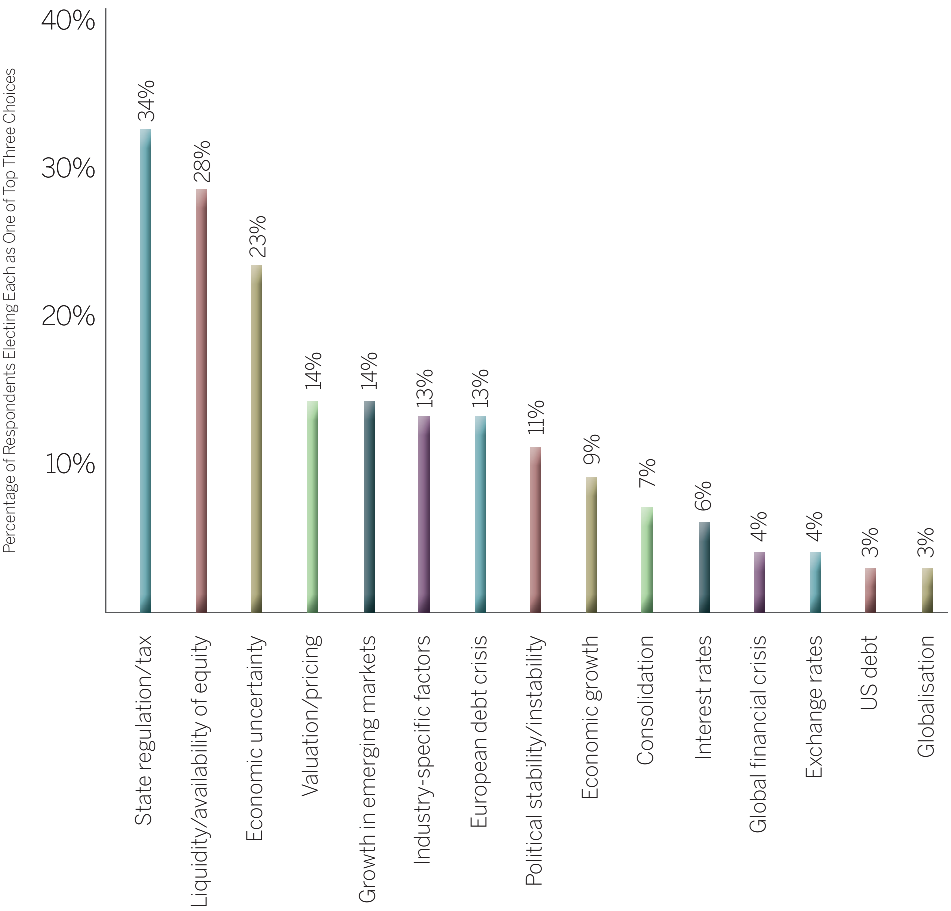
Yet a number of less positive considerations also play on the minds of those responsible for corporate M&A strategy worldwide, including what, at the time of the survey, were the prospects for renewed economic uncertainty. Only a very small minority of those whom we interviewed expressed concern about the risk of missing out on the opportunities that might arise from unexpectedly strong economic growth.

Developments subsequent to the July date of our survey have borne out our respondents' generally cautious views of the macroeconomic outlook.

Yet most of those whom we interviewed claimed that macroeconomic factors have had no or only a limited effect on their M&A strategies. Although a third responded that they have had to change their strategy considerably in reaction to recession and financial crisis, these changes were largely the result of indirect effects of current economic conditions, such as changes in the availability of finance. It seems fair to us to generalise that companies that are confident of the continued viability of their business models are willing or even keen to use acquisitions to secure growth.

What Preys on the Minds of Trade Buyers?

Economic, Political and Regulatory Factors Affecting the M&A Market



Our research revealed considerable divergence of opinion amongst corporate officers at Executive Committee or Management Board level who are responsible for M&A (henceforth, 'M&A directors') about the factors that are currently of greatest concern to them. Given free rein to discuss the issues, they cited without prompting a myriad of factors – both positive and negative – affecting the M&A environment. The picture that emerges from their comments is, as a consequence, rather mixed, with no single factor mentioned by a majority, or even by the majority within a given region. The issues that received most frequent mention as being likely to determine the lay of the land for M&A in the next two years were: uncertainty regarding regulation and taxation, the availability of finance and general macroeconomic uncertainty.

Concern about the regulatory and tax environment was mentioned by the greatest number of those whom we interviewed. Several M&A directors indicated that uncertainty about either or both of these matters is not only a significant concern, but also an increasing one.

Scepticism about the ready availability of acquisition finance – and particularly equity finance – was a leading issue for UK and US M&A directors, but far less so in Asia. Forty percent of UK and 35% of US respondents offered unprompted comments on these matters, compared with only 8% of Asian respondents. In the UK in particular, there is a sense that access to debt finance remains problematic and that access to equity is an even greater challenge. At the same time, however, many respondents noted that their own corporations' balance sheet position is an enabling rather than an inhibiting factor, and a number of M&A directors stressed that, in combination with companies' balance sheet positions, credit conditions actually support deal-making.

'The biggest thing is the availability of credit... Looking back over a period of twenty to thirty years, M&A activity has been driven more by this than anything else. The pick-up in M&A activity since the worst of the economic downturn in 2009 has been a credit driven phenomenon.'

Head of M&A, US industrial engineering company

'Corporate balance sheets are broadly strong and so there should be opportunities for corporates to make acquisitions.'

Director of Business Development, UK media company

Uncertainty about the economic outlook remained high amongst our sample, with 23% mentioning it as an important factor in their strategic thinking. Yet our respondents implied that the source of this uncertainty has changed since the first phase of the financial crisis. Worries over Continental European sovereign debt and related issues regarding the health of the region's banks, as well as the failure of US economic recovery to gather steam have become paramount. Whilst none of them discount the potential dangers from either source, they do not seem to think that they affect their companies' M&A strategy directly.

This contrasts with the global anxiety about the credit-worthiness of all counterparties – debtors and creditors – that dominated their attention only three years ago. The 'Credit Crunch' as such received only a few mentions from our respondents. Economic uncertainty was mentioned as a significant factor by US respondents more than in any other region – a pessimism that perhaps reflects their domestic economic situation. Globally, our respondents believe that the prospects for M&A are less affected by a poor economic outlook than by just plain uncertainty, which makes planning a challenge.

'I think that, on the immediate horizon, the economic factors that would affect M&A would be either the American deficit or the European quagmire; I feel they will both have some significant impact on the global economic outlook, essentially creating some kind of depression if both of those issues don't get solved in the short to medium term.'

Executive VP of Strategy & Business Development, Asian general industrials company

Continental Europeans were the most wary of the potential effects of the European debt crisis on M&A activity: 23% of Continental European M&A directors commented on the threat from this direction, compared to 5% of Asian respondents. However, the issue received mention in every region. This concern probably results from widespread uncertainty about the global implications of the European situation, its consequences outside the region and what form a resolution of the crisis might take.

'Greece has a very strong impact on the strength or weakness of the Euro and ultimately on how aggressive the market will be, whether the market will participate in transactions or not.'

Head of Financial Investments, Immoeast (European real estate investment & services company)

Twenty-five percent of Continental European M&A directors cited growth in emerging markets as a major factor that has affected the M&A environment, compared to only 8% in Asia and the UK. Whilst some of them regard high rates of economic growth in emerging markets as a source of opportunity, others were concerned about the sustainability of their growth differential over developed countries given the latter's continued weak demand for the former's products. It is likely that this divergence of opinion derives, at least in part, from the nature of the commercial activities in which the differing respondents operate.

'[Globalisation] is surely a positive, especially with the emergence of Chinese competitors in almost all sectors as a big driver... There is a fundamental need for consolidation in almost all industries that has been [accelerated by] the emergence of Chinese competitors.'

SVP Business Development, European automobile manufacturer

Key Stats

34%

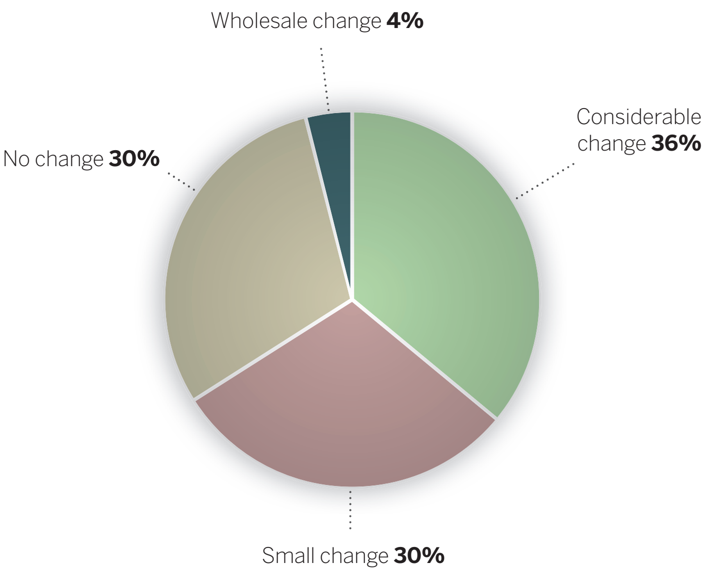
cite **state regulation and tax issues** as one of the **major factors impacting** the **M&A market**

23%

cite **macro economic outlook** as one of the **major factors**

Recent Influences on M&A Strategy

Assessing the Impact of Named Factors on M&A Strategy



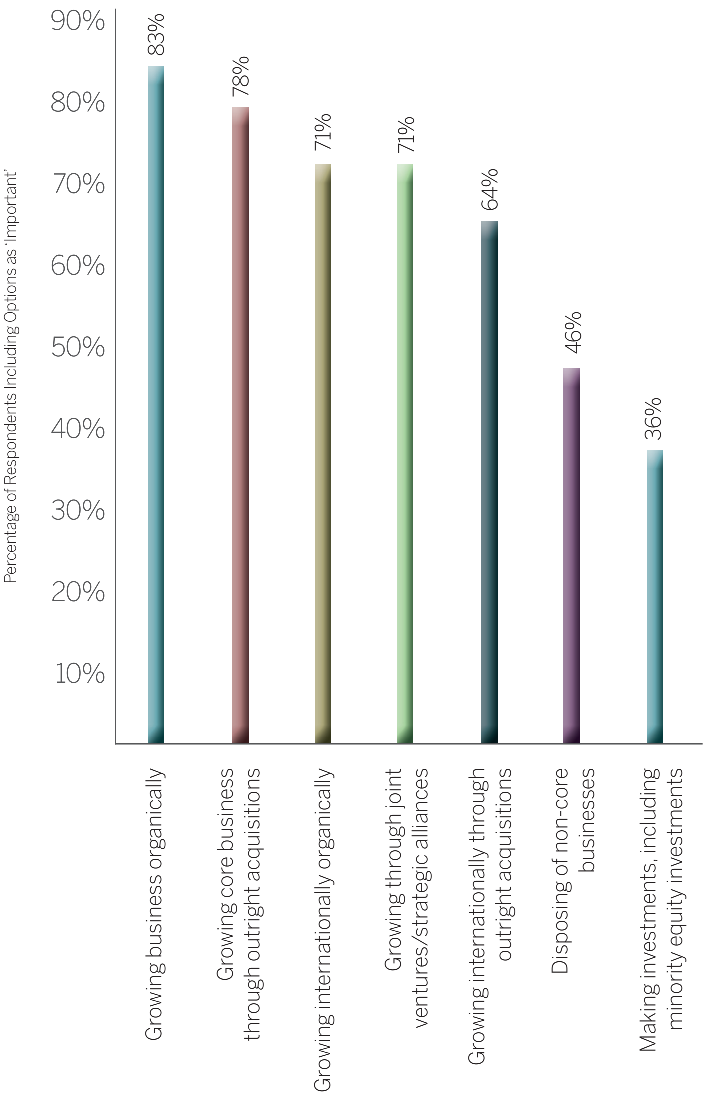
Respondents rate the amount of impact previously-mentioned factors had on their strategy

Most of those whom we interviewed claimed that macroeconomic factors have had little or no influence on their companies' M&A strategies in the last two years. In Continental Europe, a remarkable 43% said they had not changed their strategies at all. This may reflect a generally robust attitude toward M&A among Continental European companies, such that current uncertainties do not sway them from their set course. As will be seen below, much Continental European acquisition activity is likely to concentrate within the EU, often focussed on enhancement of existing business models. Continental European companies may feel that these remain strategic priorities without reference to the prevailing economic weather, unless conditions become even stormier than they are at present.

Yet a still-sizable portion of our global sample said that economic conditions have caused their companies to change their M&A strategy considerably. Given the almost unrelenting economic drama of recent years, it may be surprising that the figure was not even higher. It suggests that most companies' M&A policies are appropriately long-term in character. But the fact that it is not lower indicates that some companies' M&A strategies retain an element of opportunism, and that some companies' acquisitive ambitions extend beyond plugging gaps in their existing business models.

STRATEGIES FOR GROWTH

Important Options for Respondents' Current M&A Strategy



Assuming a company has opportunities for organic growth, it is usually its best strategy to pursue them, almost without regard to economic conditions. So it is natural that pursuing organic growth is the preferred strategy of most of the companies we surveyed. In a healthier economic environment, where capacity utilisation would typically be high, it would be unlikely that so large a majority would view organic means as their most promising source of growth.

Companies' preference for this strategy probably reflects a combination of quite distinct beliefs: that recent economic experience has weakened their competitors, so that capturing increased market share is achievable, and that they have meaningful opportunities to capture new markets for their existing production in previously un- or under-exploited locales.

A preference for organic growth was stronger in the US and the UK (where capacity is under-utilised) than elsewhere, particularly in Asia. During the recession, capacity utilisation held up fairly well in Asia and Continental Europe compared with the US and UK. This is not surprising given the depth of the slowdown in the latter countries. Their more severe recessions were more likely to have weakened domestic competitors than in markets where capacity utilisation did not drop as precipitately, offering opportunities to capture market share from them.

But our finding that nearly as many respondents believe that there could be strategic benefits to making an acquisition as put a priority on organic growth is not inconsistent with this observation. An environment in which competitors have been weakened presents opportunities to companies that have the resources to refinance or reorganise them. This may be one reason M&A directors cited competition regulations as one of their major concerns: see below.

Minority investment and joint ventures remain important strategic options for many respondents, but enthusiasm for them seems to be cooler than a few years ago. Strong balance sheets, more experience with target markets and concern over intellectual property rights may also be factors in companies' reduced interest in these strategies. Nevertheless, access to some markets, including China, an investment priority for many of our respondents – is difficult without such arrangements. This explains corporations' continued, if qualified, interest in strategic partnerships.

'Another problem is related to some countries, where it is mandatory to deal via a local partner, which can discourage some to engage in M&A.'

Global Head of M&A, Crédit Agricole (European bank)

Companies show limited interest in disposals. With valuations fairly low, companies probably believe that their interests are best served by managing candidates for disposal until better prices can be achieved, even if they are not cash-generative. Yet spinoffs are much in fashion, at least in America: witness Tyco, McGraw Hill, Kraft and the speculation surrounding Pepsi. Enthusiasm for spinoffs is doubtless fuelled by the shareholder value created by the Altria/Philip Morris International split in 2008.

Key Stats

83%

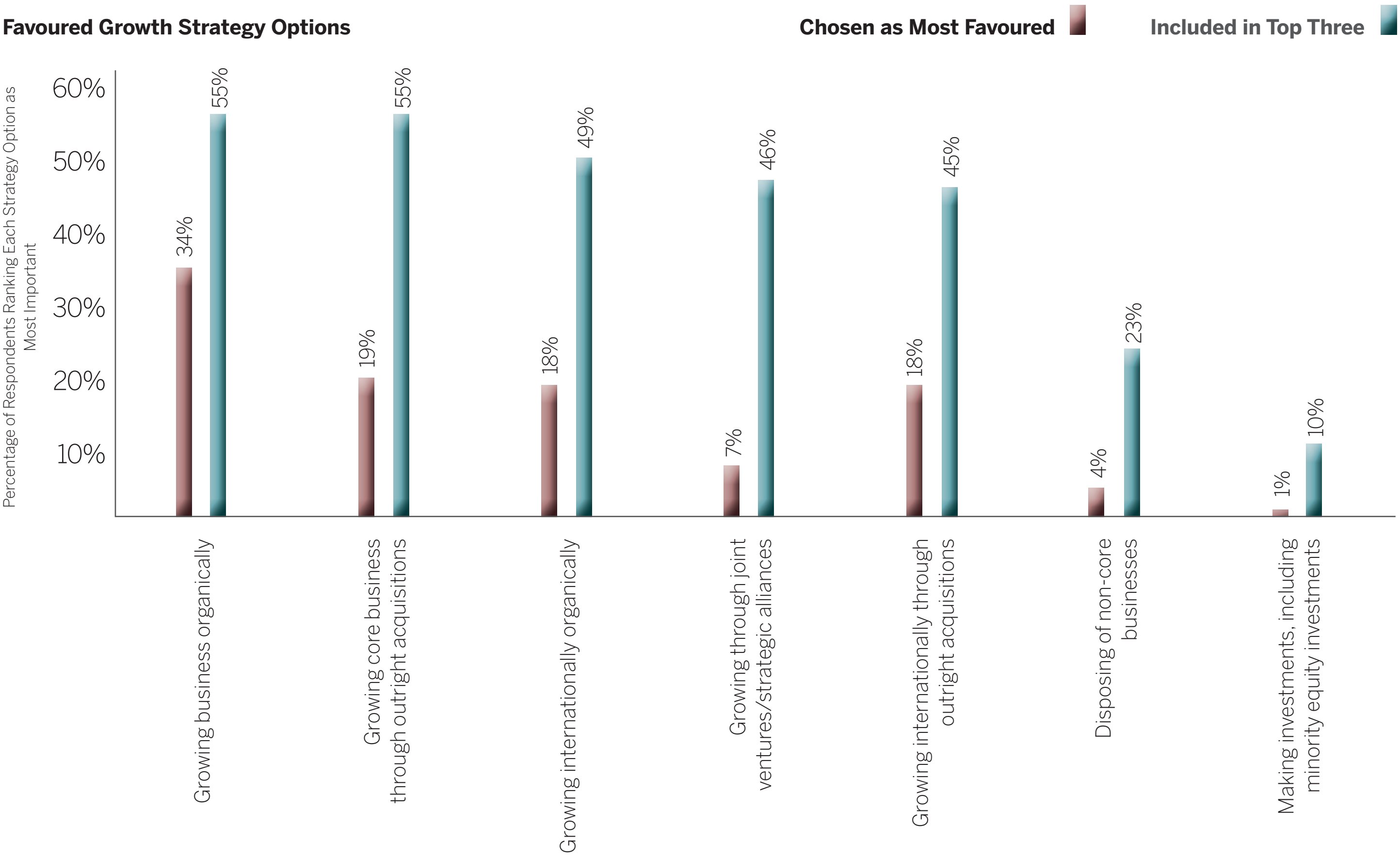
want to pursue **organic growth**

78%

ranked **growth through outright acquisition** amongst their **most important strategy options**

Strategy Options

Favoured Growth Strategy Options



As previously stated, given a single choice of strategy, M&A directors express a strong preference for organic growth over all other means of expansion, but offered the option of more than one route to growth, acquisition ranks equally with organic growth.

Yet there are significant regional differences in companies' preference for organic business development. For example, UK respondents appeared to be less adventurous with regard to M&A than their counterparts in Continental Europe, with 48% favouring organic business development compared with 25% of their Continental European peers. Continental Europeans' preferences were split evenly between strategies reliant on organic growth and those that involve acquisition. A quarter of Continental European M&A directors rated growing internationally through acquisition as their most important strategic option, compared with only 5% of our UK respondents.

Opinion regarding the priority to be assigned to organic growth also varies by commercial sector. To companies in well-established multinational manufacturing sectors, acquisition may be an imperative strategy.

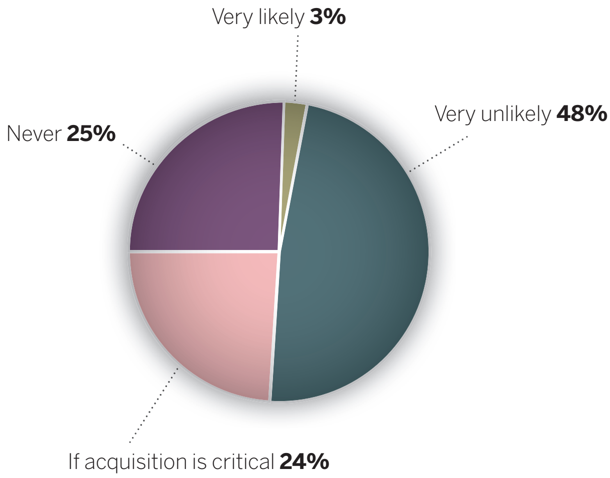
'Companies are looking for opportunities. It is better in terms of growth for a company to take the M&A route rather than look to grow internally.'

Global Head of M&A for a European chemical

The pursuit of international growth by acquisitive means is also popular amongst Asian M&A directors, with 30% rating it their single most important priority, whilst US M&A directors were almost twice as likely (28%) as our total global sample to rate the pursuit of international organic growth as their single greatest strategic priority.

Going Hostile

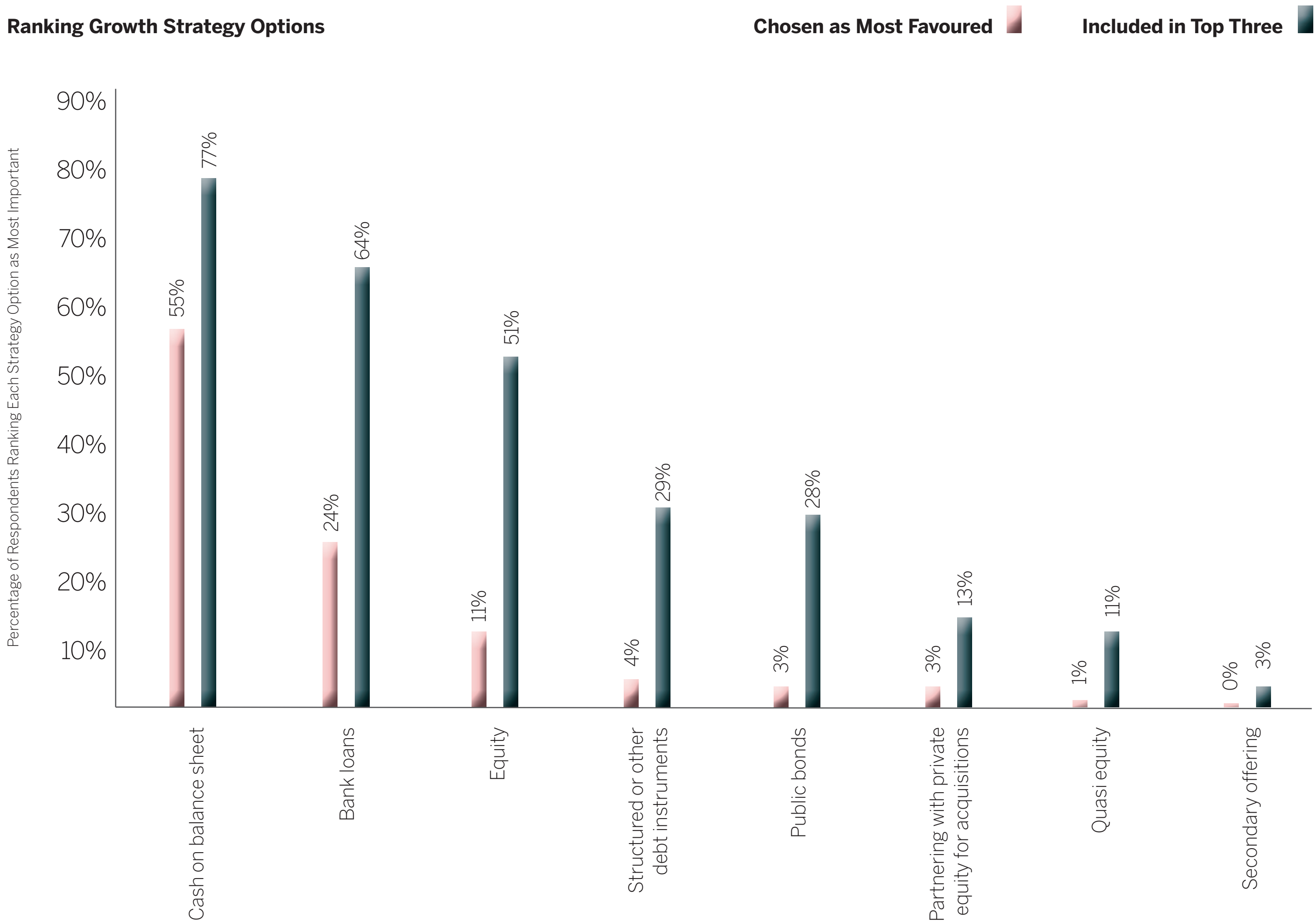
Likelihood of Considering a Hostile Takeover



Whilst those interviewed vary in their preferred strategy for M&A in the current climate, they typically agree that hostile takeovers are an unattractive option. The majority are either very unlikely to, or would never consider a hostile takeover. Only one director of M&A in each region thought that his or her company would consider this route. It is probable that an aversion to 'going hostile' is a fairly permanent feature of most strategists' thinking rather than a reaction to current economic conditions, although an extended period of high growth might soften attitudes toward it. But high levels of concern regarding regulatory and tax environments probably make it appear to our respondents to be an even less attractive option today than in the past.

Nevertheless, a quarter of those whom we interviewed conceded that their companies would participate in a hostile takeover if it were deemed to be critical, and a small minority think their companies are very likely to take this step. These findings are almost certainly due to very specific conditions in their particular markets.

FUNDING PREFERENCES: CASH IS KING, BUT NOT EVERYWHERE



Corporate cash flows have accumulated on balance sheets following a period of relatively soft corporate investment, so it comes as no great surprise that cash on the balance sheet was overwhelmingly the single most favoured source of funding for deals in the next year or two amongst our sample. This was especially the case amongst US respondents, who much preferred using cash compared to other sources such as bank loans and equity. Conversely, bank loans were just as popular as cash amongst M&A directors in Continental Europe. Equity emerges as the third most favoured source of funding for deals. Only very small minorities of our sample cited any other source of funding as their single most favoured financing alternative.

US respondents were most emphatic that deals should be funded from companies' existing resources (78%). Only 8% of US respondents chose bank debt as their preferred source of deal finance and only 5% preferred funding deals with equity over all other options. Only four of our US respondents failed to include available cash amongst their top three preferred sources of funding, probably as a result of company-specific circumstances.

In stark contrast, only 35% of Continental European respondents agreed with Americans that 'cash is king': almost as many chose bank loans as their favoured source of funding. Asian M&A directors were also relatively open to the option of funding purchases with bank borrowings (33%), although 20% more ranked cash on the balance sheet as their single most favoured source. Notably, 85% of our Asian respondents included their cash reserves amongst their top three choices, compared to only 63% in Continental Europe. Continental European respondents included bank loans amongst their top three funding options by the same margins as they included cash on hand.

Eleven percent of those whom we interviewed rated equity as their most favoured source of transaction funding, and 51% mentioned it amongst their top three alternatives. There are no significant regional differences amongst respondents' preferences for funding deals with equity, although directors of M&A departments in the UK and Continental Europe regarded such funding more favourably than those in the US and Asia.

'Debt is cheap but should not be taken advantage of. We normally do our acquisitions through equity.'

CFO, Brewin Dolphin (UK financial services company)

A few of our respondents included other funding options amongst their preferences. These minority preferences were regionally specific. For example, 43% of UK respondents and 35% of US M&A directors included structured or other debt instruments amongst their top three financing options, compared to only 15% in Asia. In Continental Europe, 23% ranked quasi-equity amongst their three most preferred financing alternatives, whilst only 5% of UK respondents were as enthusiastic about this potential source of finance.

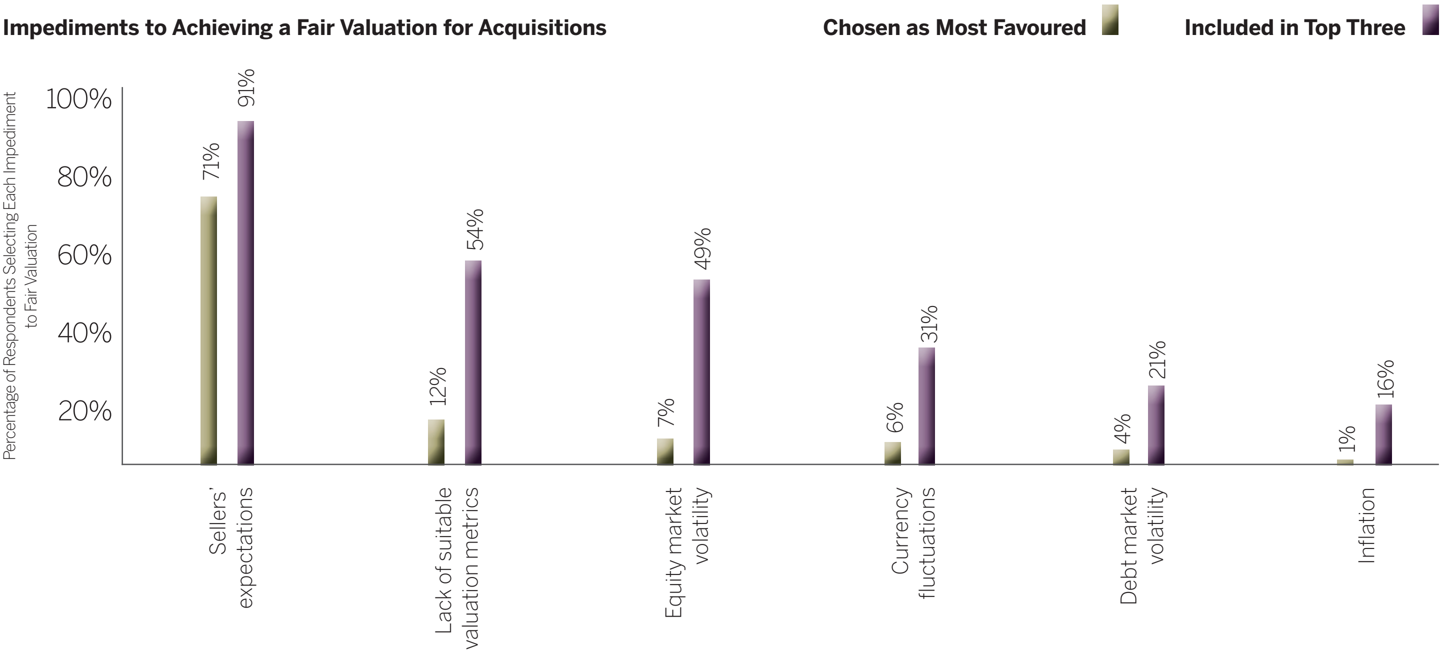
Key Stats

55%

cite **cash on balance sheet** as their most **favoured source of funding**

A LANDSCAPE WITH FEW ROADSIGNS: TRANSACTION METRICS

Impediments to Achieving a Fair Valuation for Acquisitions



According to the M&A directors whom we interviewed, sellers' expectations are by a wide margin the greatest obstacle to achieving a fair valuation for acquisitions. Ninety-one percent of those whom we interviewed included it amongst the three most prominent obstacles they see to completing a transaction successfully. Everyone we interviewed in the UK and the US included this issue amongst their top three, and nine-tenths in the UK ranked it number one. Even in Asia, where sellers' expectations were included among the top three challenges by only a quarter of our respondents and only about 55% ranked it as their primary concern, M&A directors still considered it to be the greatest obstacle by some margin compared to other possibilities. A lack of suitable valuation metrics was regarded as the second greatest obstacle to achieving a fair valuation for acquisitions and equity market volatility was regarded as the third greatest.

These observations are obviously interrelated. Equity market turbulence makes it difficult to specify an appropriate acquisition premium, and for those acquirers who would like to use equity as a purchasing currency, it also makes the value of their bid uncertain. Recent deal-making history has been a poor source of comparators for use in determining valuations: M&A activity was not strong and many of the deals that were done in the last few years were distress sales, which tend to distort many valuation metrics. Further, given the volatility of equity markets over recent years, virtually all potential sellers can recall (and not unreasonably hope to achieve) a better valuation for their companies than one based on the current market price for their equity.

Respondents' opinion of the effect of currency fluctuations on achieving a fair valuation is that it is not major. However, it was regarded as a much more significant issue by our Continental European respondents, 53% of whom ranked it amongst what they view as the three most important obstacles to deal-making, as compared to only 30% in Asia, and 20% in the UK and the US. This is consistent with Continental Europeans' preference for equity financing of their M&A activity: if equity is used as a transaction currency then foreign exchange volatility only adds to what is already a high level of uncertainty on the part of the seller as to the value of the offer it has received.

Debt market volatility is another obstacle to reaching a fair valuation that is of greater concern to our Continental European respondents, again as a likely consequence of Continental Europeans' financing preferences. Fifteen percent of Continental European respondents ranked it as the single greatest obstacle to a successful transaction, whilst not a single M&A director in the UK or Asia believed this to be the case.

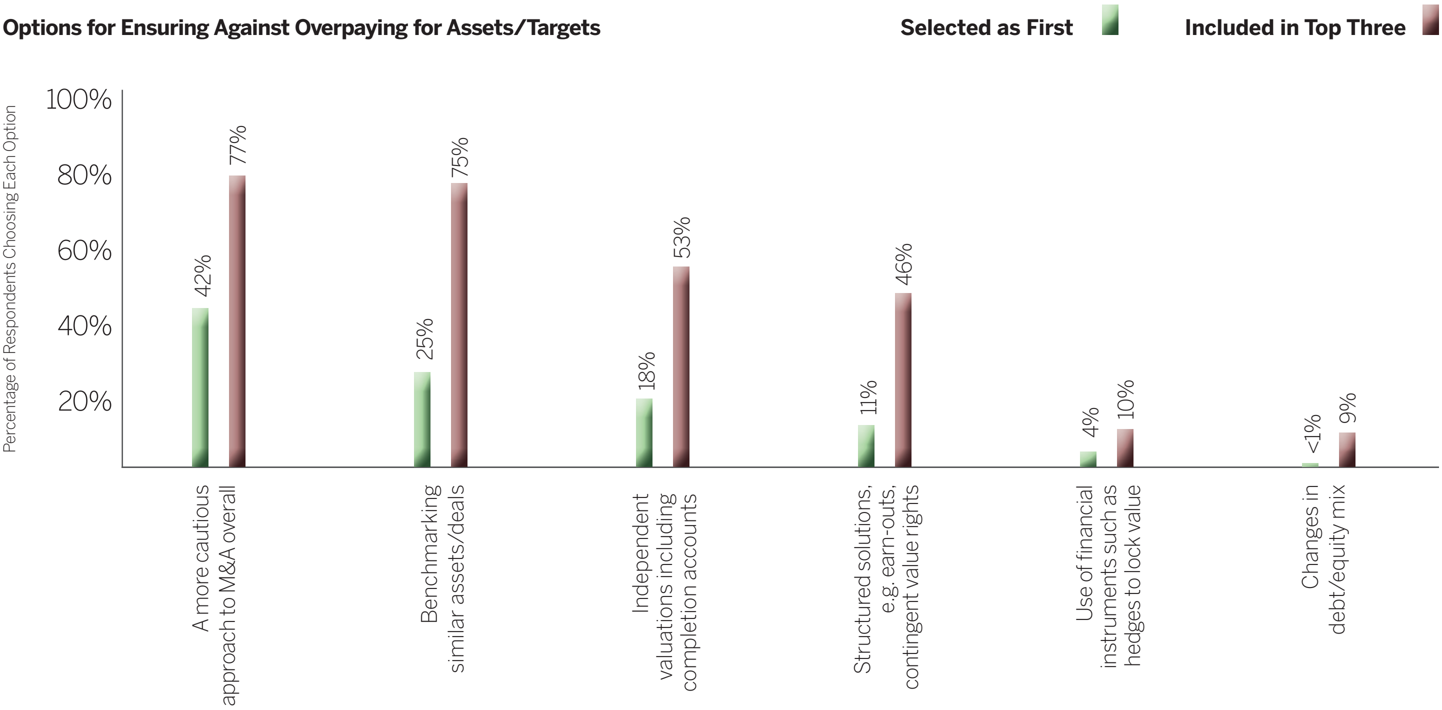
Key Stats

71%

cite **sellers' expectations** as the **greatest impediment** to achieving a **fair valuation** for aquisitions

Avoiding Overpayment

Options for Ensuring Against Overpaying for Assets/Targets



In order to avoid overpayment, a plurality of the M&A directors indicated that they regard their principal defence as a strong emphasis on transaction discipline, suggesting a cautious approach to M&A overall. Seventy-seven percent of them included this option amongst their top three defences. Respondents from Asia and Continental Europe placed the most faith in such caution, with 55% and 48%, respectively, rating it their single most important source of protection. In contrast, only 25% of US respondents believed that transaction discipline is their best line of defence.

The source of protection that was the second most favoured by those whom we interviewed was benchmarking proposed deals against similar transactions. Collectively, US-based M&A directors chose benchmarking over pursuing a more cautious policy toward M&A: 40% rated it their most preferred option. In contrast, only 13% of Asian respondents and 18% of those in the UK ranked this technique as their primary source of protection. Again, differences in the availability of comparable transactions in their home regions probably accounts for this disparity.

Independent valuations (including completion accounts) were also amongst our respondents' most preferred options for safeguarding against overpayment, but those interviewed in the US were noticeably less keen on them: only 33% of them ranked them amongst their three most preferred options. However, 53% of US respondents opted instead for structured solutions (the solution that ranked as fourth most popular with the total worldwide sample).

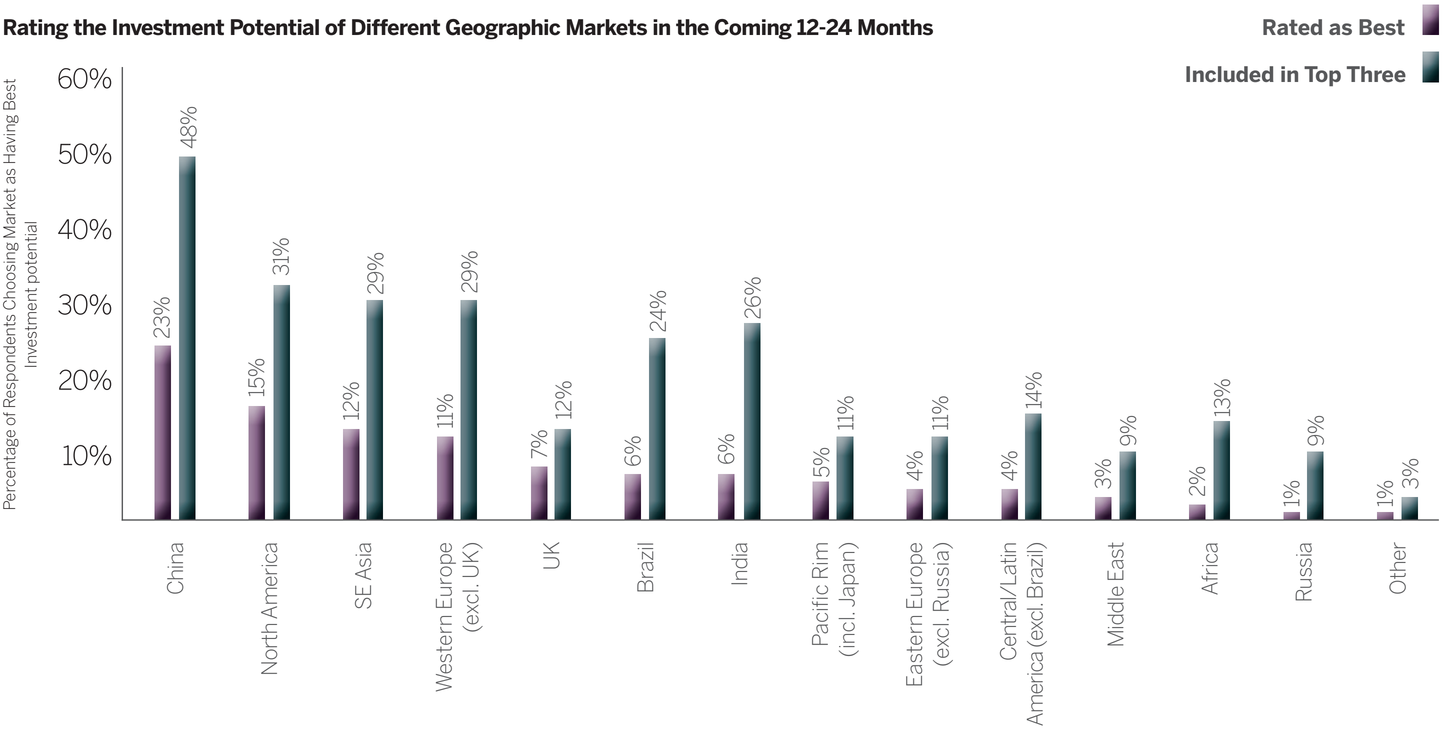
Key Stats

77%

of respondents rank taking a **more cautious approach to deal-making** amongst their **top three options** for **ensuring against overpaying** for assets/targets

CHINA'S MY DESTINATION: GEOGRAPHIC PRIORITIES

Rating the Investment Potential of Different Geographic Markets in the Coming 12-24 Months



The geographic markets likely to receive the most investment attention in the next two years are China, North America, Southeast Asia and Western Europe (excluding UK). This conclusion is quite robust, since the same four regions emerged in the same order whether our respondents were asked to identify a single priority or to pick their three most-favoured investment destinations.

With regard to their top choice, almost two-fifths of US respondents were most interested in pursuing deals in China, compared with 10% of UK respondents and 18% of those in Continental Europe. Of those interviewed in the US and Asia, 58% consider China to be one of the top three markets for investment potential, whilst less than a third of UK respondents agreed with them.

In fact, UK M&A directors appear to be less than keen on cross-border deals in any geography, with 28% rating their domestic market as their single highest investment priority. Not one M&A director in the other three regions regarded the UK so favourably. It is of particular note that not a single Continental European M&A director included the UK amongst its top three geographic priorities, in contrast to the 38% of UK respondents who did so.

Whilst Europeans do not favour the UK for investment, 40% of UK respondents ranked Continental Europe amongst their first three preferences. Continental Europeans' view their own region in a positive light as well. In Continental Europe, M&A directors were more than twice as likely as those in the US or Asia to consider Continental Europe to be one of their first three choices for investment potential. Companies within the EU seem increasingly to regard it as their 'domestic' market, an indication both that EU policy in pursuit of a Single Market is succeeding.

Western Europe (excluding the UK) is a more significant target for potential investment than Eastern Europe (exluding Russia). Only 9% of those whom we interviewed included Eastern Europe (excluding Russia) among their top three preferences. The same low percentage of M&A directors units included Russia amongst their leading choices. Even restricting our sample to European corporations, the perceived attractions of Eastern Europe and Russia did not significantly increase.

Asian M&A directors express a clear preference for investment in South East Asia. Fifty-eight percent of them rank this region among their first through third priorities, compared with only 15% of respondents in Continental Europe, 20% in the UK and 25% in the US.

Some of those whom we interviewed detect considerable investment potential in Brazil, and to a lesser extent, elsewhere in Latin America: 24% cited Brazil as one of their top three geographical markets for deals in the coming years and 14% Central or South America apart from Brazil. M&A directors in Continental Europe and the US had the strongest appetite for investment in these regions, with a third in the former and nearly two-fifths in the latter giving it a top three ranking. Continental Europeans favoured Latin America (apart from Brazil) far more than respondents in other regions, with 30% ranking it among their first three investment priorities. Asian M&A directors exhibited the least interest in the region: none of our Asian respondents ranked either Brazil or other countries in Latin America as their top investment priority and only 5% mentioned any interest in the region's investment potential at all when Brazil was taken out of the equation.

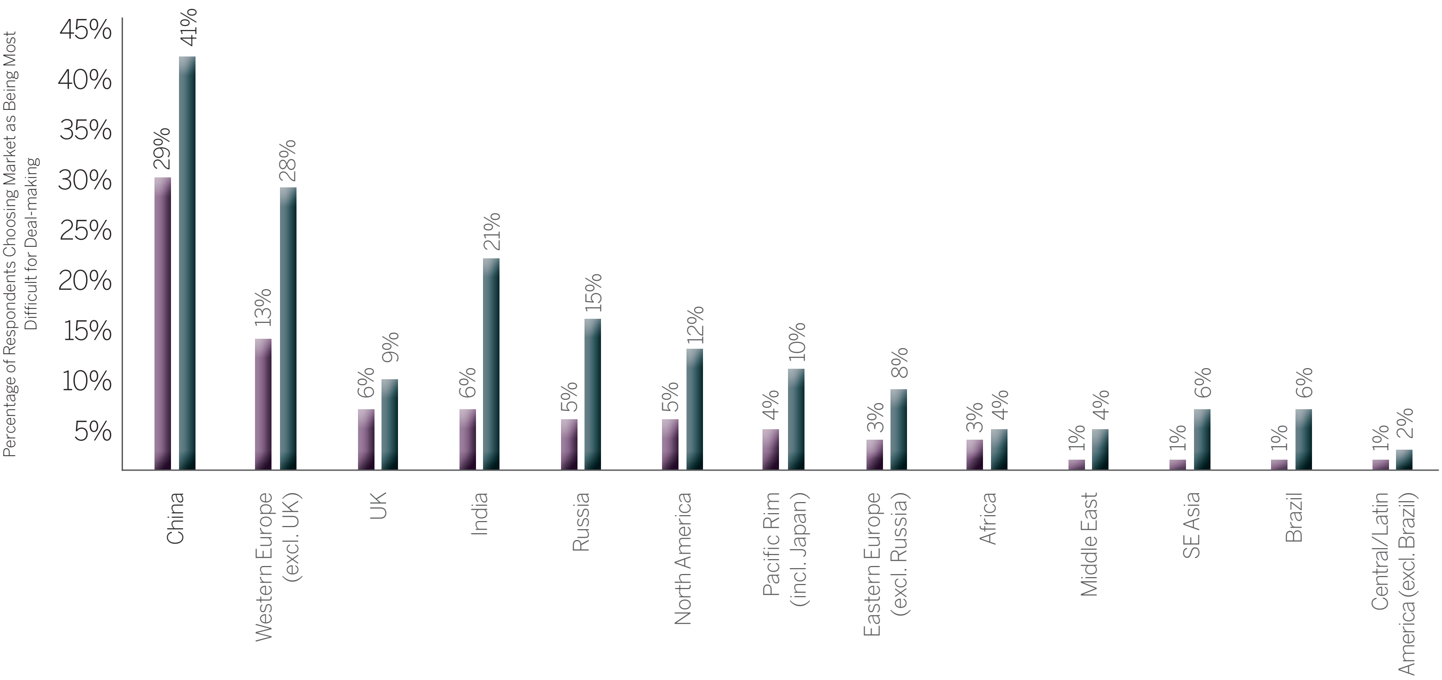
Key Stats

23%

of respondents rank **China** as having the best **investment potential** of **any geographic market**

China Again: The Most Challenging Geographic Markets

The Most Difficult Markets in Which to Complete a Deal



Opinion amongst our respondents was mixed regarding which are the most difficult geographical markets for deal-making. Aside from China and Western Europe (excluding the UK), no markets stood out. Often it seems to have been a matter of familiarity breeding contempt (or at least trepidation): for example, 23% of our UK respondents identified the UK as the market where deal-making is hardest, yet not a single one of our non-UK respondents regarded conditions in the UK as especially difficult.

Respondents globally deemed China to be both the market with the greatest investment potential and the most difficult environment for deal-making. Twenty-nine percent of those whom we interviewed ranked it as the single most difficult market. Among US respondents, 40% cited China as the most difficult deal-making environment, compared to only 20% in the UK. Whether this is simply because fewer UK companies have invested in China or because their experience has been better than that of their US counterparts is unclear. Fifty-two percent of the respondents who included China amongst their three most difficult M&A environments mentioned regulatory and other government approvals as the single biggest barrier to doing deals; high valuations (18%) and political risk or instability (15%) also received mention.

'Over the past five years, the Chinese market has been flooded with foreign investment money and valuations are now very high. As a result they have now put in place restrictions on foreign majority ownership. You see them shutting their doors on foreign investment coming in as they are flush with money on the domestic level.'

Head of M&A, Asian industrial metals & mining company

Western Europe (excluding the UK) was ranked as the second most difficult market for deal-making. Not surprisingly, given our earlier comments on the results of familiarity, Continental European respondents were most likely to cite their own region as difficult: 25% ranked it as the most difficult and 35% included it amongst their three most difficult. US respondents also considered Western Europe (excluding UK) to be relatively problematic for M&A activity, with 33% ranking it amongst the three most difficult. The biggest barriers to doing deals in this market as perceived by those who included it in their top three were high valuations and regulatory or other government approvals (both 38%).

Twenty-one percent of respondents mentioned India as one of the three markets where deal making is most difficult. Interestingly, Asian respondents were not significantly more likely to mention India than M&A directors in other regions. Fifty percent of them cited regulatory and other governmental approvals as the single biggest barriers to deal-making in the sub-continent, whilst 18% regarded the inadequacy of infrastructure as the biggest barrier.

Overall, the most frequently-mentioned barriers to doing deals in the markets ranked as most difficult for deal-making were lack of agreement on pricing and challenging regulatory and government intervention scenarios. Yet our respondents emphasised additional issues in certain markets, notably political risk in Russia and a relative lack of infrastructure in India.

Key Stats

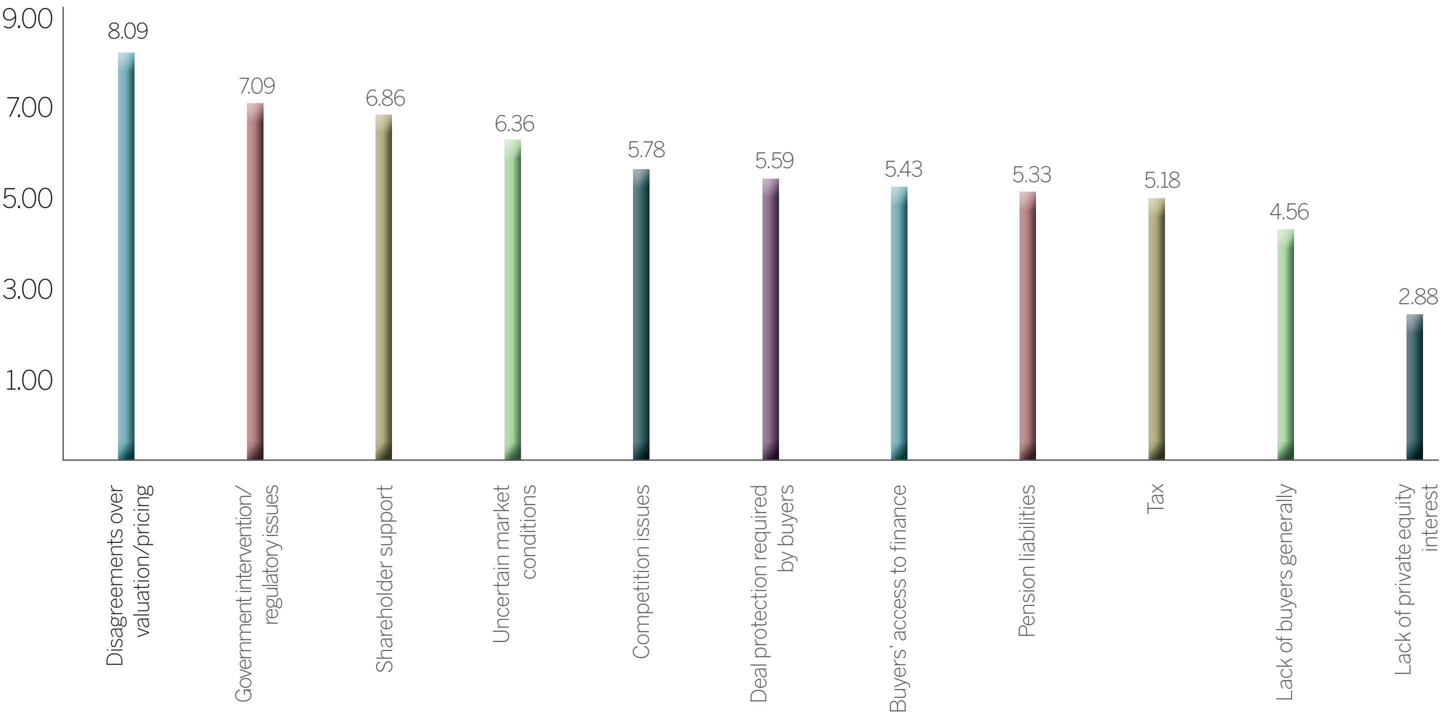
29%

rank **China** as the **most difficult region** for deal-making

CHALLENGES FACING DEAL-MAKERS

A number of important impediments to completing deals play on the minds of M&A directors. As might be gathered from their comments on achieving fair value, they regard disagreements over valuation as their greatest single impediment. Government intervention or regulatory issues and lack of shareholder support were also viewed as major challenges.

Respondents Rate Specific Impediments to Deal Completion



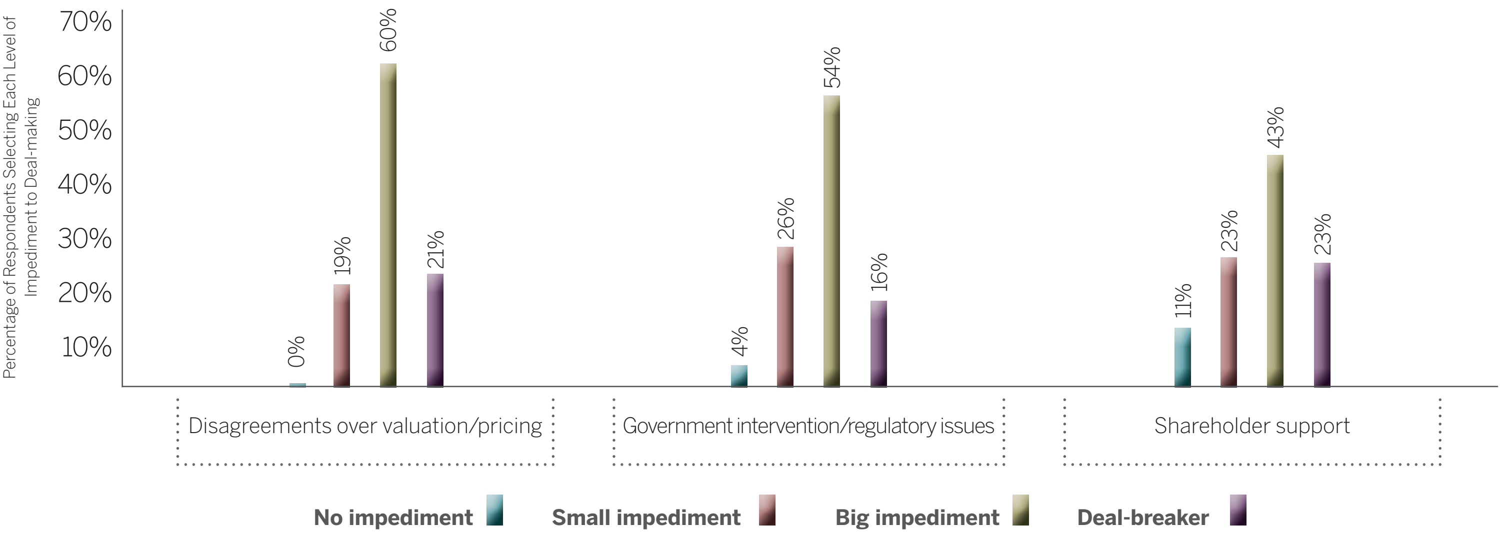
Mean scores based on respondents' ratings of each choice on a 1-10 scale, with 1 being 'no impediment' and 10 being a 'deal-breaker'

When asked to rate a range of potential impediments to completing a deal based on their perceptions of their importance, M&A directors worldwide were unanimous in the view that disagreements over valuation, government intervention or regulatory issues and shareholder support present the greatest challenges. Disagreement over valuation and pricing were clearly big issues for those whom we interviewed: on average they gave them a score of 8.1 (with 10.0 an absolute deal-breaker). Not one M&A director whom we interviewed believed that it is no impediment at all; a solid majority cited it as a big impediment and 21% went so far as to call it a deal-breaker. Such disagreements are thought to be particularly prevalent in the US (8.7 mean score) and less so in Continental Europe (7.6) and the UK (7.9).

Key Stats

On average, respondents rate **disagreements over valuation and pricing an 8 out of 10**

Respondents Rate Specific Impediments to Deal Completion



It is worth examining whether this reflects anything other than buyers' self-interest: sellers would probably have similar opinions regarding buyers' expectations. The important question is whether price negotiations are more difficult in the current environment than in the past. There is reason to think that they are. As discussed above, sellers' memories of better valuations and the difficulty of finding reliable transaction metrics pose considerably greater challenges since the financial crisis than in the period before, when financial buyers dominated the M&A marketplace and tended to boost valuations. Potential trade buyers may complain, but they are not marginalised by financial investors who all but sidelined them before 2008.

Government intervention or regulatory issues were regarded as the second greatest impediment to deal completion, with 70% of our respondents citing them as a big impediment or a deal-breaker. M&A directors from all regions seem to agree on the magnitude of this obstacle, although the specific governmental and regulatory issues that concern them vary a great deal both by region and by commercial sector, as we discuss below.

The impediment that our respondents regard as third most important is lack of shareholder support. Those in the UK score this obstacle relatively highly (7.5 out of 10), whereas those in the US find it to be less of an issue (6.0). This disparity probably reflects differences between corporate governance structures in the two jurisdictions (shareholder democracy is in several respects stronger in the UK than in the US) more than differences in shareholders' attitudes toward M&A activity.

Our respondents also regarded uncertainty about market and economic conditions as a significant obstacle to successful deal completion. Almost three-fifths of M&A directors consider this a substantial impediment. However, whilst virtually all (98%) of our respondents believe that this uncertainty impedes deal completion to some degree, only 4% consider it to be a deal-breaker as such. Where there's a will there's ultimately a way, as Interbrew's record all-cash acquisition of Anheuser Busch at the height of the credit crisis suggests. Financial market drama is unquestionably a negative influence on M&A activity that has occasionally busted deals (notably in the wake of the 1987 crash). It is regarded as an important impediment to M&A activity by some of our respondents, but history shows that it is not necessarily a deal-breaker.

Some issues emerged as significant in particular regions, even if globally they did not. For example, concerns about review by competition authorities were felt relatively strongly by those in Continental Europe and the US (6.3 and 6.2 out of 10, respectively), compared to those in Asia (5.1). Amongst M&A directors in the UK, buyers' access to finance was regarded as a bigger issue than elsewhere, with 58% citing it as a major impediment. They collectively give it a score of 6.5, whilst Continental European respondents only scored it 4.9.

'A negative factor is that the debt markets still feel very sticky and illiquid. That is providing a major constraint, especially for divestment activity.'

M&A Director, Holidaybreak (UK travel and leisure company)

M&A directors worldwide were optimistic that a lack of buyers generally should not greatly affect the completion of a deal, but a lack of buyers could clearly be a deal-breaker for companies that wish to make disposals, which may help to explain the lack of interest in disposals noted above.

Key Stats

70%

of respondents cite **government intervention or regulatory intervention** as a **big impediment or a deal-breaker**

Governmental Impact on Deal Activity

Legislative and regulatory attention to the financial sector, to labour protections and the perception that economic nationalism is on the rise have raised uncertainties about the operating environment for target companies and the reception their acquirers might expect to receive. And much recent change in financial regulation affects the availability of finance, which in turn affects M&A. The remarks of M&A directors whom we interviewed suggest increasing concern about what they perceive as the potential for these factors to adversely affect the M&A environment.

Whilst 43% of our respondents comment that these factors have had no significant effect on their ability to complete deals, a majority indicated that they have been a hindrance. It is also important to note that most of those who claim not to have been affected by changes in regulation operate primarily in their domestic markets, and so are not faced with the challenges presented by protectionism or changing attitudes of less familiar governments. Here, familiarity seems to breed contentment: it is uncertainty about the regulatory direction, rather than regulation as such, that seems to cause particular anxiety amongst our respondents.

'[Regulatory, competition and governmental factors] significantly affect the timing, speed, investment cost, utilisation of management assets and structures of deals.'

Head of M&A, Asian automobile manufacturer

However, only a minority of those whom we interviewed reported that regulation prevents the completion (11%) or pursuit (7%) of deals altogether. In the US, 15% stated that the regulatory environment can act as a prior constraint on the pursuit of certain transactions. In contrast, no respondent in Asia believed this to be the case. This is probably the consequence of different degrees of regulatory transparency in the two regions: despite the inconsistent application of anti-trust law in the US, there is at least a body of case law and precedent that permits acquirers of US targets to anticipate authorities' response. Continental Europe probably falls somewhere in between. It is safe to say, however, that regulatory and governmental factors play a large and increasing role in shaping the M&A environment, but most of our respondents seem to believe that they do not raise insurmountable barriers to deal activity. Nevertheless, opinion is divided.

'My view on the matter is that usually a solution can be found. It may take, depending on the situation, various amounts of time and effort but deals don't usually have to be called off because of regulatory or legal problems.'

SVP of M&A, European general industrial manufacturer

'The regulations, particularly company or anti-trust approval, have slowed down several transactions and have kept us from pursuing a number of [possible] transactions.'

M&A Director, Danisco, a European food producer

It is likely that this difference of opinion has its roots in the regulatory regimes specific to these companies' commercial activities: note that the food industry has attracted direct government interference, as for instance in the case of the proposed acquisition of Italy's Parmalat.

The potential for state intervention is something of a wildcard facing many M&A directors. The perception is widespread that, in some countries, government authorities have effective veto power over M&A deals within a particularly prized commercial sector, or even more generally over the entire domestic business community, and that government regards the protection of these 'national champions' as a political imperative. The extent to which these governmental prejudices affect successful deal completion depends on the ideological nature of the government and how 'sensitive' the industry sector in question is deemed to be.

'In some countries, primarily emerging market countries… basically the country has a direct 'yes' or 'no' as to what you can buy or sell, so it can just hold up a transaction.'

Head of M&A, UK oil & gas producer

But regardless of the party in power, countries with a history of state intervention often find it difficult to ignore political pressure to intervene, if only 'just this once.' Even countries that have traditionally eschewed intervention in deal activity can succumb to this temptation. Not surprisingly, wariness of government has increased among those responsible for corporate M&A strategy.

'The sector in which we operate has high visibility and is highly regulated… If a government does not want a deal to happen, it will not happen and if a government wants a deal to happen, it will happen.'

SVP of Business Development, European automobile manufacturer

Competition Factors

Companies that have already established a considerable market presence within a country or in a number of countries increasingly have to grapple with competition laws, according to the executives whom we interviewed. They did not regard competition and anti-trust regulation as a regionally-specific issue: instead they mentioned it in relation to a number of different countries across the globe. Concerns about review by competition authorities were felt relatively strongly by those in Continental Europe and the US (6.3 and 6.2 out of 10, respectively), compared to those in Asia (5.1).

The EU of course, offers something of a special case, and an increasingly unpredictable one. Its Competition Directorate has adopted a stance of particular activism, but without a clear statement of its new policies. The 2009 change of administration in the US was also accompanied by some change in anti-trust policy, again without an explicit statement of the regulator's new approach. This less predictable environment has concentrated the minds of M&A directors.

'Competition clearance policy sometimes can be an issue, particularly if there are large organisations coming together in one host country. Hence the need for greater clarity about UK competition clearance policy and also the need (sometimes) for greater clarity regarding European competition clearance policy.'

CFO, UK software and computer services company

Labour Regulation

Some M&A directors comment specifically on labour law and regulation. These appear to be of particular concern to US companies operating or thinking of operating in Continental Europe, whose M&A directors find EU-imposed work regulation to be a significant barrier to completing deals. They specifically mention requirements for severance pay, work council issues and contractual rights granted to employees by target companies in addition to national legal requirements. Given the light regulation of labour in the US compared to the EU, these concerns are to be expected. Even in the US, though, labour regulation – and in particular the current administration's clear bias toward unionisation – is a mounting concern to potential acquirers.

'You have to be careful sometimes with tough labour requirements that have strong severance pay. The EU region has a lot of these barriers and it hinders a lot of acquisitions.'

Head of Corporate Development, Life Technologies (US pharmaceutical and biotechnology company)

'The biggest [impediment] is the regulatory issue. If you go to EMEA there are a lot of work council issues, so it's really difficult getting things done as there is so much protection in terms of factors within the company that can prevent deals from happening.'

VP of Corporate Development, US technology hardware company

Financial Regulation

A few respondents commented on new financial regulation that has come into force in the last couple of years, and the effect that this has or could have on their M&A activity. One senior figure at a UK financial services company mentions in particular the likely consequences of Basel III, a set of banking rules introduced in 2010 that, amongst other things, will increase banks' capital requirements. Under this regime, banks will have to increase a number of their capital buffers as a preventative measure against a future financial crisis, implying a reduced ability to lend unless they can raise very substantial amounts of new capital. Basel III affects not only M&A in the banking sector itself, but also that of companies that might want to borrow from the banks that find themselves under such pressure to recapitalise. Insofar as insurance companies may be acquisitive or are potential sources of deal financing, similar effects can be anticipated from the EU's Solvency II regulation of insurers.

'On the regulatory side [the challenge] would be Basel III. Following the bank stress tests it is a case of a number of banks having to recapitalise and this will also have an effect on a number of banks' ability to lend to corporate customers.'

Deputy Head, UK financial services company

'It is obvious that regulations affecting financial institutions such as banks have slowed down the M&A pace of the banking industry.'

Global Head of Corporate Finance, European bank

The Price of Delay

Those whom we interviewed cited two major implications of regulatory and governmental involvement in their M&A activity: delays to the completion of deals and restrictions on deal structures.

Regulation adds layers of complexity to due diligence that increase the time required to reach a valuation and negotiate a deal structure. According to one US M&A director, anti-trust laws in various countries have caused delays of up to two months for his electronics company. Not surprisingly, those whom we interviewed claimed that delays were particularly lengthy when pursuing deals in countries in which they have not previously operated. It can take up to six months to obtain regulatory approvals in a new geographical region, whilst authorities seem to be able to respond more quickly if the potential acquirer already has operations there.

Delays to transaction completion can have serious consequences for acquirers well after the deal is closed. Uncertainty among a target's employees, its existing customers and especially its potential customers is inevitable once the prospect of its acquisition is public knowledge. The longer that completion is delayed, the longer this uncertainty persists and the greater it is likely to become. Employee morale will almost certainly nosedive. Existing customers will seek to protect their interests by finding alternative suppliers and will likely reallocate some of their business to them, if only to cement the relationship. Prospective customers will simply wait and see, further demoralising those in the marketing function. Once an M&A transaction is public knowledge, it is therefore in everyone's interest for it to close quickly.

'The most important constraint for us is in China, where it takes too long to reach a deal. The duration, the timing, the time needed to achieve the transaction is way too long, which really affects the synergy between the companies especially during a transitional period. It paralyses the business.'

M&A Director, Cap Gemini, European software and computer service company

Transaction Structures

When pursuing deals in particular geographical markets, a significant number of M&A directors comment on how regulation can in some cases determine the structure of a deal. Specifically, they stress the importance in some jurisdictions of having a local partner, with which to enter into a minority investment arrangement or joint venture. Very few of those whom we interviewed regarded this as an optimal investment structure: 54% of our respondents did not consider growth through joint ventures or strategic alliances to be one of their three preferred M&A options. The M&A director of an Asian travel company commented on the relative unattractiveness of this option .

'Ideally we would like to be in a position to influence the direction of the company with which we merge. This requires that we be more than [just] an equity partner.'

M&A Director, Asian travel company

One reason that our respondents cited for entering a geographical market in company with a local partner is that this tactic offers an easier route toward acquiring a foothold in some countries. In particular, a local player may be more familiar with the local regulatory environment and better-equipped to deal with the authorities.

'As we look at regulatory frameworks around the world, it impacts [deal] structure in that we often seek to partner with a local player to be responsive to and to have a voice with local regulators.'

M&A director of a US financial services company

Another reason that those whom we interviewed mentioned for partnering with a local company is simply that it is mandatory to do so in some jurisdictions.

'In Saudi Arabia, non-industrial investments are forbidden: you have to operate through a joint venture. I could name other countries such as Libya or Iran that still regulate with these types of laws.'

General Director of Corporate Acquisitions, European personal goods manufacturer

APPENDIX: NOTE ON METHODOLOGY

The Financial Times and Hogan Lovells conducted a global study amongst leading corporations into the evolving landscape of the M&A market in July 2011. The study gauged the opinions of 160 companies' officers at Executive Committee or Management Board level who are responsible for M&A, 40 in each of four discreet regions: the UK, Continental Europe, the US and Asia. Respondents were asked to confine their answers to their views of M&A prospects and challenges over the forthcoming twelve to twenty-four months.

The backbone of the survey was a multiple-choice questionnaire carried out by Consensus Research, an independent, third party research firm. The questions presented to the respondents asked them to choose among prompted responses, to rank in order of importance pre-specified factors that might affect their M&A activity or to rank in order of importance the regions in which they believed their companies were most likely to pursue acquisitions. However, all of those whom we interviewed were offered the opportunity to make extemporary comment on their views about the current M&A environment. Most of them availed themselves of this opportunity, providing a corrective to any distortion that might accidently have been built into the questionnaire and valuable anecdotal support to the conclusions we have drawn from this exercise.

The Financial Times and Hogan Lovells are presenting a series of in-person "M&A Evolution" briefing events around the world to invite discussion about and commentary on these findings. The briefings are taking place in London, Hong Kong, Frankfurt and New York, with additional cities to be announced.

ABOUT HOGAN LOVELLS

Hogan Lovells

Hogan Lovells is a global legal practice that helps corporations, financial institutions, and governmental entities across the spectrum of their critical business and legal issues globally and locally. We have more than 2,300 lawyers operating out of more than 40 offices in the United States, Europe, Latin America, the Middle East, and Asia.

Our practice breadth, geographical reach, and industry knowledge provide us with insights into the issues that affect our clients most deeply and enable us to provide high quality business-oriented legal advice to assist them in achieving their commercial goals.

Our global Corporate practice is well positioned to handle the most sophisticated and largest transactions for major companies and leading financial institutions around the world. We have an established track record of delivering transactions in complex markets and highly regulated sectors, enabling us to guide clients through every aspect of a transaction towards a successful outcome.

Wherever we are working, our focus is on helping our clients to deliver on their strategic plans for the growth and development of their businesses.

Our style is open, service-focused, and friendly. We believe that our commitment to client service, commerciality, and teamwork provides benefits to our clients and enhances effective business relationships.

HOGAN LOVELLS OFFICES WORLDWIDE

Web: www.hoganlovells.com/evolution

Email: evolution@hoganlovells.com

Abu Dhabi
+971 2 403 9600

Alicante
+34 965 1383 00

Amsterdam
+31 20 55 33 600

Baltimore
+1 410 659 2700

Beijing
+86 10 6582 9488

Berlin
+49 30 72 611 50

Brussels
+32 2 505 0911

Budapest*
Partos & Noblet
+36 1 505 4480

Caracas
+58 212 266 9772

Colorado Springs
+1 719 448 5900

Denver
+1 303 899 7300

Dubai
+971 4 377 9377

Dusseldorf
+49 211 13 68 0

Frankfurt
+49 69 962 36 0

Hamburg
+49 40 419 93 0

Hanoi
+84 4 3946 1146

Ho Chi Minh City
+84 8 3829 5100

Hong Kong
+852 2219 0888

Houston
+1 713 632 1400

Jeddah*
Al-Yaqoub Attorneys & Legal Advisers
+966 2 284 6611

London
+44 20 7296 2000

Los Angeles
+1 310 785 4600

Madrid
+34 91 349 82 00

Miami
+1 305 459 6500

Milan
+39 02 7202521

Moscow
+7 495 933 3000

Munich
+49 89 290 12 0

New York
+1 212 918 3000

Northern Virginia
+1 703 610 6100

Paris
+33 1 53 67 47 47

Philadelphia
+1 267 675 4600

Prague
+420 221 411 700

Riyadh*
Al-Yaqoub Attorneys & Legal Advisers
+966 1 211 0600

Rome
+39 06 6758231

San Francisco
+1 415 374 2300

Shanghai
+86 21 6122 3800

Silicon Valley
+1 650 463 4000

Singapore
Hogan Lovells Lee & Lee
+65 6538 0900

Tokyo
+81 3 5157 8200

Ulaanbaatar
+976 11 331 020

Warsaw
+48 22 529 29 00

Washington, D.C.
+1 202 637 5600

Zagreb*
Bogdanovic, Dolicki & Partners
+385 1 600 56 56

*** Associated offices**

Hogan Lovells

Hogan Lovells

FINANCIAL TIMES