European M&A: On the road to recovery?

Tracking global perspectives and investor confidence

CLIFFORD
CHANCE

Including analysis from

The Economist Intelligence Unit

Contents

About this report

In the first half of 2013, the Economist Intelligence Unit carried out a global survey on behalf of the international law firm Clifford Chance to assess the outlook for European merger and acquisition (M&A) activity. In the aftermath of the global financial crisis, the survey explored the attractiveness of European assets for buyers and sellers worldwide and identified the key risks and opportunities for companies considering M&A in Europe.

The Economist Intelligence Unit surveyed 370 companies that have executed, or are planning to execute, a cross-border M&A deal, from across a wide range of industries and regions. All individual respondents are familiar with their company's M&A strategy.

Foreword from Clifford Chance

Are the stars aligned for a resurgence in European M&A? Many companies enjoy strong balance sheets and have access to finance. Furthermore, the stock markets have performed strongly over the first six months of 2013. The spectre of long-term weak economic growth (or worse, stagnation or recession) and continued euro zone uncertainty continue to cast shadows over the European M&A market, but the outlook is showing signs for cautious optimism.

After the turmoil of the last five years, the European environment for M&A is finely balanced. To penetrate the current thinking of the senior deal-doers across the corporate world, we commissioned the Economist Intelligence Unit to undertake research into the opportunities and challenges currently seen by these decision-makers in Europe.

Reassuringly, perhaps, the first message from our respondents is that Europe remains an attractive and important market for M&A. The size of the European market is key for any global player. This, together with its geographical location and the number of quality assets within it, are key drivers in the market. An increasingly important issue identified by our survey – the need to manage reputational risk during acquisitions – also puts Europe in a good position, with its strong corporate governance and regulatory framework. Add to this a highly skilled workforce and high technological capabilities, combined with strong intellectual property rights, and it is clear why Europe offers great potential for buyers both inside and outside the region.

So what is holding M&A activity back? As our survey shows, in the current environment many companies continue to choose organic growth over 'big ticket' acquisitions. Clearly confidence within the boardroom is not being helped by continuing economic uncertainty in the low-growth environment. Euro zone uncertainty, and the more recent issue of a possible UK exit from the EU, make it difficult for key investment decisions to be made.

A further period of stability is the key to unlocking the potential in the market. Stability would also help to erode the valuation gap between sellers' expectations and buyers' desire to price in a 'risk discount' during choppy markets. With many of the building blocks already in place, and signs of greater confidence in the market, we believe that while the challenges should not be underestimated the opportunities for M&A activity in Europe are growing.

We hope you enjoy reading the report, and our perspectives on the key issues it identifies.

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Key findings

Sovereign debt crises, political uncertainty and weak economic growth across the board have hobbled the recovery of Europe's M&A market from the body blows delivered by the global financial crisis of 2008. But some of Europe's charms are enduring for investors who prefer to dig a bit deeper: its stable regulatory environment, its global brands and its skilled talent pool, to name just a few. A strong recovery in 2013 may be unlikely, but evidence is mounting that an upturn in the market may be approaching.

This report examines the extent to which global and European financial crises, credit conditions and investor sentiment continue to affect appetite around the world for M&A in Europe; it identifies the underlying strengths and weaknesses of the European M&A market; and it assesses the prospects for a recovery in both inbound and outbound investments, and for intra-European M&A.

The key findings of this report are:

Even in challenging times, Europe's durable strengths make it desirable. The size of Europe's economy, its central location and the quality of its assets mean it is still a key market for deal-making despite the current instability hanging over the continent. Only 5% of respondents in the Economist Intelligence Unit survey of senior business executives from across the world think Europe is an unattractive M&A market. Among Europe's strengths, respondents cite its highly developed infrastructure, the technological prowess of its companies, its talent pool and its stable regulatory and legal frameworks. Securing unique competitive advantages and eliminating intellectual property risks are often the key factors driving M&A in Europe.

Western Europe offers the most attractive M&A opportunities within the region. Just under one-third (32%) of respondents picked western Europe as their top destination on the continent for M&A in the next two years. Within western Europe, Germany has the best M&A opportunities on offer, and France and the Netherlands are a distant second and third. Preference is not, however, uniform and Japanese and Chinese respondents are principally focused on what they regard as safer European and non-euro zone markets (northern Europe and the UK). Generally there was less interest in southern Europe, suggesting that the ongoing troubles in the euro zone are continuing to deter investment in the less stable parts of the continent. Only 26% say that they are not interested at all in the European M&A market over the next two years.

European firms are turning their gaze towards high-growth markets for M&A deals. With a weak market at home, over one-quarter (27%) of European respondents think that their companies will seek to diversify their risk by investing elsewhere. And over two-thirds (69%) of all respondents agree that European companies will increasingly have to make acquisitions in high-growth or emerging markets to stay competitive. Many of the biggest European companies already have a significant presence in emerging markets, which makes increased outbound M&A activity a logical next step for European firms.

Attractive valuations of European assets are luring in bargain hunters... The downturn has depressed asset valuations in Europe, and firms that are not in a position to wait for the market to improve are being forced to dispose of assets at a discount or a loss. Potential buyers around the world, therefore, are eyeing European acquisition targets becoming available at attractive prices. A significant proportion (43%) of respondents say that the socioeconomic uncertainty in Europe is actually increasing their appetite for M&A deals on the continent.

...but at least some sellers of European assets are choosing to wait and watch. Low valuations are deterring companies from selling their crown jewels unless forced to, which is proving to be one of the key factors blocking a recovery in European M&A. Just 15% of respondents say that their firms will be selling assets in Europe in the next two years. Few big deals are being done because cash-rich companies with sizeable assets are preferring to sit out the downturn. Large European companies are the most likely to be snapping up good deals on the continent, while European small and medium-sized enterprises are the most likely to put up 'for sale' signs, as finances are tight for them and many are needing to raise cash.

Rising costs such as higher taxes and volatile currency markets are key obstacles for global firms' European M&A strategies. Respondents quote economic instability and weak economic growth in the euro zone as reasons to be cautious about European M&A. However, more specifically, executives in the survey express concern over rising costs, currency fluctuations and potential risks to corporate reputation. European labour laws and industrial relations also deter investment into the region, and 85% of Japanese and Chinese respondents are worried about the difficulty of integrating new European businesses.

Lack of finance is not an unassailable challenge; cash is the most popular currency for deal-making. Using cash to fund deals will continue to be the preferred option for companies. Over two-fifths (44%) of respondents in the survey say that they will use cash reserves to finance deals—bank loans are a distant second (25%). This suggests that economic and political uncertainty, rather than lack of finance, is the biggest constraint on deal-making. Private equity activity, a key driver of M&A activity before the financial crisis, remains subdued, but some recent deals suggest that the private equity market may have turned a corner.

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Down but not out

It has been a quiet few years for the European M&A market. In 2012 both the number and value of European M&A deals fell by more than 4% on 2011 levels, to 5,267 and €539.2bn (US$693.4bn) respectively[1]. Compared with the pre-financial crisis highs of 2007, the value of deals was down by 54% and the number by 22%.

The Economist Intelligence Unit survey of senior business executives from across the world confirms that business sentiment on M&A is still far from confident. Over one-half (54%) of respondents say that it will take another decade for the M&A market to recover fully from the impact of the global financial crisis – a view shared by companies both within and outside Europe. According to Christopher Kummer, the president of the Institute of Mergers, Acquisitions and Alliances (IMAA), a Vienna-based think-tank, a rebound to 2007 levels is unthinkable for now. However, there is reason to believe the worst may be over.

Robert Kindler, the global head of M&A at Morgan Stanley in New York, points out that merger activity is closely correlated to economic growth, which has been anaemic in Europe. The Economist Intelligence Unit's Forecasting Division expects western Europe to grow by just 0.1% in 2013 after suffering a modest contraction in 2012. In contrast, the US should grow by 2.1% in 2013, a forecast whose optimism is reflected in the relatively stronger American M&A market in the first quarter of 2013.

The value of the European M&A market is significantly down according to market data, in part because very few big strategic deals are being done. "Company boards will hesitate before betting the house on a big merger or acquisition, given the crisis," says Thierry d'Argent, the global head of corporate finance at Société Générale, a French bank. That means acquisitions that are not 'seriously material' to the overall health of corporate balance sheets are more likely to happen than much larger cash acquisitions. The market is therefore likely to be centred on the €1bn (US$1.3bn) deals. This is not, however, the whole story. Although deal values remain down on pre-crisis days, the impact of uncertainty on the number of deals has been less extreme, with annual volumes in 2012 not significantly different from levels in 2005 (see Figure 1).

Mr Kindler is confident that in Europe, not unlike in the US, a rebound in economic growth and equity markets, along with the cash piles many companies are sitting on, will translate into a more dynamic global M&A market sooner rather than later. Scott Moeller, director of the M&A Research Centre at the Cass Business School in London, also expects M&A activity to mirror movements in stockmarkets with a bit of a time lag. "There needs to be a sustained recovery in stock values for around six months for the broader M&A market to recover," he says. Given that European stockmarkets have started to recover over the past year, a potential upturn in the M&A market may be on the cards.

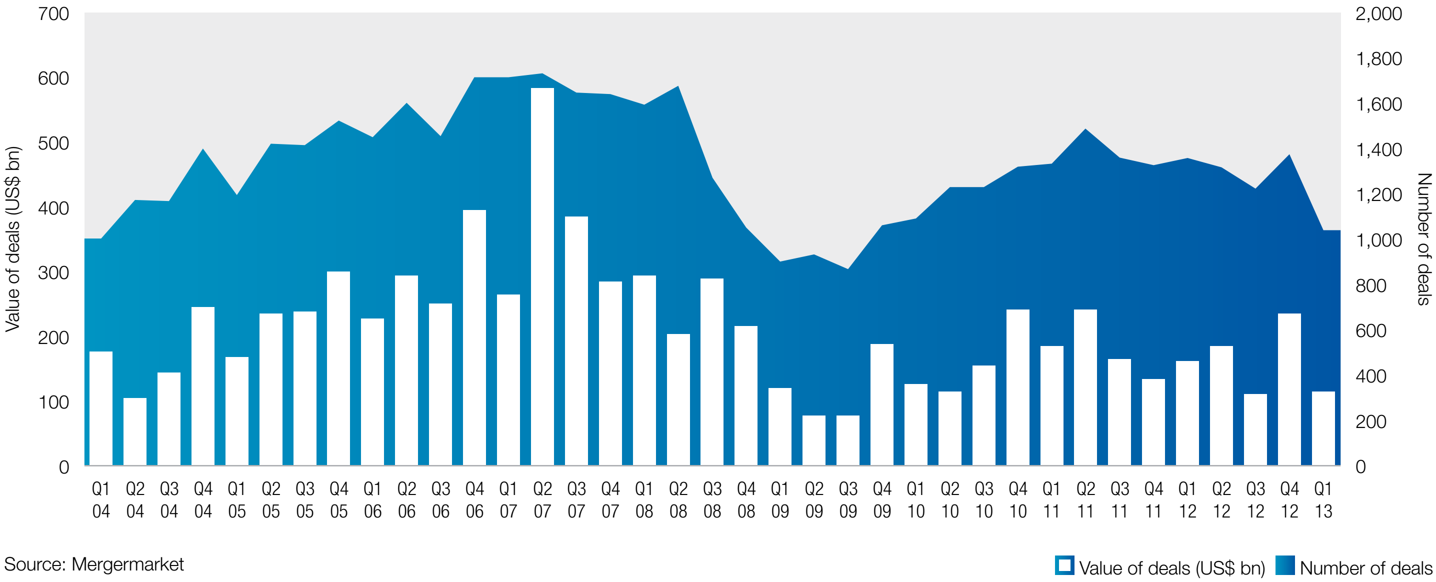
The Clifford Chance view:

"Equity markets in the US and Asia have experienced a prolonged period of relative stability and are broadly on an upward trajectory, with Europe following suit. The rising equity market should improve boardroom confidence and, for those who anticipate a sustained rise, now may seem a good time to buy. Having said that, equity markets are being driven by liquidity as much as fundamentals and remain prone to shocks, as seen near the end of May. Despite gradual adjustment to a 'new normal', slow growth globally and the generally fragile macroeconomic environment mean they are not immune to corrections."

Malcolm Sweeting, Senior Partner

1 Mergermarket data, 2013.

Figure 1: European M&A: Volume and value of deals 2004-2013 (by quarter)



Source: Mergermarket

Figure 2: European M&A: Top 10 announced deals in 2012

Announced date	Bidder country	Bidder company	Target company (seller, stake)	Target country	Deal value (US$ m)
February 2012	Switzerland	Glencore International Plc	Xstrata Plc (65.92% stake)	UK	45,598
November 2012	Russia	Rosneft Oil Company OJSC	TNK-BP Limited (BP, 50% stake)	Russia	31,140
December 2012	Russia	Rosneft Oil Company OJSC	TNK-BP Limited (Access Industries; Alfa Group; and Renova Group of Companies, 50% stake)	Russia	28,000
July 2012	Germany	Volkswagen AG	Porsche AG (Porsche Automobil, 50.1% stake)	Germany	14,238
May 2012	US	Eaton Corporation	Cooper Industries Plc	Ireland	11,940
April 2012	France	GDF Suez	GDF Suez Energy International (30.23% stake)	UK	10,867
September 2012	Italy	Cassa depositi e prestiti Spa	Gruppo Sace Spa (Italian Ministry of Economy and Finance)	Italy	7,800
January 2012	Japan	Sumitomo Mitsui Financial Group Inc	SMBC Aviation Capital Limited (The Royal Bank of Scotland)	Ireland	7,300
December 2012	Spain	Fondo de Reestructuración Ordenada Bancaria	NCG Banco SA (6.84%)	Spain	7,173
November 2012	Belgium, France	Government of Belgium; Government of France	Dexia SA (undisclosed economic interest)	Belgium	7,005

Source: Mergermarket

The Clifford Chance view:
Board-level concerns around euro zone issues are evolving

"Our survey respondents predictably express concerns around the ongoing uncertainty in Europe, and these are shared by the boards of many of our corporate and banking clients with operations in Europe. The key risks are really two-fold: on the one hand, there are of course the euro zone issues – for example, the continued risk of euro fragmentation or an exit of one or more nations from the euro. The second concern is more fundamental – namely whether the European project itself can, and will, remain on track. We are finding many of our clients are currently keen to discuss our insights in both these areas.

The risk of a complete failure of the euro has receded significantly since this time last year. When Mario Draghi stood behind Europe's commitment to the euro project being irreversible, and confirmed that everything would be done to maintain that policy, he pushed back the risk of fragmentation and calmed the markets. Rescue funding has been injected into countries that need it. But as the recent Cypriot crisis has vividly demonstrated, while the markets may have calmed, the real fundamental issues are still there – unsustainable debt levels, the toxic link between the banks and the sovereigns, the need for structural reforms, the challenge of generating growth and a weakened banking sector struggling to adapt to regulatory change. There are new initiatives to effect institutional changes, such as banking union, but there's still a long way to go.

The rescue funding provided by EFSF and ESM provides the oxygen to beneficiary countries to buy time to return to long-term economic health. This time must be used effectively to make structural changes, to reform the banking sector and to create the conditions for economic growth. The austerity programmes are where you start to get into the politics. Implemented in order to tackle the unsustainable debt, there are often ensuing sociopolitical problems including high (particularly youth) unemployment. This puts increasing pressure on the political consensus that has been achieved and gives rise to questions as to whether there needs to be a policy evolution to 'austerity plus' to stimulate growth to ensure that the European project is not blown off track.

Whilst supporters of the European project realise that economic growth is an imperative, this growth will need to be financed. This requires a healthy banking sector which performs its usual function of transforming savings and liquidity into finance for the real economy. The current challenge is whether the regulatory responses to the crisis of 'protecting tax payers at all costs' will strangle the financial markets, isolate pools of liquidity and de-risk the banks to an excessive extent. This could create a huge restraint on growth which the 'shadow banking sector' is not large enough to compensate."

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"Board-level concerns are evolving as the prospects for economic growth and the constraints of new banking regulation take centre stage."

The Clifford Chance view:

"We are seeing early signs of the increased availability of leveraged finance in Europe, following the return of liquidity in the US acquisition finance markets. This should assist private equity and other financial sponsors, for whom equity cheques have been larger than they would like in recent years, and potentially with public takeovers generally, where "certain funds" facilities are required."

Patrick Sarch, M&A Partner, London

The Clifford Chance view:

"What will be the trigger needed to uncork the flow of assets on to the market? Certainly strong equity markets and a period of relative calm across the region would increase the sense that firmer pricing may be achieved, as buyers gain confidence in a more stable market. Across many sectors in the euro zone, there needs to be a general acceptance by sellers of lower pricing levels, in line with the recent re-set of the market (other than a handful of top assets, which will sell at a good price in any market). Given the current European wall of debt – an estimated US$430 bn due by the end of 2014 – we expect that squeezed companies will be persuaded to sell at sensible prices."

Jeroen Koster, M&A Partner, Amsterdam

How low can they go?

A major challenge facing deal-makers is depressed asset valuations, which open the door to bargain hunters but deter companies from selling undervalued businesses in Europe. Just under one-third (31%) of survey respondents say that European assets are undervalued, and out of these nearly two-thirds (64%) think valuations will either drop or stay about the same over the next two years. According to Francesco Tanzi, the chief financial officer of Pirelli, an Italian tyre maker, the difficulty is aligning a seller's price expectations with the valuations of those in a position to buy. "Each has a different way of viewing the present climate: the seller sees it as temporary, while the buyer is discounting its negative long-term effects," says Mr Tanzi.

Mr Kummer of the IMAA points out that European valuations rose in the first quarter of 2013, with the average price/earnings (p/e) ratio increasing to 9.3, from 8.3 in 2012. However, that remains well below the pre-crisis highs in p/e multiples (12.7 in 2007)[2]. As a result, many of the businesses that buyers covet most are still off the market. And that leaves the European market with a number of distressed sales. "That means companies in need of restructuring. Corporates tend to avoid targets that need restructuring, and such firms have traditionally been the preserve of private equity," says Mr Kummer. His verdict? "No one is selling the good companies that firms want to buy because prices are too low, and no one is buying the restructuring targets coming up for sale."

But that is not the whole picture. The Economist Intelligence Unit survey found that just over one-quarter (26%) of respondents would consider divesting underperforming assets in Europe over the next two years. There could also be some good assets coming onto the European M&A market from spin-offs of non-core divisions as one-half of executives in the survey say that a key reason for selling assets in Europe is to focus on core business. A recent example from Spain is Repsol selling its LNG assets to Shell.

2 Thomson Financial, Institute of Mergers, Acquisitions and Alliances (IMAA) analysis.

Credit no constraint

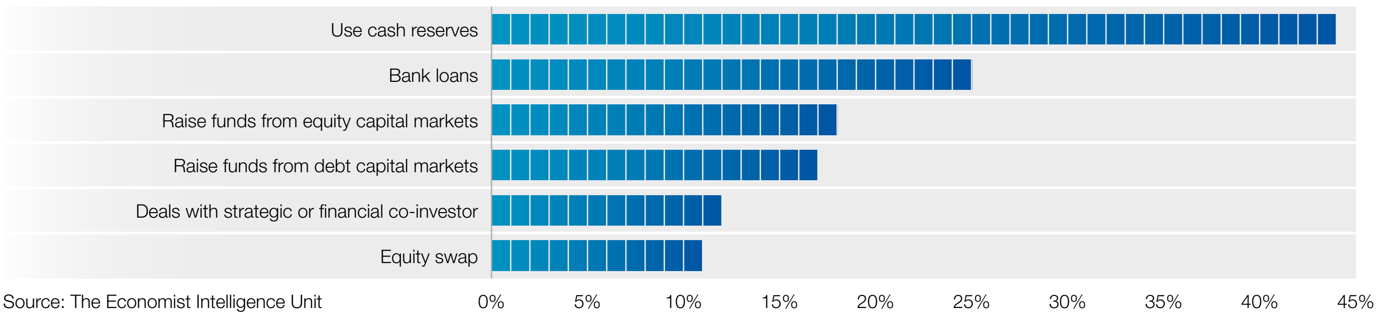
"The shortage of available credit is certainly a factor weakening M&A activity," says Francesco Tanzi, the chief financial officer of Pirelli, before adding that it is not a problem for the Italian tyre maker itself: it can fund acquisitions through existing credit lines or other non-bank means. For big companies that is fairly typical, with cheap credit now available from banks when required. However, a dearth of finance for smaller (or less creditworthy) European firms still explains many of the problems in the wider M&A market in Europe.

Some companies have looked for alternative sources of finance by tapping the 'shadow banking' market or through revised credit arrangements with suppliers and customers. However, funding can remain an issue for smaller (or less creditworthy) companies still reliant on banks. Another Italian company, Luxottica, has reversed its funding mix since the crisis, for example. Before the crunch, banks provided around 80% of the credit it needed for expansion, with just one-fifth coming from the debt capital markets. Today, the proportion has all but reversed, with 70% of credit coming from the markets and less than one-third from banks. Nonetheless, the eyewear group does not regard funding as a constraint on activity these days, although its strategy remains cautious. The Economist Intelligence Unit survey suggests that the bulk of companies now rely on their own cash to make acquisitions, with bank credit coming a distant second (see Figure 3). And a mere 2% say that difficulty in accessing finance makes Europe an unattractive market.

An area to watch is private equity (PE) investment, however, which was a vital source of M&A activity pre-2007. It has come down significantly since then, and stayed down. In 2007 PE bought into more than 1,300 transactions valued at €91.7bn (US$117.9bn). In 2012 there were little more than 1,000 PE deals worth €39.8bn (US$51.2bn)—in value terms, a plunge of 57%. And the number of PE-backed deals was down by an annual 17% in the first quarter of 2013, according to Christopher Kummer, the president of the Institute of Mergers, Acquisitions and Alliances.

Still, as Thierry d'Argent, the global head of corporate finance at Société Générale explains, there are now signs that PE funds can borrow money for acquisitions again, a development of the past year or so that means that one of the big blocks on activity is easing. That could help to revive PE investment, but leverage (or borrowing) levels are still lower than they used to be. In April 2013 European competition authorities cleared Liberty Global's €18.1bn (US$23.3bn) acquisition of Virgin Media, for example, which was part-financed by €2.8bn (US$3.7bn) of high-yield bonds and a €2.1bn (US$2.7bn) leveraged loan. More generally, Mr d'Argent reckons that PE funds will be able to borrow less than one-half of the cost of acquisitions, compared with perhaps 80% before the crisis. However, PE funds continue to be a very attractive asset class for investors and many PE firms have significant 'dry powder' in their arsenal. Sooner or later this should lead to an increase in M&A activity in the PE sector.

Figure 3: What are your company's preferred methods of financing M&A activity?



Source: The Economist Intelligence Unit

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"Things have changed since pre-financial crisis days, but PE players are highly adaptive."

The Clifford Chance view:

Private equity players adapt to the changing landscape

"Global market volatility post-Lehman has been a major issue for the industry. Private equity can function well in good times or in bad, but what it needs is stability in the economy – to be able to predict what the future looks like.

This was clearly seen in 2012, when a strong start to the year was negated by the euro zone crisis during the summer, and in the second half of the year the European PE market ground more or less to a complete halt. Investors from outside were reluctant to invest into the euro zone, and European PE houses and banks were concerned about the uncertainty of what lay ahead. Currently there is evidence of greater stability. Equity markets have performed well for the past few months and access to both bond and classic financing is good. Things have changed since pre-financial crisis days, but PE players are highly adaptive.

With fewer public auctions or new assets coming to market, we have seen more off-market transactions and an appetite for public to private deals, although these remain challenging to deliver successfully. We are also seeing changing dynamics in the European market – new entrants such as the Canadian pension funds who are actively looking to invest alongside funds, and even making direct investments themselves, and in contrast established European players scaling down or departing. US PE houses are showing an increasing interest in Europe, as are the growing numbers of Asian PE funds. For those looking to do large transactions, Europe is a safe haven due to its infrastructure and strong legal framework. As a result the risks for private equity are perceived as much lower in Europe than in the emerging markets of Africa, Asia or Latin America.

The current difficulties in Europe are creating new opportunities for private equity on the buy-side: we are seeing major players, including banks and large corporates, disposing of non-core assets which they had been holding onto in a "wait and see" approach, but are now finally starting to off-load.

Deals are, however, more complex. In an environment where everyone is more risk aware, buyers are more discerning, requiring greater, more focused due diligence, and seeking stronger contractual protections. The finance market has beome more sophisticated and therefore more complex to implement. The days of 'cookie cutter' deals from the pre-Lehman auction processes are behind us.

Looking ahead, there are good reasons to be cautiously optimistic. Although buyers remain wary, a prolonged period of market stability should create a strong platform for greater activity, with firmer pricing attracting more quality assets onto the market."

The Clifford Chance view:

Out of the shadows – alternative financing's role in European M&A

"One of the reasons that so few survey respondents identified access to capital as an obstacle to their M&A activity may be the increasingly broad range of financing options available in the market.

In addition to capital market instruments, including a buoyant high yield bond market that is driving M&A activity, there are significant options in the so-called 'shadow banking' market – which comprises non-bank lenders providing alternative financing sources for borrowers. Active borrowers in this area include infrastructure players, whose long-term funding needs will be more challenging for banks to meet in the context of Basel III, and the real estate sector which faces similar issues. SMEs are also feeling a squeeze on liquidity – facing adverse credit selection and limited access to capital markets.

Alternative financing offers attractive opportunities for non-bank lenders – pension funds and insurance companies are looking to find the tenure and yield that match their liabilities. Credit funds and money market funds are also active, the former employing many of the structuring techniques and mechanics traditionally used by PE funds and hedge funds, combined with certain securitisation techniques.

We are seeing an increased number of clients establishing funds or allocating resources to this area and there is evidence that alternative financing activity is providing much needed liquidity to the market. As such, it is having a positive impact on the real economy and is fuelling M&A and strategic growth. While a significant amount of alternative financing has been in the secondary market, we are now seeing players such as pension funds, insurers and asset managers being involved as part of the initial club deal or on the primary syndication. The experience and confidence that they gain should help this trend to continue.

Regulation of the sector is a challenge. While the term 'shadow banking' can have some negative connotations, many of the activities it encompasses are in fact regulated. Clients need to be guided through the evolving regulatory environment. We also help with tax efficient structuring and fund terms. Although there are certain obstacles to overcome, this is a valuable source of liquidity and yield to tap into.

We anticipate continued growth for this market, not least because the broad range of options available allows participants the scope to structure a transaction that best suits their particular requirements."

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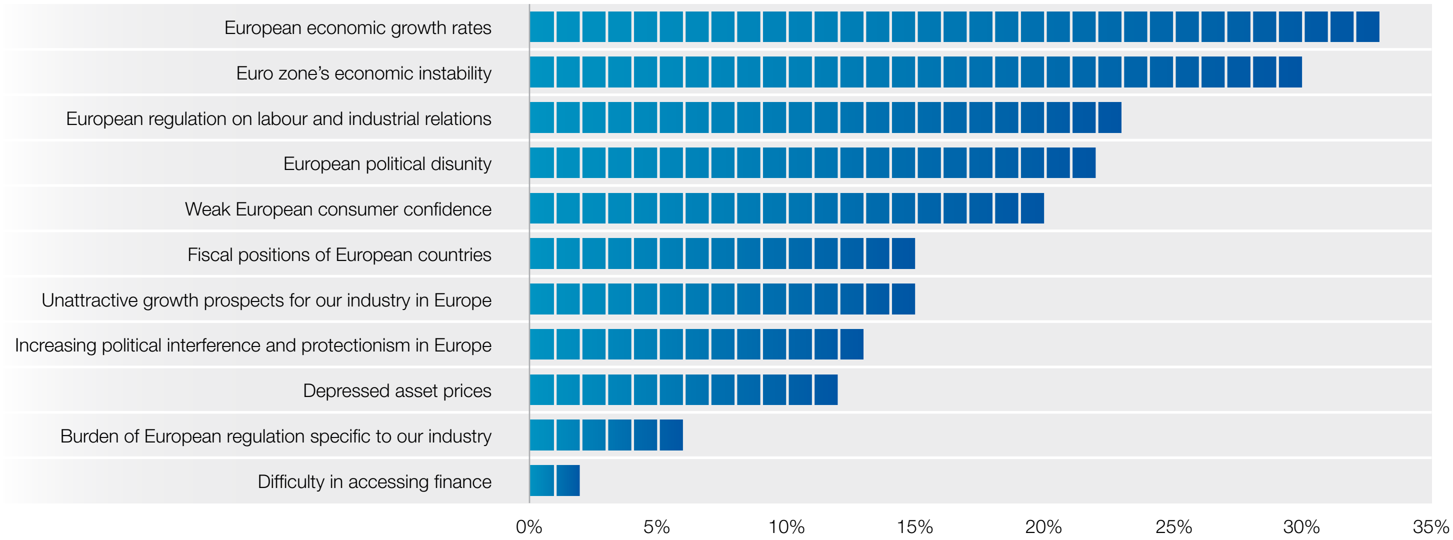
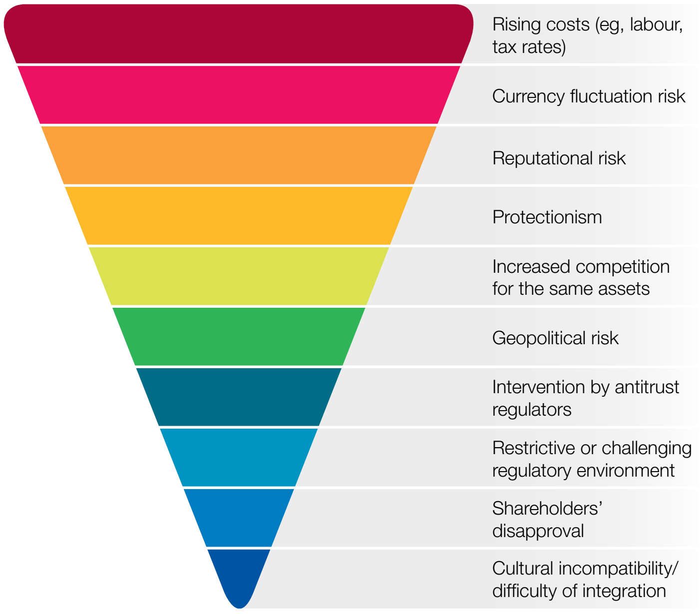
"We anticipate continued growth for this market, not least because of the broad range of options available."

Figure 4: What makes the European market unattractive from your company's point of view?



Source: The Economist Intelligence Unit

Figure 5: Top 10 risks for executing M&A strategy in Europe over the next two years



Source: The Economist Intelligence Unit

Cash-rich, M&A shy

With political and economic uncertainty still hanging over parts of the euro zone, it is perhaps unsurprising that companies have curtailed their appetite for M&A in Europe. Respondents to the Economist Intelligence Unit survey quote European economic growth rates (33%) and economic instability (30%) as the most unattractive features of the European market (see Figure 4). European labour laws and industrial relations also deter investment into the region, and 85% of Japanese and Chinese respondents are worried about the difficulty of integrating new European businesses. A succession of high-profile failed deals, ranging from the EADS and BAE Systems merger to Yahoo's aborted purchase of Dailymotion, also make executives wary of entering the European M&A market.

Nearly three-fifths (59%) of respondents say that the risks of M&A in Europe outweigh the benefits at the moment, with Europe's volatile economy and weak growth singled out as the biggest deterrent to activity. As for the biggest risks to doing M&A in Europe, respondents cite rising costs (including wages and taxes), currency fluctuations and reputational risks, which can arise from public scrutiny of failed or difficult deals (see Figure 5). Continuing weak growth across many parts of Europe has also heightened executives' fears that beleaguered European governments will resurrect protectionist walls.

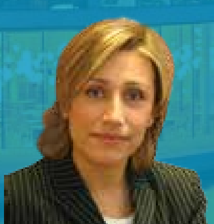
The Clifford Chance view:
Successfully navigating labour laws in Europe

"Our survey respondents value the talent and skilled workforce across Europe, but nearly one-quarter of respondents identify European regulation on labour and industrial relations as an unattractive feature of the market. Despite the complexity of modern employment law and the perhaps surprising degree of diversity in the regimes across Europe, with the right preparation and advice the obstacles can be successfully navigated.

For many investors from outside the region, the employment laws and regulations in Europe are seen as 'employee friendly' and adversely impacting on competitiveness. US investors, for example, find it frustrating that the different countries in Europe have different regimes – some stricter and more cumbersome than others, but all requiring different processes and timetables – particularly where it is a pan-European deal with employees in multiple countries. Also, the reality of having to consult and (in some cases) negotiate with employee representatives is alien to them: US domestic labour laws generally focus on protecting employees from detrimental working conditions, rather than, both in terms of an acquisition and post-acquisition integration and restructuring, guaranteeing economic benefits.

The key is to identify issues upfront and plan carefully, as employee issues can often become critical to the timing of a European M&A transaction and to achieving post-acquisition synergies. They may also influence deal structure and even pricing. It is therefore essential to start early – that way you identify opportunities as well as challenges, and factor obstacles into the timetable.

Although European labour laws can pose challenges, our experience is that they are largely surmountable. Deep knowledge of all local employment laws and nuances is important, and so is the global perspective – to bridge the cultural difference and focus expertise on the client's objectives."



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"The key is to identify issues upfront and plan carefully."

Cash has been piling up on the balance sheets of global corporations, including European firms that have taken a cautious approach to growth. The cash mountain accumulated by European companies in recent years, which now totals more than €1trn (US$1.3trn), is not being put to work: it is a buffer against economic uncertainty rather than a war chest for acquisitions. This is the case across the continent, including southern Europe. In a recent report, the ratings agency Standard & Poor's pointed out that Italian and Spanish companies are boosting their cash reserves as the two countries grapple with their sovereign debt issues[3].

That helps explain why the Economist Intelligence Unit survey found that more than three-quarters (76%) of respondents are concentrating on organic growth, with less than one-quarter (24%) favouring M&A as a route to expansion (see Figure 6 on page 21). This trend is apparent as much in mature Western economies such as the US, where more than four-fifths (81%) of respondents say that their companies are pursuing organic growth, as it is in China and Japan (97% each). More than two-thirds (72%) of executives surveyed for this report say that their firms are focusing on their core business and 62% are focusing on established markets, so few will be looking at acquisitions to enter new markets. "New investments and expansions are still not a top priority for a CFO," says a survey respondent from the energy sector in western Europe.

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The Clifford Chance view:
Scrutiny by antitrust regulators increases

"Intervention by antitrust regulators is unsurprisingly a concern among M&A investors into Europe, as the European Commission and the national antitrust authorities of the EU Member States have increased their scrutiny over the last few years. While the actual number of cases blocked is relatively low, a large number of mergers are only cleared subject to conditions and obligations (mainly divestments). The need to make divestments is particularly crucial to strategic buyers and can cause massive delays for the deal. The likelihood of divestments being required can even be a considerable disadvantage during the bidding process – bringing unwelcome uncertainty, and deal risk for sellers. It is, therefore, necessary to analyse merger control feasibility at the very outset of the deal, and implement appropriate and creative structures to outweigh these potential disadvantages (eg by setting up a backstop structure)."

3 Cash, caution and capex—Why a trillion euro cash pile is unlikely to drive a European capex boom, Standard & Poor's, 2013.

The Clifford Chance view:
Mitigating political risk in difficult economic times

"In difficult economic times, it is natural for survey respondents to assess political risk (including around tax) and protectionism with enhanced vigilance. Bank deposit seizures in Cyprus have made investors understandably nervous, as this was a new frontier in terms of government intervention in business operations.

To an extent it is about perception of risk as much as risk itself. The Cyprus situation is a good example of that. We currently find investors have an almost knee-jerk reaction to the country – so even where there may be significant benefits and no identifiable extra risks attached to using a Cyprus-based vehicle on a deal, for example, they still want to stay clear.

As for protectionism in the true sense of the word, the reality is that in Europe things are not too bad. Every country could be termed 'protectionist' in the sense that governments are playing to particular political audiences in the way that they revere their 'national champions'. But you really need to go down to the next layer – for example an outsider might find it hard to successfully conduct a hostile takeover for a national champion, or might be subjected to hostile tax treatments, and so on. But the European Union superimposes a wrapper which means these kinds of interventions can actually be challenged – so for example in the banking sector when takeovers of national banks were blocked by governments, the European Commission and the courts stepped in and successfully got them back into line. So in the European context (unlike in other parts of the world) individual countries do not have carte blanche to impose whatever restrictions they like.

Tax risks can be more complex to judge. There are real risks (increasingly these involve onerous extra-territorial reporting such as FATCA); risks that are threats on the horizon (the European FTT and the moves towards country reporting in the EU); and risks that don't involve actual payment of tax but do involve adverse publicity (Google, Amazon and Starbucks have been criticised in the UK in relation to tax in spite of apparently fully complying with tax laws). Planning for all three requires insight and judgment. As independent counsel – we don't sell tax schemes – we are well placed to assess these risks and advise on how to steer away from the shallows, and on what to do if you run aground.

When it comes to political risk, our clients are increasingly sophisticated. They insist on more preparatory work, not only due diligence but also seeking a real understanding of who the regulators are, or who the government is – they want to know as clearly as possible what they are embarking on.

With our insights around political, fiscal and reputational risks we seek to anticipate and mitigate risk – which is a very tough job – by putting in place legal strategy, procedures and compliance protocols to contain risk. We can also sometimes help through 'future-proofing', in other words we use our deep understanding to spot potential issues and find solutions to the problems. For example, a current investment opportunity might, as a result of political developments, be categorised as state aid at some point in the future, which would then trigger a substantial repayment to the government. There's a clear financial value to working around those types of issues. But of course there are other risks against which you cannot future-proof, and we can never offer a world that is risk free."

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Inmarsat's strategic goals guide M&A plans

"I wouldn't acquire a company just to add size," says Rupert Pearce, chief executive of the UK satellite operator Inmarsat. "Shareholders won't buy that any more. Rather, there has to be a clear strategic rationale." Inmarsat has bought several companies around the world in recent years as it launches new-tech satellites allowing it to offer a plethora of new communications options to customers in its three main business areas: maritime, aerospace and government. And, although M&A is not the central plank of its expansion strategy, it is actively acquiring companies for their products and their access to new markets. That means, in Mr Pearce's view, Inmarsat can be prepared to pay a good price for a firm in Europe – crisis or no crisis.

Set up by the UN in 1979, it began trading in 1982, offering a not-for-profit service to provide satellite communications to maritime users (and maritime still accounts for half of its business). Privatised in 2000 and listed on the London Stock Exchange in 2005, it has diversified into providing non-terrestrial communication services to other sectors globally, with a predictably rapid rise in emerging market revenues in recent years. Generally, its preferred option is to partner with other firms to improve its coverage, but it has also made three notable acquisitions.

In 2009 it bought Stratos Global, a Canadian-headquartered telecoms company offering remote communications services, for €467m (US$600m). Then it made two smaller acquisitions, both for less than €156m (US$200m). In 2010 it bought Segovia to increase its penetration of the US government market. Segovia provides secure communications services to the US Army and other sensitive users. And then in 2011 it bought Norway's Ship Equip, a leading provider of specialist maritime communications services.

Similar acquisitions could follow as Inmarsat exploits its new technology to increase revenues, with healthy growth in new services to its core maritime market as well as in sectors such as government. As Mr Pearce points out, ongoing pressures on government spending, especially in the US, make life tough but are also encouraging governments to outsource more, rather than launching their own expensive satellites. "Increasingly they are looking to buy the service, or outcome, rather than just the bandwidth to do these things themselves."

That said, although Inmarsat is open to acquisitions, it does not expect to do any big ones – the three significant deals mentioned are not large for a company with a turnover of around €1bn (US$1.3bn). There are no obvious acquisition targets to merit 'betting the house' on an individual deal, says Mr Pearce.

The Clifford Chance view:
Survival of the fittest drives strategic M&A

"While asset valuations are the key in the context of many M&A deals, they are of lesser importance when it comes to strategic mergers among major market players. These mergers are driven by the companies' longer term development vision and goals, or sometimes by their defence (or even survival) strategy.

Goals are likely to be: strengthening market position through strategic alliances in the context of global consolidation, taking greater advantage of economies of scale, or completing vertical integration in order to increase market power. The Swiss food giant Nestlé recently purchased Pfizer's infant nutrition business, the largest-ever acquisition by Nestlé – in that case analysts commented that Nestlé was willing to pay a high premium for strategic reasons, to gain increased access to emerging markets. We have also seen key strategic deals in the mining sector – Glencore's long-awaited merger with Xstrata, to form one of the world's largest mining and commodities trading companies, being a good example from 2012.

In the current difficult environment, the strategic rationale is increasingly likely to be fundamentally defensive, as companies are effectively 'pressured' into merging to maintain their competitive advantage. An example of this is the renewable energy industry, which is facing huge challenges currently, including cost pressure and regulatory constraints. These pressures are likely to result in more alliances in that sector."

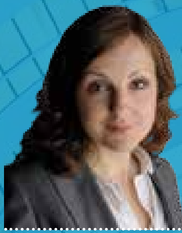

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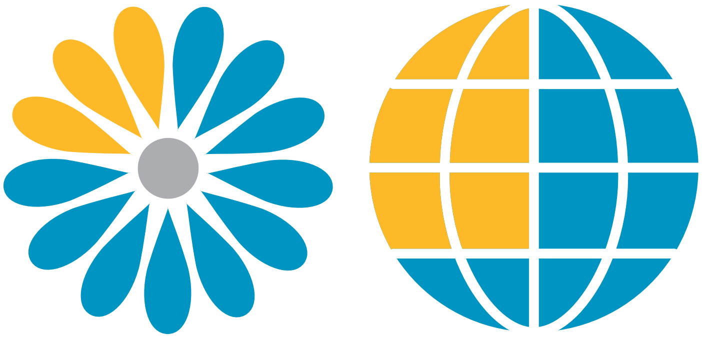
Figure 6: What is your current growth strategy?



- Focus mostly on organic growth 76%
- Focus mostly on growth through M&A 24%
- Focus on pushing for growth in established markets 62%
- Focus on pushing for growth in new markets 38%

Source: The Economist Intelligence Unit

More than three-fifths (62%) of respondents say that they do not see their companies making acquisitions before 2014 (with only 13% overall expecting to be in a position to make an acquisition in 2013). Just over one-quarter (28%) say that they are unlikely to sell anything until 2016, at the earliest.

The macroeconomic backdrop, recent trends in deal flow and the insights into business confidence from the Economist Intelligence Unit survey all indicate that the M&A market is still a long way from being in rude health. But the situation is more complex than it first appears. Though often seen as a single entity, Europe is far from homogeneous. The political and macroeconomic situation varies from country to country, as do the challenges and opportunities for investors. The acquirer who looks through the general gloom and considers Europe more closely can deploy cash effectively with well-timed M&A deals.

3

What lies ahead

If anecdotal evidence is any indication, then an upturn in Europe's M&A could be approaching, although a return to pre-crisis peaks any time soon is unlikely. Société Générale's Thierry d'Argent says that he is seeing more deals in the €1bn–1.5bn (US$1.3bn–1.9bn) range. He affirms the safety-first policy that most companies seem to be following, but says that more small to mid-sized deals are being put on the table.

"Some of them are not happening, and they are taking a very long time to close as companies take time to consider the various ways the crisis could play out, but there are enough deals around to suggest that the appetite is there again", says Mr d'Argent.

Europe's share of the global M&A market crumbled from over 40% by value in 2007, before the global financial crisis, to less than one-third (31%) in 2012[4]. This highlights how serious the impact of the euro zone troubles has been on M&A activity, even within the context of a subdued world market in general. Nonetheless, survey respondents still see the continent as one of the two most important markets in the world for growth and M&A opportunities, the other being Asia Pacific. What the research for this report makes clear is that the recent uncertainties and troubles in Europe have not dimmed the continent's allure as an M&A market; they have only put it on hold.

There's life yet in the 'old continent'

Over two-fifths (42%) of respondents see growth and acquisition opportunities within Europe, with a remarkably low proportion (5%) saying that Europe is a fundamentally unattractive M&A market. This view is held more strongly by European (75%) and North American (42%) executives than by those based elsewhere: only one-fifth of executives in Latin America view Europe as offering attractive M&A or growth opportunities, and just 6% for South-east Asia. The contrast with the view from Europe could not be starker: more than 70% of executives from Germany, Italy and Spain see attractive growth and M&A opportunities on their own continent.

Of all the regions in the world, only the more buoyant economies of the Asia Pacific region are seen by senior executives in the survey as offering better growth and M&A prospects, with Europe well ahead of both North and Latin America and the relatively fast-growing markets of the Middle East and Africa.

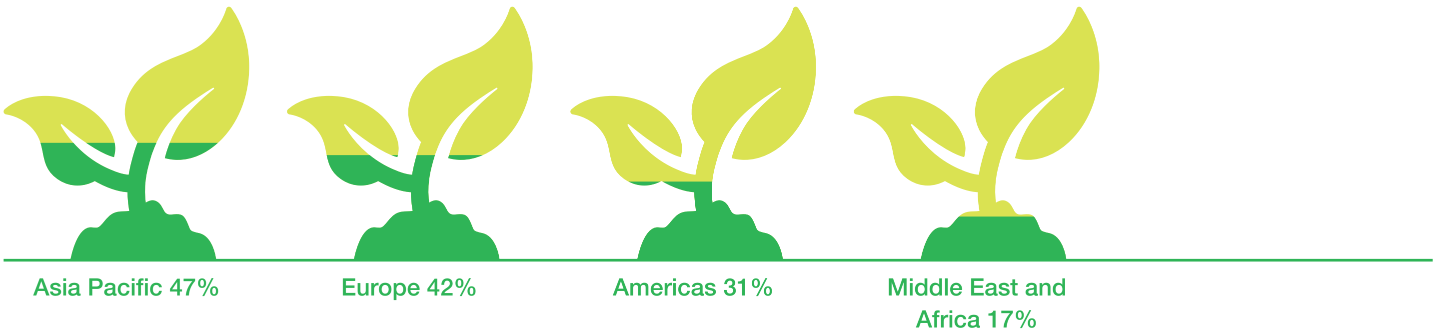
The Clifford Chance view:

"Europe remains, despite the uncertainties, a key market for anybody wanting to be on the global stage, and a key role for us is to help our clients plan and strategise around M&A opportunities there. Our expertise and ability to analyse, not only the legal issues, but also the full implications of transactions – whether that's antitrust or political issues, or moral and reputational ones, such as the current media and political spotlight on 'fair tax rates' in Europe – is where we bring our key insights and value to our clients."

Matthew Layton, Global Head of Corporate

4 Mergermarket data 2013.

Figure 7: Which regions offer the best growth and M&A prospects for your company currently?



Source: The Economist Intelligence Unit

Europe's continuing importance in the world of M&A is borne out by the fact that the nascent multinationals based in emerging markets are increasingly sizing up opportunities across the continent. TOTVS, a Brazilian software company, admits that the economic instability and uncertainty in Europe make it unlikely that it will expand into the continent any time soon, but adds that it will look at entering Europe within the next five years. For now, TOTVS is servicing Europe out of Brazil after shutting down its small Portuguese subsidiary in 2012 as part of a global cost-cutting drive.

Meanwhile, automobile companies from China have bought European brands including MG Rover and Volvo in recent years and are now ramping up their European operations. As significantly, General Motors, the US auto behemoth, has so far refused to sell its Adam Opel subsidiary in Germany, despite the bankruptcy of the parent company and mounting losses in Europe. Europe is not just a big market but an important source of research and product development, it argues.

The sheer size and importance of European markets does rather suggest that M&A activity will pick up at some point. The big question is when. There are cautious signs that it is starting to happen. "The numbers suggest the potential for a significant pick-up of announced deals in the second half of 2013," says Philip Whitchelo, the vice-president of strategy and product marketing at Intralinks, a provider of technology platforms that support collaboration and secure content management between firms. According to Intralinks, which also tracks early-stage M&A deals (sell-side M&A mandates and deals reaching due diligence), the number of such deals rose globally by 11% year on year in the first quarter of 2013, which should feed into a higher number of announced deals in the second half of 2013. However, Mr d'Argent points out that in reality these deals face far more risk of failure or delay than those in, say, North America, with companies in no hurry to sign and willing to pull out if there is another euro zone sovereign crisis of the sort seen recently in Greece and Cyprus. "But the appetite is there again," he says.

Finding the bright spots in Europe

The Economist Intelligence Unit survey shows executives do not tar all of Europe with the same brush: they recognise that the challenges and opportunities can vary by country or sub-region.

Respondents report a clear preference for deals in the bigger and more stable economies of western Europe (especially Germany) and the UK over countries in southern, central or eastern Europe (see Figure 8).

Figure 8: If your company were to consider doing an M&A deal in Europe in the next two years, which regions would it be interested in?

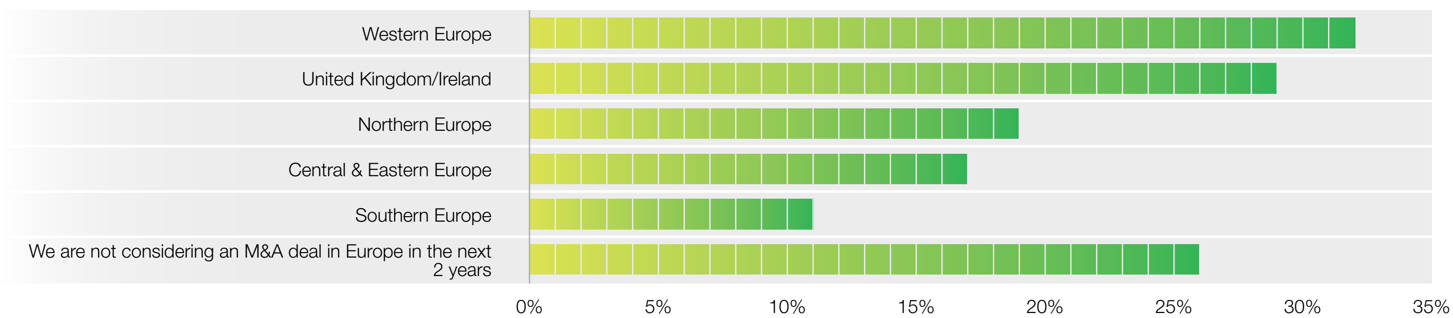
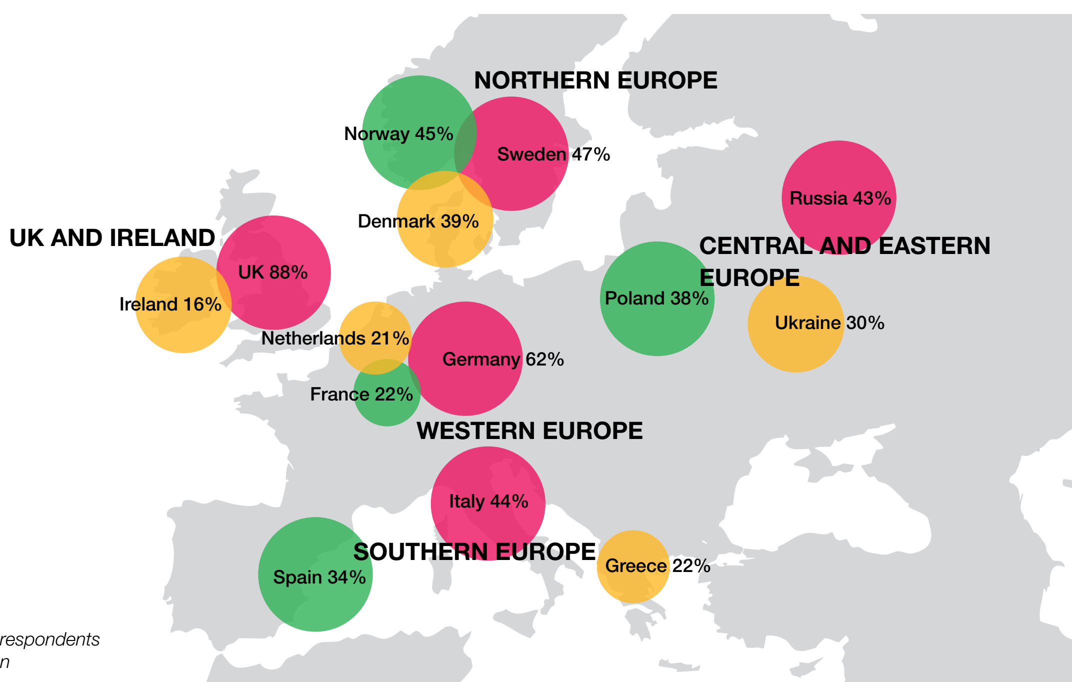


Figure 9: Within these European regions, which countries offer the most attractive opportunities?



Note: percentages exceed 100% because respondents could pick multiple countries for each region

Source: The Economist Intelligence Unit

The Clifford Chance view:
Any generalisation about Europe will fail

"Europe is diverse in terms of wealth, culture, opportunity and growth, as well as the strengths and weaknesses of its economies.

Europe comprises 50 countries of which 27 are members of the European Union. Of these, 17 have the euro as a currency. It hosts three of the world's richest countries with more than US$100,000 GDP per capita (Monaco, Liechtenstein and Luxembourg), and some of the world's poorest, down to less than US$2,000 GDP per capita (Moldavia). Switzerland and Bosnia are comparable in size and less than 500 miles apart, yet the Swiss are almost 20 times richer than the Bosnians.

Quite naturally though, even sophisticated observers generalise and group together clusters of countries. The survey demonstrates a hesitancy regarding the opportunities and prospects in central and eastern Europe, as well as southern Europe. On the other hand, the survey also shows a surprisingly strong endorsement of Scandinavia.

When looking at the 'most attractive' countries for M&A, Denmark, Norway and Sweden, which are all outside the euro zone, all feature in the top five, whilst Finland – a country that is in the euro zone and arguably comparable in size and strength – does not even feature in the top ten. This result suggests that Scandinavia is labelled as attractive simply because most of its countries are outside the euro zone. The notion that economies within the euro zone are 'voted down' by outside investors when compared to comparable non-euro zone destinations, corresponds to the insights we gather through conversations with our clients.

We see this as a vote against the perceived uncertainty overshadowing the euro zone, rather than a vote against the euro itself. When asked whether certain hypothetical political or economic events would impact their appetite for M&A in Europe, some respondents indicate that these events would actually increase their appetite for M&A in Europe. This is apparently the case whether the event is negative or positive, such as a break-up of the euro zone, the UK leaving the European Union, another banking crisis, the outcome of the German elections, the further expansion of the euro zone, or improved fiscal and economic union in Europe. This may in part be because even negative events may ultimately reduce uncertainty. This underpins the view that the investor community is not fixated on one or other outcome of any ongoing political or economic policy debate or position; rather, it is uncertainty that they fear.

However, there is also evidence from the survey that within the euro zone investors are able to differentiate and target opportunities that offer brands and technology, even if located in areas where appetite is weakened by the uncertainty, such as southern Europe. Italy, for example, has been targeted in recent times for its brands and manufacturing know-how, notwithstanding the turmoil – with notable transactions such as the €3.3bn acquisition of Avio by General Electric, the acquisition of Ducati by Audi-VW and the acquisition of Valentino Fashion Group by Mayhoola."

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Most attractive European countries for M&A

1	UK
2	Germany
3	Sweden
4	Norway
5	Denmark
6 =	France
6 =	Russia
8	Netherlands
9	Poland
10 =	Italy
10 =	Luxembourg
10 =	Switzerland
10 =	Ukraine

Source: The Economist Intelligence Unit

Still, within southern, central and eastern Europe there are bright spots of interest. Just under one-third (30%) of Spanish and Italian respondents say that they intend to acquire businesses in southern Europe over the next two years – compared to 11% on average. And of respondents who are interested in central and eastern Europe, Russia and Poland are seen as the countries likely to offer the most attractive opportunities.

In 2012 North American firms were responsible for 68% of inbound M&A into Europe by value, with Eaton Corporation's €9.3bn (US$11.9bn) acquisition of Cooper Industries being Europe's largest inbound deal of the year[5]. But some new sources of investment in European M&A have also moved into view, such as sovereign wealth funds. The Qatar Investment Authority, for example, has made some high-profile acquisitions lately, including buying Valentino Fashion Group in Italy, the iconic football club Paris Saint-Germain and the department store Printemps, also in France. The Qataris have also committed to up to €1bn (US$1.3bn) in Italian investment over the next five years, as part of a joint venture with Fondo Strategico Italiano, a sovereign fund.

Chinese state-owned enterprises are also increasingly making an appearance in the European M&A market. In 2012 Chinese companies were more active in Europe than Europeans were in China[6]. Recent deals include China Investment Corporation's minority investment in London's Heathrow airport and France's GDF Suez. As well as acquiring European industrial and manufacturing companies, Chinese firms have also snapped up venerable European luxury brands such as Britain's Aquascutum (bought by YGM) and Italy's Cerruti (now controlled by Trinity Limited) and Ferretti Yachts (acquired by Weichai). Europe has a unique portfolio of luxury brands, attracting buyers from other big emerging markets such as India (the Indian steel magnate Lakshmi Mittal's family has bought Germany's Escada) and Hong Kong (France's Sonia Rykiel forms a part of Fung Brands).

What these deals highlight is that overseas buyers are keeping a keen eye out for high-quality European businesses coming onto the market.

The Clifford Chance view:

"The M&A market across central and eastern Europe remains variable, with some sectors and countries proving more attractive than others. For example, there is continued interest in the TMT sector in Poland, and in healthcare throughout the region, while there are concerns about countries such as Hungary."

Agnieszka Janicka, M&A Partner, Warsaw

The Clifford Chance view:

"Although it is difficult to do deals in a climate of uncertainty, there are definitely opportunities, but they tend to be in niche sectors and buyers are being very value-conscious. Financial services, energy, infrastructure and real estate are key sectors where increased activity is likely."

Kathy Honeywood, M&A Partner, London

5 Mergermarket data 2013

6 Mergermarket data 2013

How Europe looks from afar

It is clear from the Economist Intelligence Unit survey that non-European companies remain wary of doing M&A in Europe currently as macroeconomic and geopolitical conditions continue to create uncertainty. But they are also excited at the prospect of being able to buy blue-chip brands and world-class expertise at attractive prices. Good examples of firms who have their eyes open for opportunities that may arise are two emerging market firms interviewed for this report: South Korea's Hanwha, a diversified conglomerate, and the Brazilian software firm TOTVS.

At present, the primary focus for these two companies is on expansion into nearby, fast-growing markets as they try to increase international revenues. For Hanwha, that means expanding its life assurance operations in South east Asian countries such as Vietnam, and it is actively looking for acquisition targets in this, its biggest business area. TOTVS still books 95% of its sales within Brazil but wants to double its international presence over the next few years, largely through expansion in Latin American countries such as Mexico.

Such a strategy is to be expected, but for all the concentration on local markets there are signs that both of these firms could expand in Europe over the next few years. Last year, Hanwha bought Q-Cells, a respected but financially troubled German solar panel maker, to complement production from a plant owned by its solar power division in China. “It allowed us to avoid trade barriers against China from the US and probably the EU”, says Hanwha's head of M&A, Mr Goo Min. But it is also something of a trophy asset: “It's a symbolic brand, the Mercedes of the solar market.” Mr Min mentions not only the technology but also the team of highly skilled researchers the acquisition brought into his group. Above all, though, Q-Cells was cheap, costing €233.3m (US$300m) last autumn, compared with a valuation of €1.56bn (US$2bn) three years ago, according to Mr Min. “We're looking to make more opportunistic acquisitions in Europe.”

TOTVS has no immediate plans to buy European assets, but this may change. “We won't touch southern Europe because of the crisis,” says its chief financial officer Alexandre Dinkelman, “and more stable countries such as Germany and the UK are intensely competitive.” TOTVS does intend to expand into the Americas, however, by buying companies to penetrate the market for some of its existing specialist product areas such as health and education software. It intends to follow the same niche strategy in Europe, perhaps “in five years' time”, and on a country by country basis. The outsiders seem to agree: Europe is too big to ignore and, if you want to be a global player, sooner or later you need to be in Europe.

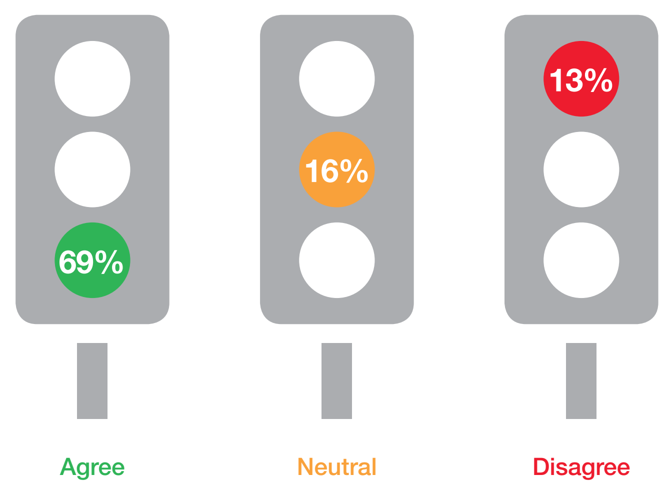
Emerging markets beckon Europe's finest

While non-European buyers are looking into the old continent, European firms see the potential of snapping up promising businesses in emerging markets. "In general we watch what is going on in countries with rapidly developing economies and the potential to become interesting markets," says Mr Tanzi of Pirelli's strategy outside of Europe. His company has recently entered a joint venture in Indonesia for motorcycle tyre production and acquired a retail chain in Latin America. Venturing outside of Europe in search of growth is already proving a popular option among European executives, with outbound M&A from Europe totalling €131bn (US$ 168bn) in 2012.

More than two-thirds (69%) of respondents say that European companies will need to do more M&A deals in fast-growing emerging markets such as India and China to remain competitive (see Figure 10), suggesting that an upturn in outbound investment is around the corner as companies increasingly look to new, fast-growth markets to compensate for European stagnation. However, today's figures remain moderate in absolute terms, with European M&A activity into countries such as China still modest by global standards. And the trend remains downwards: in the first quarter of 2013, the number of outbound deals from Europe fell by an annual 16% to just 277, with values down by 36% to €17.4bn (US$22.4bn)[7].

There is plenty of evidence to show that capital flowing out of Europe is going into fixed direct investment: from European carmakers like Volkswagen and Fiat building big new plants in countries such as Russia and China, to retail giants such as Metro in Germany extending their footprint across emerging markets. However, relatively little of this is being done through M&A or joint ventures. And some firms have conversely been pulling out of smaller, less successful emerging market countries to concentrate on a few larger or more promising markets. The preference of European firms to avoid M&A for their expansion in emerging markets is yet more proof of firms' continuing wariness of M&A as a source of value creation.

Figure 10: European companies will increasingly have to do M&A in high-growth markets to stay competitive



The Clifford Chance view:

"Consistent with the survey findings, it may take a little while for the pace of execution of transactions in Asia Pacific to match the underlying interest from European companies, although we think this is as much due to a temporary drop off in business fundamentals in the region, as it is to general reticence on the part of potential buyers."

Simon Cooke, M&A Partner, Hong Kong

7 Institute of Mergers, Acquisitions and Alliances

The Clifford Chance view:
The temptation of the high-growth markets

"Many European companies are looking towards the emerging markets for new M&A opportunities, as they look to counter the impact of the low-growth environment on their home turf.

Over half of European respondents to the survey indicate that the key focus of their growth strategy is on accessing the high-growth markets – including China, Latin America, India and South east Asia – and nearly 70% of senior executives in the survey agree that European firms will increasingly need to access such markets to stay competitive.

We are seeing considerable interest from Europeans, as well as other international players across the globe, in the key growth markets. Principal areas of focus include the many infrastructure projects and energy opportunities in Latin America, and consumer-facing industries such as retail and healthcare in China and South east Asia.

But at the same time, investors across the board are increasingly risk averse and this is borne out by our experiences in these markets. Clients are requiring more rigorous due diligence to be undertaken around financial, tax, environmental and compliance issues, and bribery and corruption are a more significant concern to buyers in emerging markets than they are in developed markets.

In addition to these business-specific risk issues, our international clients are also looking to us to help them navigate the local cultural and regulatory environment. When accessing any of the emerging, high-growth markets for the first time, there is a lot to learn in terms of the local dynamics – not least antitrust, government policies (which can mean local as well as national), and licensing and tax requirements, coupled in some countries, such as Brazil and China, with a somewhat protectionist approach to inward investment. Potential buyers need to be prepared for this. It is always important to have advisers on the ground in the region who have substantial experience in dealing with the relevant regulators, tax authorities and government bodies. It is also essential to be flexible and have respect for the local culture, language and ways of doing business in the target country. Approaches and methods generally need to be adapted to fit with local practices.

Ironically, sometimes the 'open door' to the emerging markets is located in Europe itself. Many European multinationals are selling businesses in developing economies, not because they are underperforming or distressed, but because they need to focus on their core business or raise cash to reduce debt. The emerging markets assets on sale may be attractive because of the selling price, the potential for growth in the developing economies where they are based and, crucially, the internal management and control systems they may already enjoy thanks to their existing position as part of an international group."

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Europe's enduring attractions

Among executives participating in the survey, Europe remains an attractive market thanks to its highly developed infrastructure, treasure trove of intellectual property, technological know-how and skilled talent (see Figure 11). All these qualities are reflected in the comments made by individual survey respondents, which repeatedly highlight the "highly urbanised population" and "high level of productivity" of "the world's largest combined economy". Europe's attractiveness also encompasses its highly skilled workforce and, as one US survey respondent in the industrials sector puts it, "access to leading technology". Europe's socio-political and legal framework attracts praise too, as it is stable, flexible and conducive for business, at least on a long-term basis. A US survey respondent in the retail industry makes precisely that point: "Europe has stability and transparency in terms of the political, legal and regulatory environment".

The Economist Intelligence Unit survey also makes clear the changing drivers of deal-making in Europe. In addition to buying companies for their market share or gaining access to markets with long-term growth prospects, other key drivers of today's European M&A market are securing know-how, expertise and technology, as well as eliminating intellectual property risks (see Figure 13 on page 34). A classic example of this is South Korea's Hanwha, which bought a German solar panel maker last year (see How Europe looks from afar on page 28). The German firm cost a small fraction of its value just three years ago, meaning that the South Koreans are eagerly scanning the market for more opportunistic bargains. In a similar vein, JS Group, a Japanese building material company, bought Permasteelisa, a large Italian building contractor, in August 2011; and Putzmeister, a German cement pump maker, was snapped up by Sany, a Chinese construction firm. Transactions such as these allow international buyers to gain access to world-class researchers and products, along with an international brand name that can help them achieve their expansion plans.

There is also no shortage of non-European firms seizing opportunities to buy world-class firms at discounted prices and, as Tata Motors did with its purchase of Jaguar Land Rover, buy their way into branded or high-margin markets they may otherwise struggle to penetrate. The same is true of some European multinationals, with the eyewear group Luxottica buying retail chains over the past year as an efficient way into countries such as Spain and Portugal.

Figure 11: Top 10 features that make Europe an attractive place to consider M&A

1 **Europe's highly developed infrastructure (eg, transport, energy, technology, etc)**

2 **Access to developed technological know-how**

3 **Availability of skilled talent**

4 **Europe's sociopolitical, regulatory and legal environment**

5 **Access to many global brands**

6 **Size of the European market**

7 **Ability to secure higher profit margin in Europe**

8 **High consumer spending levels in Europe**

9 **Europe's central location and ease of access to several markets**

10 **Attractive asset valuations**

Figure 12: In your own words, what makes Europe an attractive M&A destination?

The Clifford Chance view:

Market integrity supports traditional deal structures

"A strong message from our survey respondents is that the certainty, flexibility and integrity of Europe's legal and regulatory environment are key positives for prospective M&A investors.

While buyers from developed markets may take for granted a clear and stable framework in areas such as tax, labour laws and industry regulations, these factors, and a lack of corruption or major political interference, remain important attractions of Europe for those comparing investment opportunities around the globe. This view appears little affected by the increasing regulatory challenges of growing protectionism and antitrust hurdles that buyers have to navigate in some jurisdictions.

The stability and predictability of the European legal and business environment may also explain the apparent preference of our survey respondents for traditional M&A (58% of survey respondents) over JVs and partnerships (20%). Whereas investors into emerging markets may prefer to take a minority position alongside a local player in order to share risks, mitigate integration issues, build cultural capital (and in some cases to address foreign ownership restrictions), most investors in Europe feel sufficiently confident to take a controlling position from the start rather than 'test the waters' in this way.

Equally, on the sell-side in Europe, we are typically seeing full exits being preferred as sellers seek to divest non-core businesses, raise cash or effect distressed asset disposals. However, certain vendor clients are also entering into JVs and partnerships where there is a specific rationale, such as to share technology or expertise, or when it can help to bridge a pricing gap, enabling the seller to maintain a stake that they consider may increase in value."

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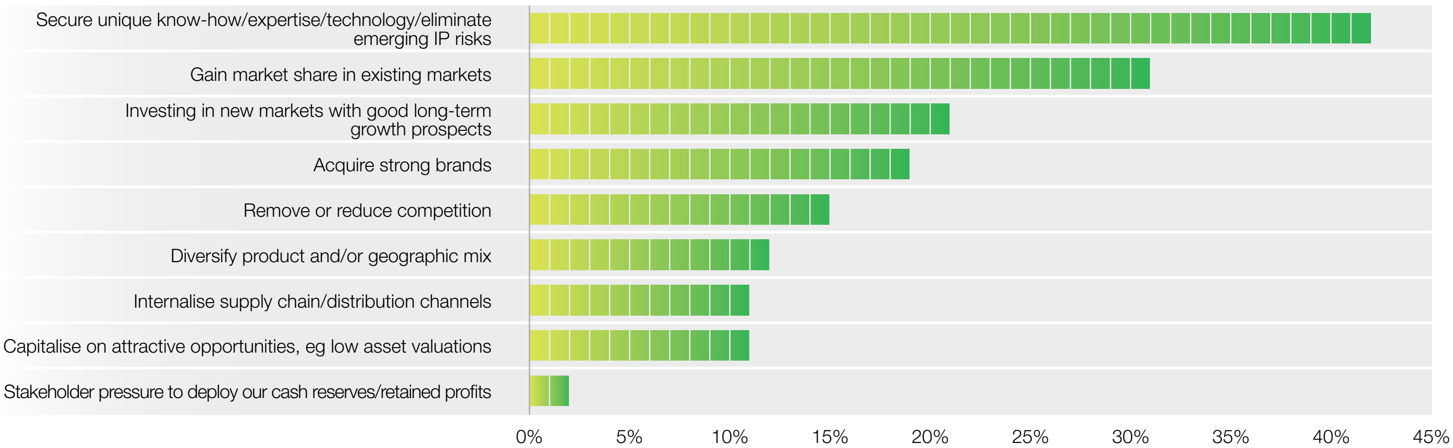
Figure 13: What are your company's main drivers for pursuing M&A opportunities in Europe?



Source: The Economist Intelligence Unit

Capitalising on the crisis?

The difficult economic environment is starting to unearth increasing numbers of distressed businesses, creating opportunities for outside investors looking to buy, or otherwise take control of, European businesses at a good price. Spain's Abengoa selling Befesa to Triton Partners is a good recent example of this.

The ability to capitalise on the financing difficulties of European players may explain another of the more remarkable findings of the Economist Intelligence Unit survey, which suggests that another flare-up in the euro zone could actually make companies more eager to embark on M&A activity. More than two-fifths (43%) of respondents say that the socioeconomic uncertainty in Europe has increased their appetite for M&A, with an extraordinary 50% saying that a break-up of the euro zone would make them more likely to pursue M&A opportunities. Even a much-feared banking crisis would increase the M&A appetite of 44% of survey respondents.

Should economic conditions in Europe worsen, the euro could slide, making European companies cheaper still to buy for American or Asian firms. As significantly, these results suggest there is less fear of the difficulties that would stem from, say, Greece being forced out of the euro area. For all the problems, the opportunities to buy into a major market cheaply would multiply.

The Clifford Chance view:

Distressed companies in Europe will increasingly create M&A opportunities for hedge funds and distressed debt specialists

"Businesses, particularly medium-sized operations, that are financially impaired – many of them carrying far too much debt having over-borrowed in good times – are to be found across all sectors and regions of Europe. Often perfectly viable businesses, their debt burden prevents them from raising new money from the credit or bond markets to invest or to expand. However, their existing lenders have hitherto been reluctant to take the steps necessary to free up these businesses from their debt burden – eg by converting some of their loans to equity. At the same time those lenders are reluctant to call it a day and push their borrowers into insolvency. Lenders are fearful about how much – or how little – they would recover on their loans if their borrowers were forced over the brink even though – ironically – such an outcome could indirectly lead to the 're-birth' of some of those businesses through a forced sale of the viable parts of those businesses to a buyer willing to invest. The resulting paralysis means that these businesses stagger on in 'zombie mode'.

We are now seeing increasing numbers of distressed targets in Europe – in particular in the shipping, real estate and infrastructure sectors and in the more distressed territories in southern Europe. Because those are fundamentally distressed environments, lenders are having to confront the reality that their loans will never be repaid – even if low interest rates mean that these businesses can still afford to service the debt in the meantime. A combination of looming loan maturities, regulator pressure on banks to provide properly for non-recoverable loans and strategic decisions by banks to exit from these sectors in order to focus on their core product lines – means that lenders will be increasingly willing to press the button to exit a particular situation – to achieve whatever value they can – and then move on.

These situations create opportunities for the existing lenders, who could, if they wished, take control of these businesses through a 'loan to own' deal, but they are usually reluctant to do so. However, this opens the door to a new breed of financial investor – one who sifts through the rubble, looking to get into and control businesses at a good price. Essentially, the investor buys the target company's debt and then uses the legal controls which that debt gives him to take ownership of the business – either through forcing a liquidation and sale of the business – on a debt-free basis – to a new vehicle or through converting that debt to become a controlling shareholding in the existing company. Either way, the investor ends up owning the business. He can then turn the business around, raise new capital and give it a fresh start, debt-free. Of course it is not without its perils, and sometimes it backfires. Until now 'loan to own' has been mostly a US phenomenon, but US hedge funds, private equity and specialist distressed debt funds are increasingly eyeing up European opportunities too."

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Luxottica: seeing opportunity in a crisis

It is unusual to find a major multinational without a sizeable presence in Europe. But one such, at least on the retail side, is Italy's Luxottica, an eyewear company that owns a series of luxury brands such as Ray-Ban and Oakley, as well as retailers and manufacturers of optical glasses and sunglasses. But it has little presence in the European retail market, which it describes as "too fragmented" to be an investment priority. At the moment it is concentrating upon expansion in fast-growing emerging markets such as India and China. But in the past year it has also bought three European firms, including two retail chains.

These acquisitions were "opportunistic", admits Luxottica's chief financial officer Enrico Cavatorta. From scratch, Luxottica was able to buy a leading position in Italy's, Spain's and Portugal's eyewear retail markets for sunglasses on the cheap, although it paid a relatively handsome amount for an upmarket French brand of glasses. "Good companies still fetch a good price," says Mr Cavatorta.

Luxottica is already the biggest wholesaler in Europe, supplying its glasses and sunglasses to often small, independent, opticians in many countries. But up to a year ago it had little presence in the European retail market outside of the UK. In November 2012 it announced the acquisition of a minority stake in an Italian retailer, paying €45m (US$57.9m) for 36% of a leading eyewear seller, the unlisted 900-store Salmoiraghi & Viganò. Luxottica bought the stake as part of a financial restructuring, and has the option of buying control from the family owner over the next few years. In August the same year, it announced that it had bought 90 Sun Planet sunglasses stores in Spain and another 30 in Portugal, making it the leading seller of sunglasses in both countries.

Mr Cavatorta points out that both the Spanish and Portuguese purchases can quickly be folded into Luxottica's existing global branding and distribution systems, making a fast return on capital realistic despite the troubled economies in both of the countries it has bought into. But he also admits that these stores were gobbled up largely because the crisis made them remarkably cheap to buy. Both were valued at approximately one year's sales, perhaps half of the cost of a similar company in China.

It is a good example of how the euro zone uncertainty is opening the door to opportunistic buying, but Luxottica also shows why European assets are attractive. In November 2012, it announced that it was paying €90m (US$115.7m) for Alain Mikli, a French luxury eyewear maker – close to two years' worth of the firm's sales and far from a low price.

Now, it is concentrating on emerging market expansion, pointing out that European and US markets are saturated whereas up to two-thirds of the people in some of these countries who need glasses do not have them. Europe is not a core part of this strategy, and the group is still not interested in trying to buy its way into the optical glasses retail market. "There is no dominant European player [to buy]," Mr Cavatorta points out, but rather a series of national chains many of which are already Luxottica wholesale customers. However, it is looking for acquisitions on the sunglasses side as the recent troubles throw up bargains.

4

Conclusion

Europe's M&A market has had a difficult few years but may be at a turning point. Deal flow remains weak, mostly as a result of the uncertainty and instability in the euro zone and the slowdown in economic growth across the world. That is also the context for the Economist Intelligence Unit survey's strong finding that M&A activity is unlikely to recover fully from the global financial crisis for some time to come.

But the research for this report also makes it clear that businesses across the world realise that many of Europe's advantages as an M&A market are timeless: from the strength of its infrastructure and legal systems to the quality of its brands and workforce. The risks inherent in Europe today are also opening up sizeable opportunities for investors willing to bet on bold and shrewd decisions. In the short term, deal flow will continue to be characterised by bolt-on acquisitions, non-core asset sales and bargain hunting, a natural consequence of doing business in volatile times. But evidence is mounting that buyers are re-focusing on Europe, sizing up attractive opportunities on the continent, and willing to open their wallets if they see value for money in a deal. A combination of weak demand at home and attractive opportunities in new markets is also pushing European companies to expand further afield in order to enable growth.

The more vexed question is whether the European M&A market will recover from its long, and deep, slump to account for over 40% of the global market as it did before the financial crisis. The views of business leaders interviewed for this report suggest that the big chill is starting to ease, tentatively supported by increased bank lending and rebounding capital markets, and that an upturn in activity levels may be on the cards.

There is no doubt that a significant and sustained pick-up remains hostage to economic and political factors in the euro zone and beyond – but when the long shadows across Europe finally clear, the continent could fight back to regain its place at the centre of the M&A universe.

The Clifford Chance view:

"No one is expecting significant economic growth across Europe in the short term and this is inevitably affecting the general attractiveness of the continent as an M&A destination. But for those willing to look beneath the surface, a purchase of the right business in the right sector at the right price could prove wise over time. Our clients with a longer term perspective are increasingly seeking out opportunities to acquire (in particular) technology, skills, brands and other assets which may have the potential to be leveraged beyond Europe. Those investors are invariably cautious and value-conscious, but may still spot available targets which in practice bring little more risk than a foray into higher-growth, but less understood, emerging markets."

Guy Norman, M&A Partner, London/Dubai

Findings from the survey

Top 10 features attracting M&A in Europe

1	Europe's highly developed infrastructure (eg, transport, energy, technology, etc)
2	Access to developed technological know-how
3	Availability of skilled talent
4	Europe's sociopolitical, regulatory and legal environment
5	Access to many global brands
6	Size of the European market
7	Ability to secure higher profit margin in Europe
8	High consumer spending levels in Europe
9	Europe's central location and ease of access to several markets
10	Attractive asset valuations

Top 10 risks to executing European M&A strategy

1	Rising costs (eg, labour, tax rates)
2	Currency fluctuation risk
3	Reputational risk
4	Protectionism
5	Increased competition for the same assets
6	Geopolitical risk
7	Intervention by antitrust regulators
8	Restrictive or challenging regulatory environment
9	Shareholders' disapproval
10	Cultural incompatibility / difficulty of integration

Top 5 drivers for European M&A

1	Secure unique know-how/expertise/technology/ eliminate emerging IP risks
2	Gain market share in existing markets
3	Investing in new markets with good long-term growth prospects
4	Acquire strong brands
5	Remove or reduce competition

Top 5 drivers for M&A outside Europe

1	Investing in new markets with good long-term growth prospects
2	Gain market share in existing markets
3	Diversify product and/or geographic mix
4	Secure unique know-how/expertise/technology/ eliminate emerging IP risks
5	Acquire strong brands

Top 10 key competitors for buying European assets

1	Large European companies
2	US companies
3	Small or medium-sized European companies
4	Chinese companies
5	Private equity firms
6	Emerging market companies (excl. BRIC)
7	Canadian companies
8	Sovereign wealth funds
9	Japanese companies
10	Indian companies

Top 10 most likely sellers of European assets

1	Small or medium-sized European companies
2	Large European companies
3	Emerging market companies (excl. BRIC)
4	US companies
5	Private equity firms
6	Chinese companies
7	Brazilian companies
8	Australasian companies
9	Canadian companies
10=	Indian companies
10=	Sovereign wealth funds

Top 10 risks to M&A strategy outside Europe

1	Currency fluctuation risk
2	Rising costs (eg, labour, tax rates)
3	Geopolitical risk
4	Restrictive or challenging regulatory environment
5=	Reputational risk
5=	Increased competition for the same assets
7	Protectionism
8	Intervention by antitrust regulators
9	Cultural incompatibility / difficulty of integration
10	Shareholders' disapproval

About this report

This report is published by Clifford Chance LLP and written by the Economist Intelligence Unit, with the exception of the foreword, the Clifford Chance perspectives and those quotes which are attributed to Clifford Chance. The views expressed by the Economist Intelligence Unit do not necessarily reflect those of Clifford Chance LLP.

About the research

The Economist Intelligence Unit surveyed 370 companies that have executed, or are planning to execute, a cross-border M&A deal, from across a wide range of industries and regions. All individual respondents are familiar with their company's M&A strategy. About two-fifths (39%) are based in Europe, one-third are from the Asia-Pacific region, nearly one-fifth (16%) are from the US and the remainder are based in the Middle East, Africa and Latin America. Just over one-half (53%) of companies represented in the survey have annual revenue in excess of US$1bn, and the remainder have annual revenue between US$500m and US$1bn.

To supplement the survey, the Economist Intelligence Unit conducted a series of in-depth interviews with senior business executives and other experts including:

- Thierry d'Argent, global head of corporate finance, Société Générale
- Enrico Cavatorta, chief financial officer and group general manager, Luxottica
- Alexandre Dinkelman, chief financial officer, TOTVS
- Robert Kindler, global head of M&A, Morgan Stanley
- Professor Christopher Kummer, president, Institute of Mergers, Acquisitions and Alliances, Vienna, and professor at Webster University, Vienna
- Goo Min, head of M&A, Hanwha
- Scott Moeller, director, M&A Research Centre, Cass Business School, London
- Rupert Pearce, chief executive officer, Inmarsat
- Francesco Tanzi, chief financial officer, Pirelli
- Philip Whitchelo, vice-president of strategy and product marketing, Intralinks

We are grateful to all interviewees and survey participants for their valuable time and insights. The Economist Intelligence Unit would also like to thank the Clifford Chance global M&A team for their insights.

All currency values in the report are calculated using the applicable Economist Intelligence Unit annual average exchange rate for 2012.

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