Impact of the UK Takeover Code Reform – One Year On

Autumn 2012

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Impact of the UK Code Reform – One Year On

A year after the overhaul of the UK takeover regime, we have looked at UK public M&A activity to assess whether the Panel's objectives have been met and to see if the deal landscape has altered.

The Panel's key objective was to reduce the tactical advantage obtained by bidders and redress the balance in favour of target companies. There was also a desire to increase confidentiality surrounding bids and thereby protect against protracted virtual bid periods.

There were, however, significant concerns at the time the new rules were introduced that the new requirement to identify potential bidders early in the process, together with the ban on break fees, might adversely impact the attractiveness of the UK market, particularly for overseas bidders or private equity bidders. Advisers were also conscious that the fixed 28 day PUSU period might prove too short and inflexible to enable complex bids, particularly hostile bids, to stand a chance of succeeding.

"The public M&A market in the UK remains subdued in the wake of the continued financial crisis, although as a firm we have been involved in a number of high profile mandates, including SS&C's successful bid for GlobeOp, Motorola Solutions' offer for Psion and Shell's battle for Cove Energy."

Steven Fox, public M&A partner

Key Takeaways

* Deals of £100m +
**The FSA reported the lowest levels of trading ahead of takeovers in nearly a decade – Source: FSA Annual Report 2011/12 http://www.fsa.gov.uk/pubs/annual/ar11-12/section3.pdf

Takeover Code Reform – reminder of the key changes

Before we consider the market data, here is a brief refresher on the Panel's objectives and key Code changes relating to those objectives:

Panel's objective	Summary of New Code Provisions
Increase protection for targets against protracted "virtual bid" periods	■ Target to identify all known potential bidders in announcement commencing offer period ■ Potential bidders to clarify their position within 28 days of identification (unless period extended by target) - automatic 28 day "put up or shut up" period (PUSU)
Strengthen target's position	■ General prohibition on target agreeing deal protection measures including break fees and inducement fees (except following formal sale process or in favour of white knight after hostile firm intention announcement) ■ Ban on the use of implementation agreements
Increase transparency and improve the quality of disclosure	■ Disclosure in relation to offer-related advisory fees and expenses (including those incurred in bid financing) ■ Increased disclosure of bid financing arrangements, bidder's plans for target and other financial information in offer documentation

"Whilst the new rules have settled down quite quickly, principals and advisers have certainly experienced frustration in certain areas. Hopefully the Panel's review of the rule changes later this year will be an opportunity to reflect on some of these concerns."

Lee Coney, public M&A partner

The Panel's perspective:

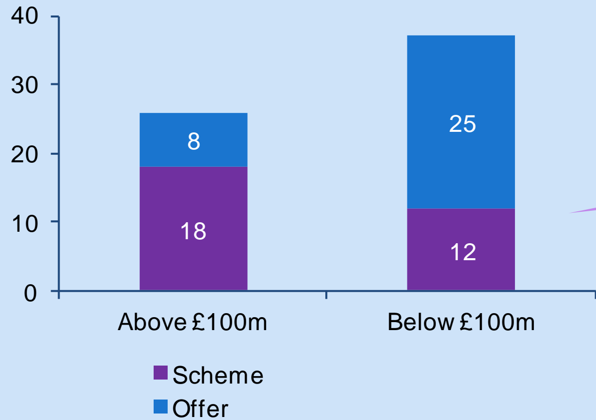
"I am pleased that early indications are that these changes are meeting their principal aims of reducing the tactical advantage obtained by offerors and redressing the balance in favour of offeree companies.

At the same time the concerns of some critics, to the effect that the UK would become a difficult place in which to execute takeover offers and that many bidders would be deterred, do not seem to have been borne out."

Sir Gordon Langley, Chairman of Takeover Panel
(extract from statement in 2012 Panel Annual Report)

Deal Landscape – trends for £100m+ deals

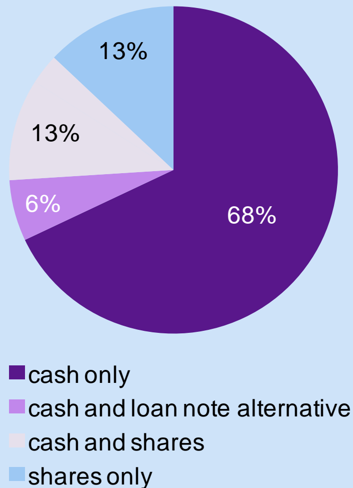
Schemes dominate on high value deals….



"Schemes of arrangement remain the structure of choice on large deals, despite the fact that implementation agreements are no longer permitted because of the stamp duty savings and guaranteed 100% ownership on the scheme becoming effective."

David Pudge, public M&A partner

Cash is king….



Whilst deal activity remains subdued relative to pre-financial crisis levels, the value of larger deals has increased to £24bn (from £21bn)*

26 Rule 2.7 "firm intention" announcements (down from 33 in the previous year)*

Five target companies were subject to competitive bids (on a par with the previous year)*

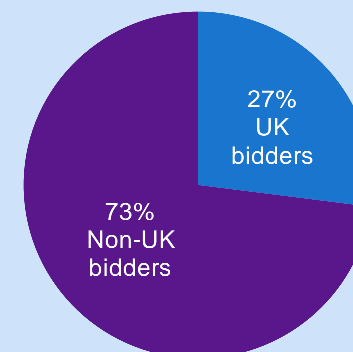
46% of deals kicked off with a leak announcement compared to 45% in the previous year*

**The data is based on higher value deals (£100m+) and the comparative statistics are for the year to 18 September 2012 and the preceding year to 18 September 2011*

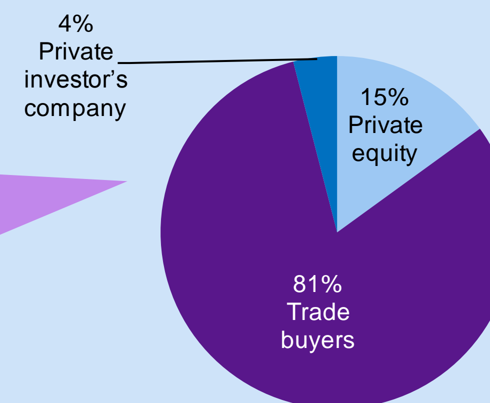
Recommended or Hostile? – All deals

- **91%** of firm offers (58 out of a total of 64 firm offers) were recommended at announcement
- **Four offers were hostile** throughout the offer period
- Four offers were initially recommended at the time of the Rule 2.7 firm intention announcement, however, **the recommendation was later withdrawn following a higher competing offer**
- **On one offer the target board sat on the fence** providing considerations for acceptance or rejection of the offer (*Acorn Global Investments offer for Dhir India Investments, December 2011*)
- **Most recommended bids went through**
- One recommended bid structured as a scheme was **voted down by shareholders** (*Ontario Teachers' Pension Plan offer for Goal Soccer, August 2012*)
- Glencore/Xstrata is another deal to note – there were clear indications that if the originally proposed deal had progressed to a vote, it would have been blocked by Xstrata shareholders

Inbound investment accounted for 73% of higher value bids*…



Trade buyers accounted for 80% of higher value bids*…



"It is too early to decide whether private equity houses have been put off P2Ps. The low number of deals and interest in possible public deals are more a factor of the market generally than an indication that PE houses are no longer interested in participating. The disclosure of financing terms, especially market flex, remains a particular concern."

Jonny Myers, Corporate partner in our private equity practice

Formal sales – our insights

The new process for companies putting themselves up for sale has been popular. Of the 101 target companies which entered an offer period in the past year, nearly 20% used the formal sale process. However, to date, only two formal sales have actually resulted in successful deals.

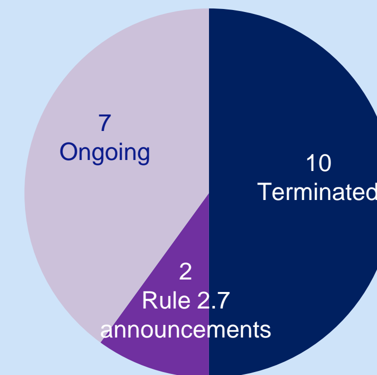
Insights into formal sale process

Using the formal sale process potentially opens the door for a number of dispensations not available on other Code transactions. All companies have sought the dispensations allowing anonymity for potential bidders and no imposition of PUSU deadlines.

Whilst others have sought the dispensation from the break fee prohibition, only one target company (*Cove Energy*) was successful in doing so (see pg 9). Only one company (*Lochard Energy*) has stated in its formal sale announcement that it intends to seek the break fee dispensation. Our experience is that the Panel is reluctant to allow targets to agree break fees; the Panel requires strong assurances that the highest price has been flushed out.

Once a company has initiated a formal sale process, this does not ensure bidder anonymity indefinitely – if the potential bidder's identity is leaked or there is rumour and speculation, the Panel is likely to require an announcement confirming that person's interest in the company. An example of this arose in relation to Cove Energy's formal sale process, where ONGC Videsh was required to confirm that it, together with GAIL (India), was participating in the formal sale process.

Formal sale processes – what has happened?



- Over 40% of formal sale targets could be said to be in financial difficulty , of which 6 have terminated the process and 2 are ongoing

Reminder of dispensations

Provisions / restrictions	Dispensation available?
Naming of bidder in target announcement	✓
Automatic PUSU	✓
Break fee (not work fee)	✓ (for one bidder that has participated in process)
Other offer-related arrangements	✓ (in exceptional circumstances)

Case study - Shell's bid for Cove Energy

Clifford Chance advised Shell on its high profile competitive bid for Cove, a company which put itself up for sale via the new formal sale process. Due to the size and nature of the deal, in some ways it was seen as the first real test of the formal sale regime

"A competitive bid always puts the Code rules into sharp focus and this deal was no exception. We had to navigate the "new" formal sale process. Our client, Shell, was able to procure the first break fee since the new rules came in which was a small consolation in light of PTTEP's successful higher offer."

Tim Lewis, public M&A partner

January 2012

Cove puts itself up for sale – Cove Energy plc, the AIM listed upstream oil and gas company, put itself up for sale via the formal sale process under the Takeover Code. Cove successfully obtained dispensations such that any participant in the formal sale process was not required to be publicly identified and was not subject to the 28 day PUSU.

An even playing field – The participants in the process were required to sign NDAs containing standstill provisions, designed to ensure an even playing field. In addition to share dealing restrictions, bidders were prevented from unilaterally contacting local governments where Cove had interests, including Mozambique. As the approval of the Mozambique government was required, early support of the Cove board was essential.

February 2012

Pre-conditional offer – Following intensive discussions with Cove, Shell announced a pre-conditional possible offer of 195 pence in cash for each Cove share. The making of a firm intention announcement was conditional upon the approval of the Mozambique government. The Board of Cove noted that it would expect to recommend Shell's offer at that price and that it would progress matters with Shell to the point where such an offer could be made.

Publicly competitive situation – Only two days later, the process became publicly competitive. PTT Exploration and Production Public Company Limited, Thailand's national oil company, announced a pre-conditional possible offer of 220 pence in cash for each share (a premium of 12.8% to Cove's bid). Cove subsequently announced that it was reviewing its recommendation and that the formal sale process was continuing.

April 2012

Engagement with Mozambique government – Cove engaged with the Mozambique government regarding the deal. In April, Cove announced that the government would be imposing a tax charge of 12.5% on the deal.

Firm intention announcement and break fee – After discussions with the Mozambique government, Shell announced a recommended firm intention to make an offer for Cove at 220 pence per share. Such announcement confirmed that the Panel had granted a dispensation from Rule 20.1 allowing Cove to agree a 1% break fee, the first and only of its kind to date. Shortly thereafter, governmental approval of Shell's bid was received.

May 2012

PTTEP follow suit – On the first closing date of Shell's bid, PTTEP decided to re-engage and up its offer. It announced a recommended cash offer of 240 pence and confirmed that it had also received the Mozambique government's approval.

July 2012

Resolution of competitive situation – As the Takeover Code timetable progressed, it became apparent that a competitive situation was likely to remain on Day 46 and hence it would be necessary for a resolution process to be established. As the bid parties were unable to agree a process, the Panel ruled in July that an auction should be conducted publicly. The rules of the auction permitted each bidder to announce to the market one revised bid per day, such bid being revised by a fixed amount in whole pence (i.e. no minimum increment bids or by reference to a formula, features which had been seen in other public auction procedures).

Shell decides to walk away – A few hours before the auction process was due to start, Shell announced that it would not be increasing its offer nor would it be participating in the public auction. With PTTEP's higher offer remaining on the table, it was only a matter of time before PTTEP was able to declare its offer unconditional as to acceptances, which it did on 31 July 2012.

Deal protections – the headlines

> "The Panel has been very keen to police offer-related arrangements. It has been carefully reviewing co-operation agreements and directors' irrevocables over the last year to ensure that they do not stray over the line of what is permitted by the Code. Bidders and their advisers have clearly been pushing the boundaries of what is acceptable. There has been a noticeable shift in the balance of undertakings being given by targets and bidders respectively, creating a new range of market practice (which I wouldn't say has yet coalesced into a "market standard"). This is a key area where the Panel has been successful in its aims of strengthening the position of target companies."
>
> Patrick Sarch, public M&A partner

Strict application by Takeover Panel of ban on offer-related arrangements

As expected, the Takeover Panel has strictly applied the prohibition on break fees and offer-related arrangements contained in Rule 21.2, other than those types of offer-related arrangements specifically permitted by Rule 21.2(b) (see below). In the one case where a break fee was agreed (*Shell's bid for Cove*), the Panel was initially reluctant to allow Cove to agree a break fee even though Cove had put itself into a formal sale process.

The Panel took a pragmatic approach in the context of Myriad's offer for Synchronica, allowing Synchronica to enter into a security package comprising a fixed and floating charge over its assets to secure a short term loan agreement provided by Myriad to fund Synchronica's payroll costs.

The Panel previously indicated that where a company was in such serious financial distress that the board was actively seeking an offer to be made for it, the Panel might grant a dispensation allowing it to enter into a break fee or work fee. We are not, however, aware of the Panel having granted any such dispensation.

The rise of the co-operation agreement

With implementation agreements banned from September 2011, co-operation agreements (or bid conduct agreements) have become a regular feature in takeovers.

Co-operation agreements were entered into in about half of all deals in excess of £100m. These agreements have generally become the home for one or more of the offer-related arrangements specifically permitted by Rule 21.2(b) such as:

a) non-solicitation of employees, customers and suppliers;

b) commitments to provide assistance for the purpose of obtaining regulatory or governmental consents; and

c) agreements relating to any existing employee incentive scheme(s).

Our experience is that these agreements are vetted by the Panel to ensure that no prohibited offer-related arrangements have been included.

Stakebuilding

With most traditional deal protection measures on the banned list, stakebuilding and gathering shareholder commitments are the main tools available to bidders and targets.

We have seen increased focus by bidders on exploring the benefits and assessing the risks of purchasing target shares during the course of a bid, and several instances of bidders agreeing a series of measures with one or more major shareholders (for example purchasing part of a shareholder's stake at the offer price upon announcement, and securing an irrevocable commitment to accept the offer in respect of the rest of their holding). This package effectively provides the shareholder with an upfront "sweetener" (in terms of a certain partial cash exit) as an encouragement to give the irrevocable undertaking.

Even though there is more consideration of share buying since the Code changes, often it does not progress to an actual market operation. This appears to be due to the complex web of legal and commercial challenges which stakebuilding presents.

Irrevocable undertakings – their evolution and importance

In the absence of offer-related undertakings from target companies, irrevocable undertakings from shareholders remain a vital tool for bidders, as they are one of the few remaining ways of reducing execution risk.

Directors' (mostly) hard irrevocable undertakings featured in nearly 80% of the deals announced post-September 2011 whilst a mixture of semi-hard and soft irrevocable undertakings were given by investors in nearly 70% of those deals.

Although bidders are keen to secure hard irrevocable undertakings from institutional investors, institutional investors remain reluctant to provide these other than in exceptional cases.

In addition, we have seen somewhat of an evolution in the features of such undertakings. Matching rights as well as non-solicitation undertakings have become more prevalent. More unusually, we have seen directors and a shareholder undertake to pay an amount equal to the loss the bidder suffers if they divest, or accept a third party offer, in relation to their shares (*Dentsu's bid for Aegis Group, July 2012*).

Virtual bids – the statistics

57 bidders have been subject to the fixed 28 day "put up or shut up" deadline

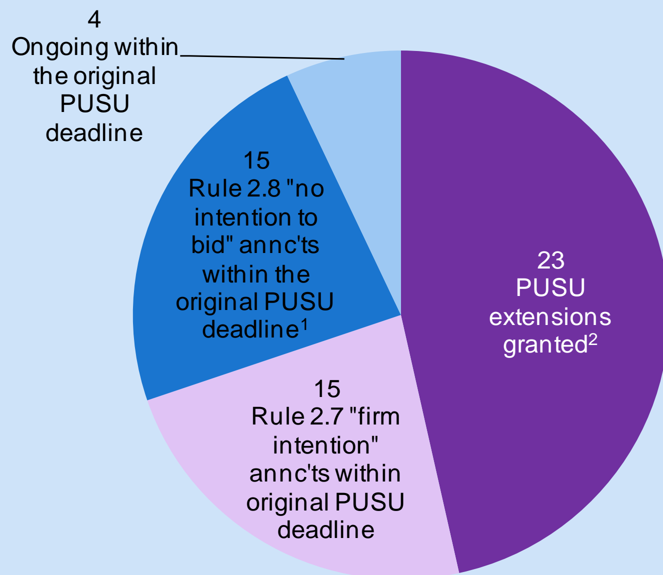
Average virtual bid period = 38 days

The private "down tools" regime, formalised in the Code changes, has been invoked by potential bidders wishing to walk away from a target without being named. This regime does not, however, guarantee anonymity if there is continued rumour and speculation – earlier this year Emerson Electric privately downed tools in relation to a possible bid for Invensys, however, sustained market rumour forced Invensys to disclose that talks had terminated with the US company in June.

Average PUSU period (including extensions) = 45 days

The Panel granted PUSU extensions in relation to approaches made to 22 target companies by 23 potential bidders

Outcome as of 18 September 2012



Of the 22 targets to which PUSU extensions were granted:

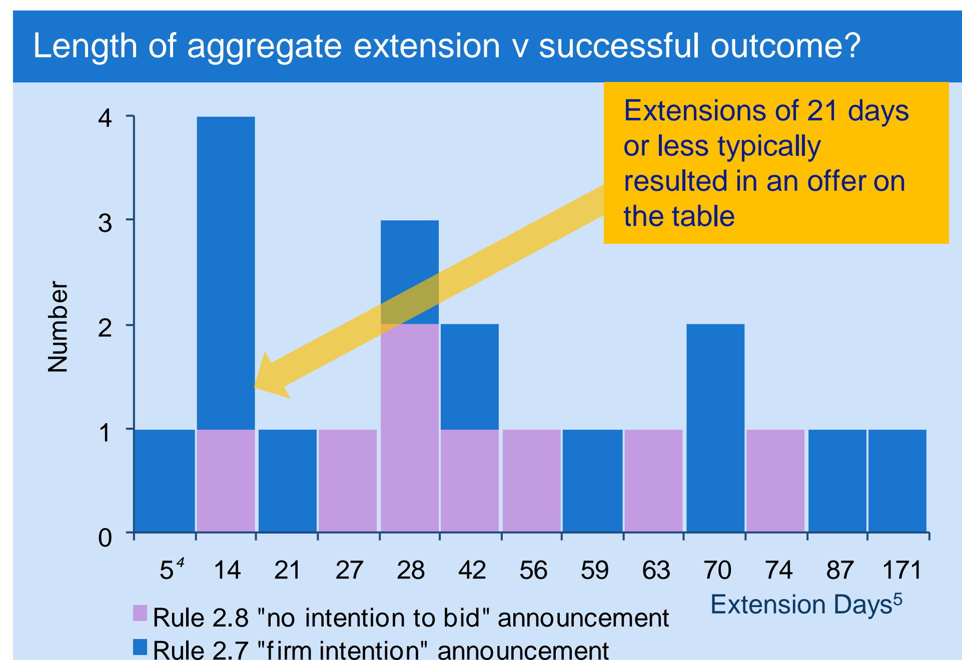
- 12 had more than one extension
- 2 involved competing bidders[3]
- 2 were still within the extended PUSU timetable as at 18 September 2012

[1] *Includes one instance where the deadline was set aside as the target company entered into administration*
[2] *In relation to 22 target companies as this figure includes PUSU extensions granted to competing bidders*
[3] *In relation to the bid for Cable & Wireless Worldwide, Vodafone and Tata Communications were given aligned PUSU deadlines and on the possible offer for Misys, Temenos Group was given a PUSU extension which was aligned to the PUSU deadline of joint bidders, CVC and ValueAct Capital*

There has been one example (*SDL's bid for Alterian, November 2011*) of a board response announcement including a statement that, in the event that a PUSU extension was required, the target board would be willing to seek Panel consent to the extension. Whilst a target company can unilaterally make a statement of this nature, a potential bidder cannot oblige a target to do so as this would breach the ban on offer-related arrangements.

Outcome of PUSU extension[1] as of 18 September 2012	Number	%
Rule 2.7 "firm intention" announcement	12	55
Rule 2.8 "no intention to bid" announcement[2]	8	36
Still ongoing within extended PUSU timetable	2	9

Longest single extension? 54 days[3]	Extension granted most often? 28 days
Shortest single extension? 1 business day	



[1] *Includes companies which entered into an offer period prior to 19 September 2011*

[2] *Includes one instance where the PUSU was set aside as the target entered into administration and one where the PUSU was set aside on announcement of an asset sale*

[3] *STE (Clean Recycling & Energy) agreed a 54 day extension in relation to Spara Acquisition's possible offer, followed by a 45 day extension*

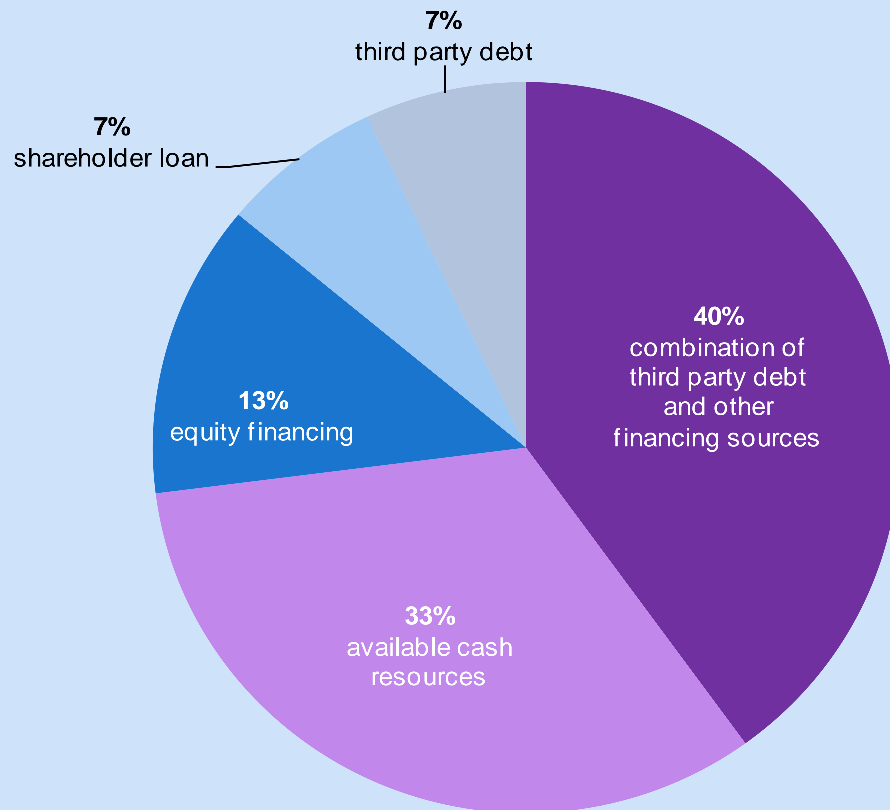
[4] *This number relates to business days*

[5] *Calendar days unless stated otherwise*

Bid financing - our insights

Whilst debt financing is still being used, particularly to fund larger deals, many bidders are using available cash resources either alone or in combination with equity financing and shareholder loans.

An analysis of the financing sources in relation to the Rule 2.7 “firm intention” announcements of cash offers in the year to 18 September 2012 reveals:



Features of third party debt emerging from these deals include:

- dispensation from disclosing market flex terms until offer or scheme document posted
- letters of credit used in several deals, a form of financing not often seen in the UK public M&A sphere and which may permit less disclosure as the target shareholders are exposed to the issuing bank’s credit, rather than the bidder’s. This structure may potentially give corporate bidders an advantage
- a good proportion of deals were funded using short term or interim facilities, with a view to refinancing shortly after completion of the bid

Recent Deals and Contacts

Our high-profile UK Public M&A experience in 2012 to date includes advising:

- Royal Dutch Shell on its proposed £1.12 billion takeover of Africa-focused Cove Energy
- International Power in connection with the £6.4 billion recommended cash offer by GDF SUEZ, to acquire the 30% stake not already owned by it
- SS&C Technologies Holdings on its £575 million (US$900 million) takeover of GlobeOp Financial Services
- Dominion Petroleum in relation to its £139 million takeover by Ophir Energy
- LCH.Clearnet Group on the recommended cash offer by London Stock Exchange Group to acquire a majority stake in LCH.Clearnet (valuing it at €813 million)
- Motorola Solutions on its £129.3 million takeover of Psion

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Data has been compiled from public sources for deals announced up to and including 18 September 2012.

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Available through the Global M&A Toolkit at **www.cliffordchance.com/GlobalM&AToolkit**

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