

# The Art of Today's M&A Deal in Europe

## Identifying Concerns and Overcoming Risk in European M&A Opportunities

In early 1980s London, the British Venture Capital Association would hold a monthly lunch where representatives from the U.K. private equity industry could meet and chat about issues germane to their business. The event took place at an exclusive hotel near Harrods – and just four tables were needed.

*by Edwin Charnaud, Eric Warner  
& Chris Morgan Jones*

That was the scale of U.K. private equity in those days. And if continental European practitioners had been invited too, one extra table would almost certainly have sufficed.

Today, the landscape is radically different. The latest figures from the European Venture Capital Association show that private equity funds raised €71.8bn in 2005, an increase of more than 250 percent on the €27.5bn raised the previous year.

Figures for 2006 are likely to be equally impressive – proof, if it were needed, of how far European private equity has come in the past few years.

The industry now accounts for around 20 percent of mergers and acquisitions in Europe and employs approximately six million people across the region. In the U.K., where private equity is particularly entrenched, it accounts for one in five private sector jobs and pays almost £30bn in taxes.

### **Up whose street?**

There is little question, therefore, that private equity has become an influential player on the European corporate stage. But with this growth and development come new challenges.

The number of firms working in this space has increased dramatically and the funds at their disposal have shown a commensurate increase. This means more money than ever before is chasing each M&A opportunity that arises. Competition is intense and it is becoming harder and harder to generate the returns that investors expect.

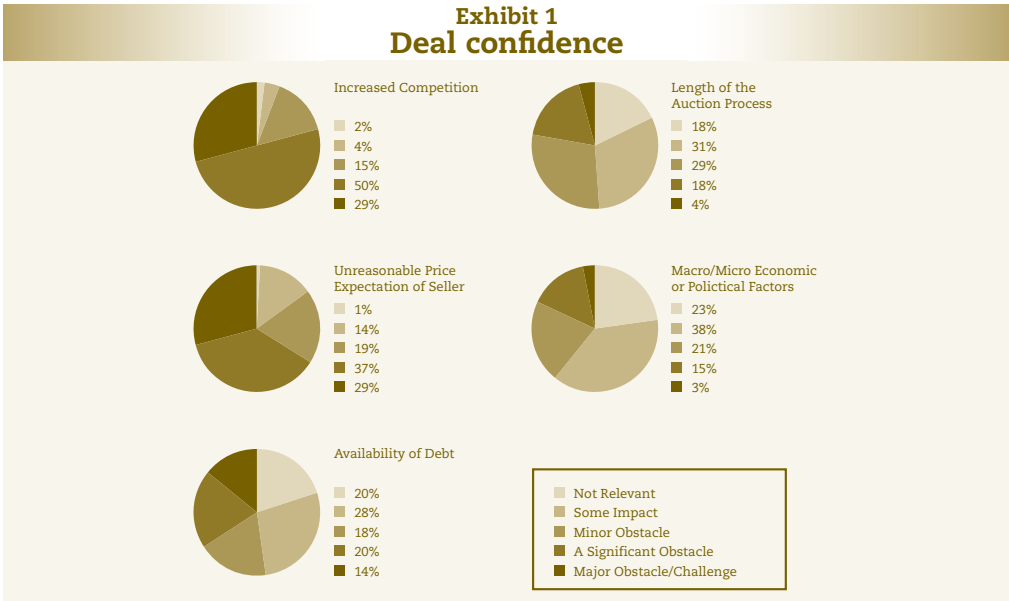
Within this context, Marsh, Mercer Human Resource Consulting and Kroll thought it would be intriguing to pursue two avenues of enquiry. We wanted to discover what concerns private equity firms the most in the current environment and we wanted to explore ways in which these concerns could be overcome.

We commissioned a research study to find out what European private equity professionals consider to be the greatest risks affecting their industry and how they are responding to changes in the M&A environment.<sup>1</sup>

The report revealed an industry in flux, evolving and developing in line with the world around it. The journey on which it has embarked is not an easy one, however.

<sup>1</sup> Copies of the report – “Successful Investments: Overcoming Deal Risks” are available at: <http://www.marsh.co.uk>

## Exhibit 1 Deal confidence



In the early days, when private equity was a rarity in Europe, practitioners tended primarily to use leverage to make deals work for them. They would buy a business at one price and sell it at a higher price a few years later, earning handsome returns for themselves and their investors by taking on more leverage than the corporate market. Competition was less intense, too, and private equity firms could afford to pick and choose the businesses they were interested in buying and the prices they were prepared to pay.

Now conditions have changed profoundly. Competitive pressures are acute and private equity firms say the greatest obstacles to deal completion are competition and unreasonable vendor expectations (see exhibit 1).

Clearly, these two issues go hand in glove. As competition increases, vendors believe they can make more money from transactions, so they attempt to raise the price at which they are prepared to sell out.

## **The leading edge**

Both factors are forcing firms to work harder so they can stay ahead of their peers and generate the returns investors require. Indeed, many firms consider their peers to be the biggest competitors in deal situations (see exhibit 2).

Trade buyers are often thought to have the edge in particular bid situations, given the synergistic benefits they can bring to a deal. Yet in many scenarios private equity players believe their rivals pose a greater threat.

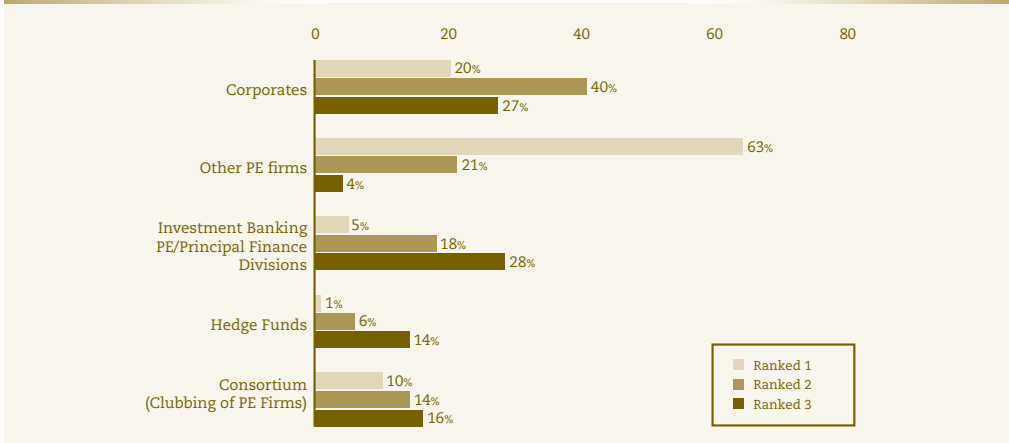
Given that bids are largely run as auctions in the current M&A environment, private equity firms invariably find themselves pitted against a number of their peers. Prices can be driven up to what many perceive to be unrealistic levels. Many professionals feel they have to spend far more time and effort than they used to evaluating transactions before and during the auction process. As costs and prices rise, so do the stakes.

Practitioners also feel a greater need to differentiate themselves from the competition, particularly as certain private equity firms are felt by their peers to be more interested in winning at any price than in completing deals that will deliver strong returns.

Traditionally, acquirers tried to differentiate their bids through price or speed of completion. Today, transactional risk insurance solutions can – and increasingly do – provide a competitive edge.

Transactional risk solutions allow private equity firms to manage risk during a competitive situation. The ability to price or mitigate an identified risk means it can often

## Exhibit 2 The competition



be removed as an obstacle from the deal process – an attractive proposition for a vendor who may be expecting a particular issue to be a serious stumbling block during sales negotiations.

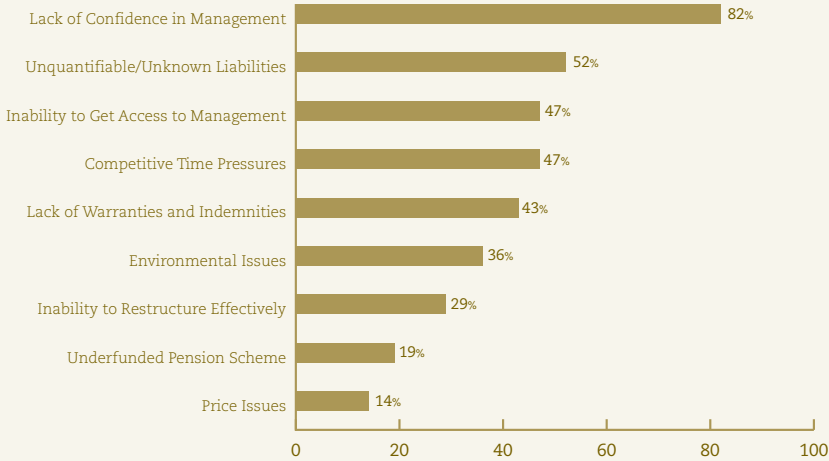
Transactional risk solutions are bespoke, and are being used with increasing frequency to replace more onerous warranties and indemnities. In the past three years, for instance, Marsh has seen a 400 percent increase in the number of insurance deals relating to warranty and indemnity risks.

### The insiders

Insurers have also become increasingly comfortable with risks involving tax and litigation, and solutions are being structured to overcome such issues and help acquirers distinguish their bid proposals from those of their peers.

In competitive auctions, where there are a large number of bidders, private equity firms can also benefit from knowing more about whom they are up against and the criteria that

### Exhibit 3 Deal concerns



vendors will prioritize when making decisions. Finding out more about the strengths and weaknesses of rivals can be particularly useful, helping bidders present their case more effectively. Knowledge about competitors and the vendor can also help firms know when to pull out of a bid situation early, saving time and money for other investments.

Yet even when a firm does emerge with the winning bid, there is little time to savor victory. The changing landscape means there is greater pressure than ever before to drive efficiencies within a business to generate appropriate returns – even if the price paid is considerably higher than would have been the case a few years ago.

Firms are making more effort, therefore, to invest actively. Some are using buy-and-build strategies to take advantage of cost synergies. Others are holding on to investments longer to focus on greater value creation.

Whatever methods are used, it takes a first-class management team to achieve success. Perhaps it is not surprising then that respondents to the “Successful

Investments: Overcoming Deal Risks” study said a lack of confidence in management was their biggest reason for pulling out of deals (see exhibit 3).

The management challenge is twofold. First, firms need to be more convinced than ever of management’s ability to deliver value. Second, increased competition means the demand for proven managers and chairmen has intensified. Both are in short supply.

This, in turn, means effective assessment of management is crucial. Fortunately, private equity firms have a range of tools at their disposal to analyze managers’ skills as individuals and their ability to work together as a team. Assessments can also equip acquirers with a better understanding of the challenges facing managers so they can quickly determine whether incumbent teams have the necessary skills for the job.

In some cases too, private equity firms discover hidden legal liabilities or undeclared corporate affiliations after completion. Had these been known earlier, they would, in many cases, have resulted in profound changes to the way a deal was structured. Rigorous and comprehensive due diligence can reduce the chance of such difficulties occurring, which frees management to focus on the future rather than problems from the past.

### **Assistance in the field**

Clearly, due diligence is important whenever transactions are contemplated. But when private equity firms move into new territories or sectors, this analysis becomes imperative.

A few years ago, firms would have barely considered the possibility of investing in Central and Eastern Europe or parts of Asia. Nor would they have considered investing

in sectors like renewable energy or IT. Today, however, firms are becoming more intrepid, seeking higher returns by looking at new regions and industries. In fact, almost a third of respondents to the study said they were interested in sectors they had not considered just two years ago.

Driven by the desire for more generous returns and less competition, private equity professionals are also aware of the need for vigilance when considering uncharted jurisdictions or less developed industries.

Some territories are considered prey to particular challenges, such as environmental risk, political instability, weak financial controls and inadequate legal protection. Nonetheless, private equity firms strive to feel comfortable that they are not taking on undue or excessive risk. They tend to try and reduce potential threats or danger by working with local experts, carrying out extensive and careful financial and operational due diligence, and using warranties and indemnities.

Insurance can be helpful, too. In Central and Eastern Europe, for instance, environmental liabilities are sometimes cited as potential deal breakers. But the specialist environmental insurance market has become increasingly keen to provide assistance in this field and cover can be structured to protect against historic pollution liabilities.

Insurance can also be used to plug warranty gaps caused by cultural differences that may exist between the giver and potential receiver of warranties. Tax and litigation issues can be addressed by the insurance market as well to provide greater comfort to private equity firms as they venture further afield.

Insurers are, therefore, evolving in step with the private equity industry. For, across the market, whether in well known or lesser known territories, the need for clarity is growing – clarity of purpose, clarity of outcome and clarity about the way a business operates.

This desire for clarity arises from private equity firms' increasing concern with competition and increased pricing. These two factors combine to make it harder than ever to achieve above-average returns.

Some professionals suggest the benign cycle of low interest rates and low inflation is coming to an end, imposing further pressure on the industry. Others point out that even if economic conditions continue to favor private equity, the ferocity of competition will inevitably make life harder.

However, private equity has made its mark on the European corporate landscape and its influence will almost certainly grow over the coming years. Acknowledging the changes that affect the environment in which it works can be seen as a stage in the industry's evolution. Managing those changes to best effect is the challenge for the future.

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*Edwin Charnaud is a managing director of Marsh and leads the firm's European, Middle East and African Private Equity and M&A practices. He can be reached at [edwin.charnaud@marsh.com](mailto:edwin.charnaud@marsh.com) or 44 207 357 3057.*

*Eric Warner is a worldwide partner with Mercer Human Resource Consulting. He heads the firm's European Private Equity and M&A practice. He can be reached at [eric.warner@mercer.com](mailto:eric.warner@mercer.com) or 44 207 626 3771.*

*Chris Morgan Jones heads Kroll's Business Intelligence practice in Europe, Middle East and Africa, which advises clients on partner risk, reputation risk and competitor intelligence issues across the region. He can be reached at [cmorgan@kroll.com](mailto:cmorgan@kroll.com) or 44 207 029 5000.*