

2006 Trends in Cross-Border M&A: A European Perspective with a U.S. Commentary



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A European Perspective by Scott Simpson and Lorenzo Corte

2006 was the biggest year for global mergers and acquisitions, with deal volume reaching approximately \$3.5 trillion, compared to \$3.3 trillion in 2000. International financial sources and these authors believe that the surge in European M&A has been the principal driver for the 2006 boom. European M&A grew 18% to a record \$1.3 trillion, representing 40% of global merger activity. By contrast, deals in the U.S. totaled \$1.2 trillion (a marked decrease from the \$1.53 trillion reached in 2000) and accounted for 36% of worldwide merger activity (as opposed to 46% in 2000).

While AT&T's \$83 billion bid for BellSouth in March was the largest transaction announced in 2006, four of the five other largest transactions were in Europe. Europe has seen large pan-European takeovers, such as the fiercely fought over \$33.8 billion merger by Netherlands-based Mittal Steel with Luxembourg-based Arcelor, Banca Intesa's \$38.8 billion bid for Sanpolo IMI, the \$73.5 billion takeover of Endesa of Spain contested between E.ON of Germany and Gas Natural of Spain, and the \$30.2 billion takeover by Ferrovial of BAA.

In this article, the authors explore the principal trends in European cross-border M&A, utilising the Mittal Steel-Arcelor takeover battle to illustrate how these trends worked in practice, and then provide a U.S. perspective on these European trends.

The Upsurge in European M&A-Primary Drivers

One of the principal factors driving the current global and European M&A boom has been private equity. According to international financial sources, volume of leveraged buyouts reached an unprecedented \$563 billion and there were eight buyouts topping the \$10 billion mark announced in 2006. LBOs accounted for 17% of the deals announced in 2006.

The upsurge in European M&A is also founded on favourable underlying economic conditions. Large companies restructured their balance sheets substantially after the downturn that followed the March 2000 stock crash, implementing significant operational and financial cost cuttings, and positioned themselves for growth opportunities as they arose. The cost of capital continues to be relatively low, and capital has been fairly easy to raise, making it easier for strategic players and private equity funds alike to lever up and offer cash, as opposed to stock, as consideration. In fact, the proportion of cash that was offered in this merger wave to date marks one of the principal differences between the current takeover boom and the one at the end of the '90s.

A driver unique to Europe has been the need for horizontal cross-

border consolidation to create a class of pan-European champions able to compete around the globe. The European market continues to be extremely fragmented in a number of industries and that has presented significant M&A opportunities. Executives of European companies are moving to grow by way of acquisition based on the realisation that they need to increase the scale and geographic footprint of the companies they manage if they are to position them to seize growth opportunities in the principal developing economies. This was clearly the case in the Mittal Steel-Arcelor merger, the takeover of Endesa and the merger of Banca Intesa and San Paolo IMI.

Europe has also seen an unprecedented rise in hostile takeovers, which was caused by an additional layer of factors. Strategic industrial players have seized the window of opportunity opened by stable economic conditions to achieve growth by way of acquisition. But in order to snatch up opportunities as they arise, beat competition from private equity players, and force consolidation in the face of the reticence of target management, national governments and, at times, national regulators, strategic players have had to resort to aggressive takeover tactics. Changes in the structure of continental European capital markets in past years have been crucial in laying the ground for this upsurge in hostile takeovers; in the last 10 to 15 years, Europe has seen an increasing number of companies coming to market, and overtime, European stock has become more widely held and increasingly liquid. All of these factors are causing a change in the way European executives and shareholders see hostile takeovers, which is reminiscent of the change in mentality that took place in the U.S. as a result of the wave of hostile M&A activity in the '80s.

The Diminishing Role of National Governments in European M&A

Notwithstanding the continued harmonisation of European laws, national governments still seek to intervene in cross-border takeovers. A few recent examples include the involvement of the French and Luxembourg governments in the early stages of the Mittal Steel-Arcelor merger, of the French government in the proposed takeover of Suez, of the Spanish government in the takeover of Endesa, and the Italian government in the merger of Autostrade and Abertis. National governments express an interest in most high-profile mergers in continental Europe, and, if they are hostile takeovers, national governments can be a significant factor.

That said, while in certain circumstances national governments have been able to influence the outcome of takeover battles, their ability to do so is diminishing substantially as European stocks become more widely held and stock market forces drive takeovers

to completion. For example, Dutch ABN AMRO's takeover of Italian Banca Popolare Italiana, which was strongly opposed by Italy's government and Italy's central bank, was successfully completed in the first quarter of 2006. Further, in Mittal Steel's unsolicited takeover of Arcelor, while initially the governments of France and Luxembourg strongly opposed the transaction, following criticisms from other governments in Europe, the EU Commission and market forces, those governments took a more passive position.

It is reasonable to assume that as stock markets continue to expand, market forces and industrial logic will prevail in Europe over national protectionism.

Lack of Regulatory Uniformity and Regulatory Arbitrage

A clear obstacle to European consolidation is the lack of regulatory harmonisation. While for the last 15 years, the EU Commission has been trying to create a regulatory infrastructure that would be conducive to consolidation, it has achieved mixed results at best. Certain milestones have been reached: the single currency, the EU prospectus directive, and one accounting standard for all listed companies. However, in other areas, largely as a result of member states' lack of political willingness to put national champions up for sale, the EU Commission has not achieved its objectives to establish a uniform takeover code, or uniform set of corporate governance standards. In fact, golden shares and structures designed to facilitate national protectionism continue to exist.

This lack of uniformity has opened the door to the use of regulatory arbitrage. A case on point is Mittal Steel's multi-jurisdictional offer for Arcelor. As the offer was launched in four jurisdictions in Europe, where offer timetables and disclosure standards differed, the first hurdle Mittal Steel faced was to establish which of the supervisory regulatory authorities would be competent to clear Mittal Steel's offer documents.

The EU prospectus directive clarified that in respect of the issuance of shares, given that Mittal Steel is a Dutch company, the Dutch AFM would be the sole competent authority and that, once cleared, the Dutch prospectus could be "passported" in the other four European jurisdictions. However, as to the offer document, given that the EU Takeover Directive had not entered into force in any of the member states where the offer was launched at the time the offer was announced, it was unclear which authority would be competent. Luxembourg was Arcelor's place of incorporation, where Arcelor was headquartered and one of four markets on which its stock was listed, but Paris was Arcelor's primary listing market, with over 90% of the trading activity. While each of Spain and Belgium accounted for less than 5% of the trading activity of Arcelor stock, these regulators, which had played an important role at the time of Arcelor's creation, did not wish to relinquish their authority on the offer in the absence of any regulation to the contrary. As a result, each of the four regulators asserted jurisdiction on the offer mechanics and aspects of the offer that affected trading (such as advertisements and disclosure), although by and large they deferred to Luxembourg law for corporate matters.

In addition to European regulatory hurdles, Mittal Steel confronted a significant issue faced by all companies launching an offer for a widely held European company: whether or not to extend the offer into the U.S. As Mittal Steel was offering shares as consideration (as well as cash), it would have been required to register the issuance of shares in the U.S. (as well as the Netherlands) if it extended the offer to the U.S. In theory, Mittal Steel could have avoided extending its offer into the U.S. However, given the

substantial percentage of Arcelor's share capital held in the U.S. and the publicity that the offer would have (and that indeed it had), it would have been very difficult for Mittal Steel to completely exclude the U.S., avoiding any communication within the U.S. on the offer throughout the lengthy offer period. If Mittal Steel had attempted to exclude the U.S., it would have run the risk of being challenged in court by Arcelor U.S. shareholders and perhaps also U.S. securities regulators. Mittal Steel opted to include the U.S., opening the door to yet another layer of regulatory arbitrage.

From a substantive disclosure standpoint, Arcelor's primary concern was to ensure that all of its shareholders (including all of its shareholders in the U.S.) would receive the same information and would be treated equally. As general principles of disclosure required that all shareholders be given substantially equivalent information at the same time, Mittal Steel was required to adhere to the highest applicable disclosure standard in any of the six jurisdictions involved. Where disclosure rules clashed, the offer process was at times delayed and regulators were forced to take unusual positions.

Due to the complexity of the regulatory clearance process, Mittal Steel's takeover offer, announced on January 27, 2006, did not commence until May 18 in Europe and June 7 in the U.S. It is clear in hindsight that this six-month period gave Arcelor the time it needed to seek and develop strategic alternatives to Mittal Steel's offer.

Takeover Defence Trends—a Developing Trend in continental Europe

The EU Commission's repeated attempts in the course of the last 15 years, through the EU Takeover Directive, to eliminate the ability to raise takeover defences in connection with hostile bids - consistent with the approach in the U.K. - has been, barring a few exceptions, widely rejected by continental EU member states as too radical a change in approach. Most member states believed that it would have opened the door to takeovers from outside the EU and in particular by U.S. companies. As a result, the rules against defensive measures were made optional. While the EU Takeover Directive has not yet been implemented in many of the principal EU economies, most EU countries seem inclined to retain their existing framework with regard to a target company's ability to defend against hostile bids.

A trend in continental Europe is emerging with respect to takeover defences, which is a hybrid between the approach in the U.S. and the U.K. In the U.S., takeover defences are allowed subject to market scrutiny and judicial review. In the U.K., in order to limit litigation, takeovers are regulated by a takeover code, supervised by a sophisticated regulator and takeover defenses are generally prohibited.

The principal jurisdictions in continental Europe generally contemplate that targets can erect structural defences against hostile bids, provided that this ability is subject to the scrutiny of takeover supervisory authorities, whose degree of knowledge and sophistication varies widely across jurisdictions. While the latitude afforded to target boards to defend against hostile bids differs greatly from country to country, and the regulatory approach is not always consistent, the acceptability of mechanisms implemented by target boards is increasingly subject to market scrutiny.

In the Mittal Steel-Arcelor takeover battle, for example, Arcelor's first set of measures implemented by the Board - an extraordinary dividend, a proposed buyback, and a lock-up of a strategic asset ("Dofasco") was generally accepted because the market expected that it would trigger an improved offer from Mittal Steel. Mittal

Steel's proposed sale of Dofasco was determined to be against the corporate interest of Arcelor. Accordingly, once the acquisition of Dofasco had been completed in late March 2006, Arcelor transferred legal ownership of its shares in Dofasco to an independent Dutch foundation named "Strategic Steel Stichting", or "S3," in exchange for non-transferable depositary receipts issued by S3. Under the organisational documents of S3, through its ownership of depositary receipts, Arcelor retained all of its economic rights in Dofasco and the right to supervise and direct the voting of the Dofasco shares held by S3, but not the right to direct the sale of any Dofasco shares or assets, which required the unanimous approval of the S3 independent directors. Importantly, the S3 was structured so as not to preclude in any way Mittal Steel's offer. While the apparent immediate consequence of the establishment of the S3 was to cause Mittal Steel to withdraw and then refile for antitrust clearance in the U.S., S3 did not otherwise pose obstacles to the feasibility of Mittal Steel's offer.

Arcelor later implemented a white knight defence through a transaction structure contemplating the issuance of shares to a friendly strategic partner (SeverStal of Russia), which is also a technique allowed in certain jurisdictions in Europe (but not in the U.K.) and used in the U.S. Just as Arcelor took actions to protect Dofasco with the S3, Arcelor believed that an opportunity to acquire SeverStal was consistent with Arcelor's corporate interest and should, if possible, be presented as a viable alternative to Mittal Steel's original offer, which Arcelor believed was an inadequate offer. While Arcelor had a previous mandate from its shareholders to issue the Arcelor shares proposed to be issued to Mr. Mordashov (SeverStal's controlling shareholder), the Arcelor Board felt it was important to give the shareholders an opportunity to express their opinion on the transaction, in particular given the outstanding takeover offer from Mittal Steel. The Arcelor Board called an extraordinary meeting of shareholders on June 30, 2006, to vote on the SeverStal transaction. Unless more than 50% of the then outstanding Arcelor shares opposed the transaction, the merger with SeverStal would proceed. While the 50% unwind mechanism was criticised by the market, including institutional investors, the SeverStal transaction caused Mittal Steel to increase the price of its offer and to deliver better overall corporate governance and other terms. And in the end, the proposed SeverStal merger was unwound as over 50% of Arcelor's shareholders voted to unwind it.

U.S. Commentary by Scott Simpson and Roger Aaron

It is natural that, with the amount of horizontal consolidation which is necessary in order for the European markets to be more integrated and capable of competing in a global market place, the current M&A wave is being led by Europe. Add to that the interest of U.S. companies to enter Europe and European companies to enter the U.S. and you begin to see why European trends and issues are so important in understanding global M&A.

In terms of strategy and tactics, you are seeing in European M&A the same aggressive moves by bidders and strong defensive responses by targets that characterised much of U.S. M&A in the 1970s and 1980s. Indeed, the lack of a common takeover code in Europe has meant that bid tactics in Europe generally have looked more like the laissez-faire approach of the U.S. and less like the strictly regulated process of the U.K. However, we predict that over time European bid tactics will settle down (as they have in the U.S.) and a more market driven and normalised approach across jurisdictions will, in our view, emerge in Europe.

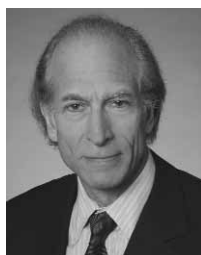
Protectionism in Europe, like the U.S., is more often than not a topic that sells newspapers driven by bold statements from politicians and is less outcome determinative. Over time, protectionism will be further eroded by market forces and further confined to certain highly regulated and specialised industries.

At present, however, certain acquisitions of U.S. companies by non-U.S. companies are getting more scrutiny than in the past under the Exon-Florio review regime. Several recent transactions, including the Alcatel/Lucent merger, were subjected to extensive and lengthy review by, and substantial negotiations with, the U.S. government agencies which constitute the Committee on Foreign Investment in the U.S. (CFIUS) before they were permitted to proceed; and permission to consummate the transactions was subject to restrictive agreements with certain of the CFIUS agencies. The CFIUS agencies were severely criticised by many prominent U.S. politicians for not restricting or prohibiting the Dubai Ports transaction and, as a consequence, have become much more vigilant and involved in all acquisitions of U.S. businesses by non-U.S. entities which might have national security implications.

It is unclear to us whether the U.S. capital markets have lost their edge to the European capital markets in the longer term or whether the "Perfect Storm" of Sarbanes-Oxley, plaintiff strike suits and Attorney General intervention is merely a temporary setback. This, in our mind, is one of the most important issues to watch given its significance on global M&A. Near term, however, we see an increasingly significant role for the European capital markets and that is likely to add to the importance of Europe in the M&A scene generally.

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