Reflections on 15 years of M&A

We asked our partners what has changed most in M&A since 2005 and found themes that resonated.

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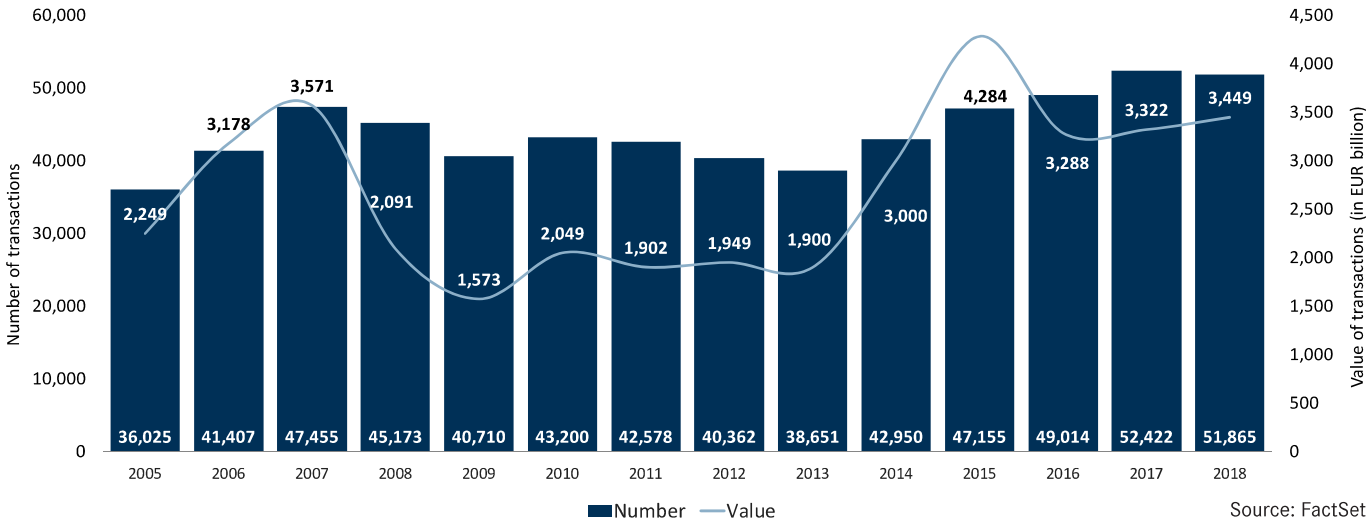
Since the founding of Clairfield Partners in Geneva in 2005 (now named Clairfield International), the mergers and acquisitions market has remained robust. Both the number and volume of deals closed continue to be cyclical over the years, reflecting the opportunistic nature of M&A. The main issues that our sell-side clients address with an M&A deal continue to be a lack of succession, a need for liquidity and estate planning, refocusing on core business, and, in some cases, differing views among shareholders. On the buy-side we see a need for M&A for the following primary reasons: the need for inorganic growth to achieve strategic goals, requirements to strengthen presence in markets or segments, or to participate in the consolidation of a market. Additionally, the coming of age of private equity funds means that there is also a segment that simply needs to find a home for its investment euros or to rotate its portfolio.

As part of our celebration of Clairfield's 15th anniversary, we surveyed our colleagues throughout our worldwide offices and asked them one simple question: what has changed most in M&A in the last 15 years? We received much more material than we expected and consequently had to choose what we considered to be most relevant to include in this article. The following points reflect the views of many senior partners who have been serving clients over the last 15 years or more in some of the hundreds of deals our partner offices have advised on since 2005.

Volume and value of mergers &acquisitions worldwide, 2005-2018



Source: FactSet

Increased activity across the globe

Global M&A activity increased from 32,000 transactions in 2004 to 47,000 in 2018, an increase of 46%. Deal value has almost doubled from USD 2.1 trillion to USD 4 trillion. These are strong growth figures in both cases and a clear sign that M&A is here to stay as a strategic tool for management and shareholders alike. Crossborder deals have also increased in deal number from 9,000 to 14,000 and in deal value from USD 600 billion to USD 1.5 trillion (estimated, due to confidential deal values).

Private equity

Private equity has matured a great deal since 2005. In 2004 there were, by some accounts, just over 1,700 private equity funds active in the market. This figure has grown to more than 5,400 at the end of 2018, creating many more specialized and niche players. During the same period, assets under management have ballooned from USD 700 billion in 2004 to USD 3.5 trillion in 2018, a fivefold increase, with an astonishing USD 2.4 trillion of dry powder yet to be deployed. In 2005 private equity accounted for just over 1,800 deals for a total value of just over EUR 300 billion while it accounted for more than 3,000 deals and EUR 380 billion in 2015. In the years in between, totals exceeded 4,000 deals and more than EUR 415 billion in value depending on the year.

Private equity funds invest in growth industries, industries in need of consolidation, and buy-and-build platforms, leading to increased M&A activity. Specialization has also led to a tiered universe of PE funds: large cap, mid cap, and small cap (to keep it simple) that invest in deals from EUR 1 million in enterprise value to more than EUR 10 billion in enterprise value. It is also interesting to note that between 2006 and 2017 while the number of listed companies in the developed market fell by 16%, private equity funds increased their portfolio of companies by 106%.

As a result of all the activity, private sellers understand PE better than 15 years ago. Gone is the image of Gordon Gekko looking to flip a family-owned company to make a mint. Private equity has generally embraced a more low-key, warm and friendlier approach looking to “partner” with families or management (even though the fine print may have changed little). With so much firepower at the ready, private equity funds will surely continue to play a significant role in providing the M&A market with much-needed activity.

Globalization

Globalization is now a fact of life for companies both large and small. Since 2004 global trade of goods and services has more than doubled to USD 25 trillion and is now equal to 30% of world GDP. Globalization has impacted every entrepreneur, who must have critical mass in order to compete in the global market. The typical family-owned business is now too small to compete globally and they must decide if they grow, or if they morph into a defensible niche player. This is a very strong motivation for them to talk about M&A. Clairfield now sees family-owned or owner-managed companies who would never have dared to undertake an acquisition 15 years ago putting it on their board agendas. They have realized what the large, listed corporates have known for some time: that M&A is a key strategic tool that enables them to rapidly reach their strategic objectives and maybe even thwart the plans of a “dear” competitor.

A generational question

In post-WWII Europe, most entrepreneurs were interested in creating a family-owned company that would be revered and have a prominent place in their community. They were reluctant to sell and afraid of what people might say about selling out, especially in the event of plant closures that could eventually affect their communities. A good deal of their decision making was emotion-based. These first-generation business owners are now well into old age, may not have a successor, and need to think about the long-term stability a new owner can give to their employees and clients. But things have changed for family-owned-and-operated businesses in the last fifteen years. The younger generations, now in their forties to sixties, are more knowledgeable about their markets, understand the challenges moving forward, how partnerships can make businesses stronger, and why taking on a financial investor could be the right move. They are much more open to rational decision-making based on the merits of the case. We might even go so far as to say that in 2005 entrepreneurs did not talk about M&A

in the ordinary course of business, but now it is a topic on every entrepreneur's agenda, both on the sell and buy sides, at an early stage of company history.

Technology

Technology has revolutionized many aspects of our lives as private citizens. It is no less true that technology has impacted how M&A processes are structured and managed. Email and word processing technology have sped up contract negotiations (in 2005 faxes were still common). Cloud services have made due diligence less intrusive and more complete, and on-site data rooms are a thing of the past. Technology means that geographic distance will not necessarily place a buyer at a significant disadvantage. While a phone call or a video conference will never replace on-site management visits, high-quality video conferencing enables buyers and sellers to develop a trusting relationship more quickly with more frequent "face-to-face" interactions but without the travel.

Information availability

The advent of the internet means that more information is available at all times, though guidance is needed to make sure it is the right information. As an old professor used to say, "questions are great, but the right questions are even better." Due diligence can be conducted faster and more securely. Identifying potential buyers, investors or targets no longer requires access to proprietary or expensive databases. Additionally, competitive analysis has become deeper and more complete, resulting in better and timelier decision making on both sides of the negotiating table. Information on deals and transaction structuring is more widely available, ranging from EBITDA and other multiples to terms and conditions in an SPA, leading to clearer market standards.

Convergence between Europe & North America in M&A practice

Executing M&A transactions in Europe and North America continues to have basic differences but we have seen convergence over the last 15 years. Some key differences, such as asset versus share deals (the latter more common in Europe), are related to tax codes and concern liability and responsibility issues. SPAs in Europe have started to look more like their North American counterparts in the last 15 years in spite of the fact that most European civil code provides more protection to both parties even without voluminous R&Ws. R&Ws seem to follow similar patterns now on both sides of the Atlantic albeit with slight differences based on transaction specific issues. The aggressively litigious US environment continues to make R&Ws more important. R&W insurance and locked-box are probably more prevalent in Europe. Non-compete, non-poaching and non-solicitation are all now standard operating procedure in SPAs and readily accepted by sellers.

Locked-box vs. completion accounts

We have seen a pronounced rise in European M&A in the use of the "locked-box" method to handle the final purchase price adjustments instead of the more traditional completion accounts approach. Post-closing price adjustments create nerve-racking anxiety for most sellers. Most of these adjustments are related to the amount of working capital delivered at the closing date. As many mid-market companies will have little experience in estimating working capital at closing, which may occur at a date different than the end of the month, sellers get nervous about "getting it wrong" and having to return part of the purchase price to the buyer. The completion accounts approach can also take several months to conclude, thus making it an anxiety-inducing experience for the sellers. The locked-box method allows for "leakage", amounts usually paid on behalf or to the sellers, and are generally identified and well known at closing. Price certainty at closing alleviates much of the nervousness that surrounds an M&A at closing and, as a result, the locked-box method is increasingly popular with sellers who want to sleep better at night up to, and beyond, deal completion.

R&W insurance

When sellers divest, they typically have to guarantee that there are no hidden or unrealized liabilities in the financial statements. The sellers make a represention (the "R") that there is no undisclosed liabilities and provide a warranty (the "W") that should any liability come to light post-closing, they will pay for it. This means that they must indemnify the buyer in the sales & purchase agreement which they sign at closing. Oftentimes, as an "insurance" policy the buyer will require a real guarantee against identified but unrealized

liabilities. Such a real guarantee typically takes one of three forms: retention of purchase price, creation of an escrow account, or a bank guarantee, all subject to a complex claims mechanism and a time limit. Over the last 15 years the insurance industry has developed an insurance product to replace these types of guarantees so that the sellers can collect the price at closing and not have to worry about a phone call from their lawyer informing them that there has been claim. The insurance is not cheap, but peace of mind never is. Private equity funds like the product because the clean break means post-closing is easier vis-à-vis their limited partner investors. R&W insurance is here to stay.

Vendor's due diligence

Due diligence has been around in one form or another since people have been doing business. When a company goes public or lists a bond offering, the coordinating investment bank conducts due diligence at the risk of being liable if things are found after the listing that damages the value of the shares of bonds. Due diligence became standard practice for acquirors in the successive waves of M&A involving private companies. The acquiror would undertake and pay for the due diligence investigation, drafted for its sole benefit, and would ask for exclusivity in exchange for undertaking the expense in time and resources. In the 2000s, audit firms began to sell a service whereby a seller could conduct a due diligence on itself, hence a "vendor's due diligence", and effectively "sell" it to the buyer. This change in procedure meant that the seller did not have to give exclusivity until approaching the closing thus allowing the seller, and their advisors, to run auctions until virtually the day before closing and ensuring a higher sale price in the process.

Sources: Clairfield research, Preqin, Pitchbook

Seller-friendly process

Back in the 1990's the guy with the money laid down the rules in M&A deals. But with the rising sophistication of the M&A process, sellers are more in control of what is acceptable and how things will be done. The process is drafted by the seller and their advisors, management meetings are used to get buyers comfortable with the business and its management, timetables are set by the sellers, increasingly sellers are drafting SPA's early in the process, and R&W clauses are lighter than ever. This is largely possible because of the increased number of bidders—specifically private equity firms who are not competitors of the business and can gain valuable access to key information. Clairfield has seen how the sale process has evolved in favor of the sellers over the last 15 years and we think that there is no turning back.

Use of M&A advisors

In the past, the seller would seek a brand name or local bank to sell their company because they did not know that any alternative existed. This would lead them to choose a Tier 1 bank, but they ended up working with the B or C team at the bank and did not get the appropriate attention, oftentimes leading to disappointing results for the client. Such results offered a window of opportunity for experienced, entrepreneurial corporate financiers looking to exit the stodgy and highly regulated corporate banking environment to set up independent corporate finance advisory businesses based on real nuts-and-bolts M&A expertise and a desire to provide top-flight service to all clients regardless of size. These firms avoid the trappings of multiproduct integrated financial institutions. Boutique M&A advisors have flourished and multiplied since 2004 across all major developed markets in Europe and the Americas. As a result of all these developments, today's clients are more savvy. Family-owned and owner-managed businesses have become much more knowledgeable about corporate finance and are better advised before a sale process starts. Clients also tend to be more demanding when selecting an advisor because of the number of advisors active in the market. Clients want to understand what deals the advisor has done in their sector, average deal size, and incentive-based success fees to determine whether an advisor is the right fit. Clients wants to know the extent to which the advisor does global transactions but are reassured that they can contact someone local (and in their native language) when issues arise. This means that advisory firms have had to develop, focus on, and market their USPs to differentiate themselves from the crowd with such things as sector focus, international presence, and proven track record.

Many of Clairfield's offices were young or only recently founded in 2005. Many of our partner firms are now recognized as among the most established midmarket firms in their respective markets. At the end of the day, this means that it is far easier to gain access to companies; when we call them with an idea, they answer. Now we have a history of success to build on. ■