

M&A and Corporate Finance

Market Update – July 2012

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The Financial Crisis

Effects on the Finnish Markets

The markets have hardly settled after our last market update. As this is not the place to revise the questions caused by the U.S. economic slowdown or the European debt crisis on the Finnish M&A and corporate finance market, we will merely outline what is likely to happen in here during the summer and the autumn.

The good news is that larger sound companies are doing very well, especially due to good demand in the international markets on capital goods, consumer durables and materials.¹ However, the slowdown and the lack of financing, will affect some of the Finnish companies in the near term.

A review of the most recent financial accounts evidences that a number of Finnish listed companies have stated (as required by IAS and the Finnish Financial Supervisory Authority) in their accounts that there may be significant near-term questions in securing the continuity of their business and operations. This means that, we will see more lower-rated corporate bonds, finance driven takeover bids and/or divestments at less-than optimal prices.

Our view is that there will be a lot of M&A market activity by these companies during the latter part of 2012. Although, if we look at Q2, spending on deals all over the world has been significantly lower than the same quarter in 2011. Private equity is likely to be more on the sell-side.

We also think that the Euro will hold and there will be a political and ECB stimulus solution to the short-to-mid term financial situation affecting the Euro-zone and rest of the Europe. However, the inability to resolve these complex issues earlier on with a stern and concise plan has affected negatively corporate financing and the economic conditions faced by the European companies and investors.

Some Effects on the Real Economy

¹ See e.g. Forbes, Volume 189, number 8, May 7, 2012, p. 103-104 on recent growth figures in profits and assets in various markets.

We see clearly that the crisis affects real economy and their financing sources. Bank financing is an option only to a portion of companies considering transactions or investments. We have been dealing with transactions that are heavily under bank control despite several subordinated layers of debt and little senior bank financing. Banks scrutinize thoroughly even the small transactions.

Banks appear to have the view that they are willing to finance good projects and corporations with sound economics. The margins for acquisition finance senior debt have been ca. 450-500 bps and the mezzanine has been around 10 to 15% (PIK + cash) plus warrants – in some cases. The levels are reasonable compared to equity return requirements but more speculative transactions are not getting much of the banks' attention.

We represent a number of high-growth companies with state of the art technology and customer base. However, even certain excellent companies are facing additional hurdles securing bank financing – or new claims for additional security. Most of the investments that we've carried out during 2012 have been pure equity and growth-capital investments of equity, preferred equity or convertible notes.

As of 1 July 2012 public equity and debt issues have become easier to carry out. Due to favourable regulatory developments, we see the feasibility of smaller bond issues becoming ever more popular as of this year and 2013.

More on this below under the “Small Public Equity and Debt Issues Made Easier”.

Private Equity and Investments

Exits needed to attract new investments

Another result of the financial crisis that is becoming more evident is the fact that M&A transactions by Private Equity or financial buyers are on hold for some time or are subject to structural changes. The situation can be summarised as follows.

1. A number of funds have withheld exits due to less-than-optimal market conditions;
2. Some funds have ample investment commitments;
3. If funds are unable to carry out exits, they are unable to convince their investors that they can do that in the future;
4. As a result, these funds are unlikely to attract new investment commitments or attracting commitments has become harder.

In addition, the solvency/capital rules affecting pension insurance companies changed so that direct investments are (as a rule of thumb) preferable to investments in PE or VC funds.

As these investors are central to the Finnish fund market, we are likely to see a number of fund closures – or forced exits in order to attract confidence by the investors. However, there is clearly room for e.g. hedge funds and opportunistic investors – even though the implementation of the Alternative Investment Fund Managers Directive will mean additional requirements for such companies.

Restructurings and Distressed Opportunities

In order to attract new investments and to create at least some return to the existing clients, the number of transactions with lesser than sought for valuation is likely to be seen.

What we will see during 2012 is a number of distressed transactions with foreign funds playing a large role in purchasing and refinancing the target corporates. There is now more experience in carrying out voluntary corporate restructurings under domestic intercreditor agreements and through statutory corporate restructurings. This should make the process of restructuring and acquisitions more reliable for the purchasers. In addition, there is a growing legal experience on restructuring distressed real-estate transactions – partly borrowed from the larger successful forced enforcement sales in Sweden.

We have been working hard at TRUST. in order to address the well-known problem of hooking up foreign fund investors and the distressed corporates (with the help of the senior banks and pension insurance companies). As always, this is material for any distressed transactions to take place – within the limits of the banking secrecy laws, as always.

Mezzanine Lenders Gaining More Weight

Our earlier suggestions relating to the Finnish restructuring market appear to have been in line with the current developments. There is a pipeline of corporate restructurings on the way. A number of the companies in financial distress have been kept afloat by the rather tolerant attitude of the biggest banks. In our view, some of these companies should have been restructured already some time ago. However, this is partially due to lack of industrial or distressed investors providing an impetus for the deal.

However, as the ranks of mezzanine and other subordinated investors have a growing intolerance to the lack of exits, we are likely to see some pressure against the banks in order to carry out extensive restructuring measures in order to rescue the target corporations.

Mezzanine creditors have in some cases been able to negotiate better-than-usual enforcement terms in intercreditor agreements in order to ensure that their interests are not wholly overlooked in financial restructuring or enforcement sale. This is a welcome development as it may make it easier for the subordinated lenders to dare to the financing table once again.

Foreign advisors and institutions should note that under Finnish law, it is hard to by-pass the owners in statutory restructuring even though the creditors would be forced to a cram-down of their claims. This means that any underlying transaction will have to be carefully structured – e.g. with adequate mezzanine protections and convertible notes.

Small Public Equity and Debt Issues Made Easier

The Finnish securities markets law is currently subject to an extensive reform. The package was planned to take effect 1 July 2012 but according to authoritative sources, the implementation will take place around October this year. Along with the changes in statutory law, the Finnish Financial Supervisory Authority will carry out a comprehensive regulatory reform this year – and extending to 2013 due to the delay in the implementation of the reform package. We have discussed the most important changes in our Securities update dated 14 May 2012 that can be obtained from www.theTRUST.fi - at “Legal Briefings”.

However, some of the changes relating to prospectus requirements were updated already as of 1 July 2012. These changes facilitate small equity and debt issues directed to general public and transfer a large part of the issues of securities requiring a publishing exemption from the Finnish FSA to the scope of automatic prospectus exemption.

Some of the notable changes are (offering of securities):

1. The current minimum prospectus offering threshold of 100,000 euros is raised to 1,500,000 euros;
2. The minimum amount capable of subscription/or minimum nominal value (avoiding the prospectus requirement) is 100,000 euros (previously 50,000 euros);
3. Issues directed solely to professional investors (previously “qualified investors”, which is somewhat different in its scope) are wholly exempted from prospectus requirement;
4. Issues directed to less than 150 non-professional investors are exempted (previously less than 100 “qualified investors”);
5. Subject to certain requirements: offerings without consideration e.g. bonus issues, dividends paid as shares, exercising convertible notes, listing of amount of shares representing less than 10% of total equity (12 month rolling) and issues to employees of the company or its groups are subject to automatic exemption (previously requiring approval by the FSA);

We are happy to advise and provide more specific information on how to carry out equity and debt issues under the new regime in Finland.

Mergers & Acquisitions

Tech Deals Flourish Despite Small Setbacks in General M&A Activity

As we have already discussed in our previous updates, Finland is a country of significant technology M&A potential. While we have been involved in several divestments during the past few years, our general view is that technology companies are more on the acquisition side. Here we clearly see that cash-rich companies buy

strategic assets in particular in cloud computing, social networking and mobile phones.

The general view also is that, while there is a decline in the overall M&A activity during the first two quarters of 2012, the decline in technology M&A was significantly lower than in other business sectors.

In addition to cloud computing, social networking and mobile phones, big data is likely to be one of the core areas. This involves handling of data at so large scale that conventional database management systems cannot handle them efficiently. Sources where this data can be obtained include financial markets, sensors in manufacturing or logistics environments, or traffic cameras throughout a major metropolis.

An example of another interesting area actually involves several forefront-entities who have announced the creation of a joint venture dedicated to “...delivering a secure, accessible environment for advanced services running on the growing range of connected devices. This includes tablets, smart-TVs, games consoles and smartphones”.

Private Equity in the Technology Sector

Private equity deals have also defied the declining M&A trend. Based on an interview with our colleagues in the Nordic countries, the valuations in technology private equity deals have been rising.

It is interesting to see and analyse what the reasons behind this trend are, but one explanation could be that technology companies currently hold strong portfolios of intellectual property rights, which are regarded protective investments, as it may be possible to use intellectual property rights as security for any future investments. This emphasises the role of patent offices in the valuation and in “freedom-to-operate” investigations.

As an example of these recent deals, mobile handset firm Nokia has sold its luxury mobile brand Vertu to private equity firm EQT VI for an undisclosed amount. The move is a part of Nokia's strategy to dispose of its non-core assets and we surely expect to see more deals as the company has publicly announced its continued commitment to smartphone range and location-based services.

Outsourcing

Strategic Changes in ICT and Performance KPIs

In the information technology sector, there has been a clear trend towards multi-sourcing environments. While some years ago, most of the deals were carried out with one single vendor, today, there are several parties involved. Companies increasingly use more multi-vendor models with the intent to access best-in-class capabilities and improve their negotiation position. Another obvious driver behind this trend is the fact that different IT service providers have different strengths, capabilities and cost structures. From the legal side, the critical challenge caused by this development is to ensure that all suppliers will work together for the arrangement.

As a result, we will definitely see more operational level agreements binding different suppliers to work together. For example, the following issues have been on the discussion agenda:

- Opening of confidentiality provisions enabling suppliers to communicate efficiently;
- Harmonization of SLA sanction mechanism;
- Establishment of cooperation procedures for Disaster recovery, testing and similar obligations;
- Creation of "Fix it first, argue later" – approach across the suppliers;
- Harmonization of intellectual property ownership questions;
- Establishment of mechanisms for escalations and disputes;
- Change management if more than one supplier is affected;

- Harmonization of IT standards and working methods across the suppliers; and
- Exit considerations and retendering procedures.

We estimate that as a next step in this development there will be service integrator models, in other words, companies who will take part of the cost-savings if compared to the multi-sourcing environment in its pure form, but who will take wider role and contractual responsibility for the integration if compared to the earlier system-integrators.

It should also be noted that part of the outsourcing deals have been discussions on right KPIs to be measured and here the trends has constantly been more towards quality and business related KPIs than slightly old-fashioned "uptime" or "restoration time". This causes considerations as to what should be measured, but also will be an elemental part of this trend towards services integrators.

The views expressed in this market update are of general nature and should not be considered legal advice or relied upon in a specific situation.

Any actual situations should be evaluated legally on a case-by-case basis.

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