

REGIONAL FOCUS: EASTERN EUROPE

Baltic M&A and private equity

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Over the last few years, general M&A activity in the Baltic States saw continued growth, with both local and foreign dealmakers seeking to invest in a wide array of sectors. Deals occurred across several sectors, including real estate development, online media, wholesale and retail trade, services, transportation and logistics, technology and agriculture.

Players in M&A transactions vary slightly, depending on the country. In Latvia, for example, deals mainly involved foreign companies acquiring local companies, but also local companies merging to gain market share. In Lithuania, both financial and strategic investors were active in the market, although financial investors were more active. Yet there has been a noticeable common trend among all three countries, which is the rise of foreign private equity firms. In comparison to five or six years ago, they have certainly shown more activity recently. In the Latvian market there are now a number of active Scandinavian players, besides local and Baltic private equity firms.

Lithuania has also been strongly impacted by the growing influence of private equity. Leading central and eastern European private equity group Mid Europa Partners acquired UAB Bitė Lietuva, a mobile telecommunications operator in Lithuania, and its subsidiary in Latvia. Similarly, Enterprise Investors bought UAB Novaturas, the largest tour operator in the Baltic States. And a few months ago, a private equity investor from the Baltic States, BaltCap, purchased Interinfo group companies in Lithuania, Latvia and Estonia, the leading operator of 'yellow pages' and electronic directories in the Baltics.

Private equity firms have managed to expand their activity in the Baltic region despite regulations only recently coming into force, or even no regulation in some cases. Estonia,

for example, does not have a specific set of regulations for private equity investments but the general framework is sufficient to support such deals. The support structure for transactions in Latvia is adequate, although the limited size of the M&A market could be an obstacle for growth among new and existing private equity firms.

In Lithuania, although private equity firms were active prior to 1 March 2008, there were no legal grounds for private equity. Investors, even local ones, had to use limited liability company structures to set up investments vehicles or private equity funds established in other jurisdictions, where legislation was more favourable, to participate in M&A transactions. On 1 March 2008, amendments to the Law on Collective Investment Undertakings of the Republic of Lithuania came into force. This made it possible to establish special collective investment undertakings – alternative investment funds, such as real estate funds, private equity funds, hedge funds and other alternative funds. Alternative investment funds, including private equity funds, may be set up as investment companies with variable capital to close-end type investment companies or funds, which are managed by the management companies. Furthermore, the incomes of the investment funds, including private equity funds, which are set up under the Law on the Collective Investment Undertakings, are not subject to corporate income tax.

The importance of due diligence

While the infrastructure to support deals may change from one country to another, conducting a thorough due diligence process – taking in legal and financial aspects, and also technical issues – during the acquisition stage is essential. For almost all transactions, due diligence should address various key areas including ownership structure, tax and financial

standing, assets, real estate, licences, regulatory issues, potential liabilities and filings, employees, and the target's relationship with suppliers.

But depending on the industry targeted, the emphasis can be put on specific areas as well. For example, it is probably essential to examine intellectual property for an information technology company, or to check the technical standing of a building when acquiring a shopping mall. Overall, the current prevailing trend is to be more careful and perform due diligences even for insignificant acquisitions, which was not the case in recent years. According to the Civil Code of the Republic of Lithuania, there is a general obligation to the parties of the transactions to act carefully. A transaction resulting from the consent given by an essential mistake may be declared invalid, however the gross negligence of one party is not a reason to consider the transaction invalid. Therefore, a buyer should act carefully and align its objectives with the target company.

The minimum requirement for due diligence is generally available in the public registers. In Lithuania, these documents usually contain general corporate information about a company, its real estate, the mortgaged and pledged assets, agreements on financial leasing and agreements with repurchase rights, as well as owned trademarks, patents and designs. However, the decision about whether to acquire a target cannot be based on this information alone – first because it provides an overall picture of a company and not deep analysis, and second, in each country there are some specific legal and practical issues that should be addressed with a local adviser. Buyers are encouraged to collect and analyse, with the help of an adviser, all information available in the public and private registers, and via the seller. Indeed, most of the infor- ►►

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mation tends to be more and more presented by the target. As it has, for some period, been a sellers' market, commonly the representations and warranties given by the sellers have been subject to the information they disclosed, so buyers must ensure that all necessary information is presented adequately in the data room.

Thorough due diligence is vital to address some issues before the transaction is closed. For example, the deal structure for buying owner-managed business differs from other structures. Often, owner-managed companies do not document their business activities particularly well. Consequently, before deciding on this structure, the investor needs to answer a number of questions. Will the previous owner continue to manage the company? If yes, is this a temporary or long term solution? What influence does the previous owner's personality have on the target business? Could the business be run successfully

without the previous owner's connections and business knowledge? What relationships exist between the target and any affiliated companies of the previous owner? Are there any key persons connected with the previous owner? Are all of the target's relationships at arm's length?

In addition, it is important to pay attention to employment relationships and payment of salary and bonuses. From our experience, there is a risk that payments in owner-managed businesses are or were made unofficially – to avoid paying all taxes, for example. Due diligence might not reveal this fact, and after the acquisition employees may start to leave the company because they do not receive the same salary. It is important to have representations and warranties on this issue. It is also advisable not to pay the entire amount at the closing of the deal. Part of the transaction value should be reserved to cover potential losses from unforeseen situations. Also, to motivate the manager and keep him or her interested in having the company continue its activities on the same basis, structuring the deal with an earnout mechanism can be helpful to achieve that goal.

Potential pitfalls for foreign investors

For foreign acquirers looking to structure a deal to mitigate potential risk, comprehensive due diligence is as important as in any other deal, if not more. Estonian legislation, for instance, regulates the rights and prohibitions of an investor quite well and gives enough protection to mitigate the risks. Nevertheless, the rights of a small shareholder are not well protected, either in practice or in theory. When purchasing a minority shareholding, it is essential to conclude a shareholders' agreement that regulates management of the business. Issues such as a responsibility, information exchange and prohibited transactions must be addressed. In addition, the deal should be structured so that the seller retains an interest in the future activities and development of the business. Earnouts are widely used to incentivise owner-managers in such cases. Buyers should keep in mind, however, that Estonia's tax system does not favour management option structures.

Investors also need to be aware of poten-

tial changes and their effects if they want to create long-term value from an acquisition. Although business ethics have undergone wide-ranging improvements in Estonia, there remains a visible difference from Nordic and Western markets. The principles of legal framework should govern the structure of the business and its daily activities. Across the Baltic States, there is no formula that fits all acquisitions so it is prudent to consult local advisers when creating the structure, depending on the target, the acquirer, and the acquirer's vision of the investment life cycle.

All these various factors should be taken into considering when conducting a transaction in the Baltic region, especially in the current financial crisis. Although 2008 began with a positive mood in the M&A market, this changed quickly during the third quarter. The end of 2008 is currently still very quiet. Seller price expectations have not yet adjusted to the market and buyers are waiting for prices to come down. Restructuring activity and forced M&A involving strategic investors and mergers between competitors should pick up during 2009.

On the other hand, private equity firms will be motivated to be more competitive and active in the market as banking finance is limited. In terms of sectors, entertainment, real estate leasing, wholesale and retail, information technology, telecommunication and agriculture are currently active. The future seems to be brighter as a number of indicators reveal interest from both potential acquirers and sellers. Further, there should be some stability in credit markets, allowing the M&A market to recover. ■

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