RECENT DEVELOPMENTS IN THE GERMAN M&A MARKET REGARDING PURCHASE PRICE AGREEMENTS

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THE GERMAN M&A market saw a downturn at the close of 2011, although activity has picked up since the outset of 2012. Opportunistic investments, economic stability and increased financing availability all had a part to play in the uptick in deal volumes. However bailouts and takeovers remain a key feature of the market, and recent developments in purchase price agreements and the growing focus on issues such as cash/debt adjustment, locked box, and earn-outs are increasingly coming to the fore. Here P+P Pöllath + Partners' Matthias Bruse discusses the issues facing clients, significant M&A developments, and what the future holds for the German market.

WHAT ARE THE MOST SIGNIFICANT DEVELOPMENTS TO AFFECT PURCHASE PRICE AGREEMENTS IN GERMANY OVER THE PAST YEAR?

Cash/debt adjustments have been the standard in the first half of the last decade. It appeared that a substantial number of cash/debt adjustments have been subject to post-closing disputes. However, in the middle of the last decade, the locked box-principle became the prevailing SPA principle in order to define an adequate and fair purchase price. Essential issues in this regard involve the definition of an appropriate leakage term.

The overall timing of transactions has grown longer. In particular, due diligence is typically taking more time than in transactions five, ten or more years ago. Therefore, it is of importance to accelerate the post-signing/closing execution by purchase price adjustment principles which avoid too many disputes.

The earn-out has always been considered a bridge between deviating purchase price expectations of seller and buyer. However, typically the earn-out bears substantial risks as regards the return expectations of the seller.

HOW WOULD YOU DESCRIBE THE STATE OF THE GERMAN M&A MARKET CURRENTLY IN COMPARISON WITH GLOBAL MARKETS?

It seems to be that German M&A markets are currently developing in a rather similar way to wider global markets. Overall market activity is still rather moderate but improvement can be expected in the course of the further year if the Euro crisis is dealt with even more efficiently.

THE TWO MOST PREVALENT COMMON ADJUSTMENT MODELS IN THE CONTEXT OF SHARE DEALS – WORKING CAPITAL ADJUSTMENT BASED ON A CLOSING BALANCE SHEET AND THE LOCKED-BOX MODEL - ARE INCREASINGLY MERGED TO REFLECT THE BENEFITS OF BOTH METHODS. WHAT ARE THE ADVANTAGES OF THIS APPROACH, AND HOW FAR HAS IT BEEN SUCCESSFUL?

The more recent models with combinations of locked box and working capital adjustment mechanisms appear to limit the potential disputes as regards adjustments based on the closing balance sheet. The procedures are speedier than a full cash/debt and working capital adjustment. It is important that the working capital adjustment is based on clear rules and definitions as regards accounting principles, in particular, consistency.

Matthias Bruse at P+P Pöllath + Partners in Munich

HOW HAS THE RECENT ECONOMIC SITUATION AFFECTED THE EFFICACY OF THE 'LOCKED-BOX' MODEL?

Following the financial crisis, more SPAs with full cash/debt/working capital adjustments were expected. However, the locked-box mechanism in combination with working capital adjustments has apparently become the prevailing purchase price adjustment principle throughout the last years.

THERE HAS BEEN A RECENT MOVE TOWARDS A GREATER CONCENTRATION OF EARN-OUTS BEING PAYABLE WITHIN A SHORTER PERIOD. HOW FAR DOES THE EARN-OUT MODEL REMAIN POPULAR, AND HOW HAS THE RISK SHIFTED FOR THE BUYER AND SELLER?

The earn-out is quite often discussed in order to build a bridge in deviating seller and purchase expectations. The prevailing risks relating to the earn-out are with the seller. Due to restructurings, and similar developments, the purchaser may be in a position to completely dilute the relevant parameters of the earn-out. Contractual protection in this regard is limited. Therefore, from the seller's perspective, an earn-out may only be acceptable if it relates top line parameters like turnover, quantities of sold products, and so on, rather than EBITDA (earnings before interest, taxes, depreciation, and amortization) or EBIT (Earnings before interest and taxes) or other performance-related parameters.

HOW FAR DO YOU SEE THE ECONOMIC SITUATION IN EUROPE AFFECTING PURCHASE PRICE AGREEMENTS DURING THE REST OF 2012? OF WHICH DEVELOPMENTS SHOULD CLIENTS BE PARTICULARLY AWARE?

The overall timing of transactions has grown longer. In particular, due diligence is typically taking more time than in transactions five, ten or more years ago. Therefore, it is of importance to accelerate the post-signing/closing execution by purchase price adjustment principles which avoid too many disputes. The combination of locked box and working capital adjustments seems to serve this purpose.

IS GERMANY'S STRONG ECONOMIC POSITION IN RELATION TO ITS EUROPEAN NEIGHBOURS GOING TO AFFECT THE LEVEL OR NATURE OF THE M&A MARKET?

Germany's strong economic position should contribute to a rise in M&A activity in Germany from foreign players. In particular, we see a substantial increase in interest by Chinese investors in the German marketplace. However, deviating pricing expectations between sellers and buyers is still a stumbling block for a substantial overall increase in activity.

IS THE INCREASINGLY PREVALENCE OF MAC CLAUSES AND ASSURED TRANSACTION FINANCING INDICATIVE OF LITTLE CONFIDENCE IN THE MARKET?

Certainly to some degree. However, MAC clauses have always been a concern of buyers while secured financing has always been a concern of sellers. MAC clauses typically are serious 'negotiation battles' between seller and buyer. Therefore, in the interest of both parties, the parties seek to structure the timeline between signing and closing as short as possible with antitrust clearance typically being the most significant hurdle to make. ■

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