Financial Investors Focused on P2P Transactions

The race to catch up has begun - No general success strategy - Without a doubt the next public takeover by private equity is just around the corner

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The global private equity market is going from record to record. According to estimates, financial investors currently have freely-disposable funds of more than 1 trillion dollars. At the same time, it has not become any easier for the industry. Subdued economic growth, volatile markets, increasing protectionism and high sales multiples at auctions complicate the search for attractive investments. Investors are constantly looking for new options, also to cope with the high investment pressure and to achieve better returns than their competitors. In Germany, one of the consequences of this is that public takeovers (P2Ps) are increasingly being focused on by financial investors.

By Dr. Benjamin Leyendecker
Partner of the firm Kirkland & Ellis in Munich, specialized in private equity and M&A transactions

In contrast to other European countries, P2P transactions by sponsors in Germany have so far been the exception. In recent years, there have been only a handful of transactions in which, in addition, there was often a major shareholder willing to sell, from whom the bidder was able to secure a significant block of shares. The actual takeover then took a back seat. There was no public takeover by financial investors with a de facto 100% free float and a correspondingly large market capitalization. That has now changed.

The successful takeover of Stada, the announced takeover of Scout24 and rumors about a large number of other companies prove that financial investors are increasingly daring to make large public takeovers in Germany without having secured a single share in advance.

Where's the change of heart coming from? While purchase prices for private mergers and acquisitions reached record levels, valuations on the stock markets fell last year, in some cases substantially. Due to the sometimes drastically changed shareholder structure with a high proportion of index funds and an increase in activist shareholders, listed companies are generally more open to a takeover than they were a few years ago, especially if the business model is difficult to implement under the short-term pressure of the capital market. In addition, the competitive environment for public takeovers is better than for private auction processes. Especially for companies with a large market capitalization, there are simply too few sponsors who can handle a P2P transaction.

The parties no longer seem to mind that P2P transactions are generally considered to be legally complex and financially difficult to control. Rightly so, because the rules of the game are somewhat more complex in Germany than in other jurisdictions. However, the specific set of rules is manageable overall. Experienced advisors can assess and guide the behavior of hedge funds, index funds and other players. The entire taking-private process can be adequately managed with the right strategy and appropriate preparation.

A decisive factor for financial investors is the optimal structuring of the takeover with the choice of the right acceptance threshold. In the past, the minimum acceptance thresholds for public takeovers were usually 75% of the shares of the target company. This was largely seen as an appropriate compromise between transaction security and flexibility for post-acquisition structural actions. This standard procedure has changed. The reasons are closely linked to changes in the shareholder structure of listed companies and the behavior of hedge funds.

The share of index funds in listed companies has risen sharply. However, real index funds cannot include their shares in the offer because their investment mandate is limited to replicating the index. The same applies to shares held by private shareholders. Experience shows that private shareholders from Germany in particular can usually only be mobilized in part to accept the offer. If the share of private shareholders and the index fund exceeds a certain number, a minimum acceptance threshold of 75% can only be reached if the hedge funds offer a disproportionately high proportion of their shares. Such an acceptance behavior of hedge funds is often unrealistic.

In contrast to pure arbitrage funds, the back-end hedge fund earns not only from the takeover, but also from the subsequent structural measures, in particular from the interest arbitrage in connection with a domination and profit transfer agreement (BGAV). Hedge funds are in the so-called prisoner's dilemma: Although they want the offer to be successful, they want to retain as many of their shares as possible. The bidder can reduce this theoretical problem through certain countermeasures, such as active communication with the hedge fund scene or the involvement of special hedge fund advisors.

The success of these countermeasures presupposes, however, that the interests between hedge funds and purchasers are at all aligned. If the hedge fund cannot earn any money through the success of the takeover because it has to deposit all its shares in the offer, this synchronization of interests is no longer ensured and the hedge fund will try to reduce its default risk by means of various complex hedging transactions. These measures make the offer a nail-biter.

The choice of the minimum acceptance threshold also depends strongly on whether the investor is actually dependent on concluding a BGAV with the target company immediately after the takeover is completed. In the case of a strategic buyer, the conclusion of a BGAV is necessary in order to leverage the synergies between the bidding group and the target company. This aspect is not the main focus for a financial investor. However, the conclusion of a BGAV offers the investor a very considerable potential for optimizing his return on equity, since the concept of annual compensation payments to minority shareholders in return for the absorption of 100% of the profit allows him to increase the total leverage on his investment.

For the conclusion of a BGAV, however, the bidder requires at least 75% of the votes cast in the general meeting. As a rule, the BGAV can be successfully concluded with a shareholding of less than 75%, especially as hedge funds are also interested in the deal. This can also be a very attractive configuration, because the sponsor has to provide less equity and still has full operational and financial control over the target company. However, with acceptance thresholds of less than 70%, certain uncertainties remain as to whether the BGAV will be concluded in the near future. The sponsor must take this into account in his investment model.

Different ways to reach your goal

The sticking point for the respective transaction structure, however, is ultimately the financing conditions. The BGAV allows access to the target company's assets for financing purposes and therefore reduces financing costs. A low minimum acceptance threshold of 50%, for example, is therefore only a viable option for a sponsor if the conditions of debt financing at this threshold are sufficiently attractive. This depends on whether the target company has a stable business development, freely available cash flow and super dividend potential, so that financing at the level of the bidder can also initially be financed without BGAV. This is the case for some target companies and not for others.

For financial investors, there are therefore various ways to reach their goals. The optimal structuring of the transaction depends on a number of factors, such as the shareholder structure, the behavior of hedge funds, the stability of cash flow and the financing environment. There is no "one size fits all" takeover strategy. Regardless of this, there is no doubt that the next public takeover by private equity is just around the corner. The race to catch up on P2P transactions by financial investors in Germany has only just begun.