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Managing transactional risk in Central & Eastern Europe

BY CLAIRE SPENCER

The number and value of M&A deals in Central and Eastern Europe (CEE) are increasing dramatically. The figures have been climbing steadily since 2002 as the region grows more attractive to investors. But there are considerable transactional risks involved, and buyers need to tread carefully.

From a macroeconomic perspective, individual countries in the region are showing great promise, notes Vladislav Severa, a partner at Ernst & Young. Czech Republic and Slovakia are attractive for their steep economic growth – around 6 percent and 9 percent respectively, in real GDP growth terms – and their abundance of growing entrepreneurial companies. In Poland, it is fairly straightforward for companies to go public, which piques the interest of private equity houses planning exit strategies. Romania generates attention due to the size of its market and population, and recent privatisation activity. Further east, the giant markets of Russia and Turkey have retail investors scrambling to establish a presence, and further interest flows particularly into natural resources, construction and heavy industry. Across CEE, the privatisation of banks and energy providers is particularly tantalising for foreign investors.

As is the case with any transaction, undertaking thorough due diligence can be pivotal to a deal's success. Running a detailed background check on the business practices of the target is critical, according to Richard Dean, a partner at Baker & McKenzie. Ultimately it could help the acquirer avoid potentially enormous liabilities. Legal advisers should carefully review the target's interface with government officials, compliance policies, contracts, ownership of assets and rights to conduct business. Meanwhile, financial advisers should undertake a review of payments and other benefits to government officials, payments into offshore bank accounts and the accounting treatment of certain expenses. The process can be a daunting in an emerging market.

Corruption is rife in certain CEE countries. To satisfy a wary buyer, the target company will need to prove it complies with anti-corruption laws. This is particularly important if either the buyer or seller have business connections with countries that vigorously enforce those laws, such as Germany, France, Switzerland and the US. "Corruption is a highly charged political issue in these emerging markets," says Mr Dean. "The bureaucracy – generally the source of much of the applicable regulation – is an active participant in corruption in these countries. Both political and bureaucratic factors can impede proper due diligence and impose pressures on targets as well as acquirers to overlook or inappropriately highlight potentially corrupt activity." In emerging markets, the dividing line between business and politics is too often obscured.

Buyers will also need to navigate complex and occasionally contradictory laws. Rather than develop a coherent legal system of corporate, labour, contract, environmental, consumer protection and competition law, CEE governments tend to modify each element a piece at a time. Many amendments later, the result is a bewildering array of regulations.

In certain deals, the legacy of former policies can undermine the deal process by causing confusion over the ownership of assets. Catalin Baiculescu, a partner at Musat & Asociatii, explains that after 1990, CEE countries underwent a complex and imperfect legal process of turning state ownership into private ownership. This was achieved in two ways. The first was through privatisation methods in which state-owned companies were sold to strategic buyers. The second involved specific restitution legislation, which reinstated a private person's ownership right over certain assets that had been confiscated by the communist regime. "This process was far from flawless, since the legislation failed to establish precise and correlated rules in all types of circumstances, thus resulting in an unclear, controversial and litigation endangered status of assets, particularly real estate," says Mr Baiculescu.

Unpredictable regulations in a CEE country can affect earnings far more than in a mature market, warns Mr Severa. "In many CEE countries, and all EU members in CEE, the major regulated industries underwent unbundlings and price regulation, which affected appropriate returns on invested capital," he says. "However, sometimes and in some industries, we still observe a residual confusion regarding valuation of the regulatory asset base, appropriate regulatory weighted average cost of capital, the basis for regulatory depreciation and so on." This can raise the risk profile of a transaction beyond the comfort levels of a risk averse acquirer, and bring a sharp halt to proceedings.

Labour legislation can also be tricky. A foreign buyer – especially from the US – should not automatically expect to walk in and clear out an entire workforce. There may be practical restrictions or financial penalties linked to restructuring efforts. "A critical challenge derives from the employee-friendly labour legislation that often hampers personnel restructuring, outsourcing and a new type of management that investors would like to have in place when acquiring majority shares in CEE companies," notes Mr Baiculescu. "Consequently, a careful review of relevant legislation and collective bargaining agreements, as well as a prudent approach to sometimes confrontational trade unions must be undertaken, in order to avoid legal traps and potential employment litigation."

Accounting processes add another layer of complication. Although IFRS is the mandatory standard for most of the CEE stock exchanges, a buyer will be lucky to find a private company that has adopted the guidelines. Lack of clarity can give sellers a nasty shock if its own calculation of value diverges wildly from the actual figures uncovered by a potential acquirer. Of course, it can also cause serious problem for buyers that base deal valuations on precise EBITDA multiples. There is usually a need to translate the target's financial figures into IFRS or US GAAP for appropriate comparison and evaluation. The situation is slowly changing as more private companies in CEE prepare for a future sale by commissioning international-GAAP compliant audits and sourcing financial advice on their record keeping processes.

Practitioners believe the single biggest impediment to due diligence is the lack of quality information. Financial statements should be in the public domain, but this is not always the case. Many companies keep their statements private, according to Mr Dean. "Obtaining accurate and complete information in these markets is a huge problem because local laws do not always require full disclosure and companies are very hesitant to disclose information that may make themselves targets for predatory companies or otherwise disadvantage them competitively," he says. When paperwork is available, it is often inaccurate or incomplete, which increases a buyer's risk.

But as Mr Severa points out, there is often still not much incentive for the target company to provide ample information to potential buyers. Lack of information rarely stops a transaction when the seller is really willing to sell, he says. "More often, the transaction might be stopped for what the information reveals and potentially causing disillusion on the side of the seller, who usually has the most optimistic expectations. There is plenty of uncertainty around transactions, especially for companies that lack a longstanding track record. Although this uncertainty goes hand in hand with young markets, buyer's often counterbalance the risk against growth prospects which are higher than those of a mature market," he muses.

Buyers should expect to do the legwork in compiling target data. Although daunting, it is not always difficult to run background checks. Contractual representations and warranties can also help to absorb a portion of the risk. Special fraud identification procedures are available. But sometimes even the most thorough due diligence effort can fail to make a company completely transparent, and foreign acquirers should draft business plans with this fact in mind.

To improve a buyer's chances of closing a successful acquisition which generates anticipated returns, there are a couple of essential steps, according to Mr Baiculescu. First, buyers must undertake thorough legal and financial due diligence. This involves gathering all essential data and using all the legal tools available in the target country. It is preferable if local lawyers and accountants, who fully understand the legal, economic and political environment of their country, carry out due diligence. Then, if the acquisition documents will be based on local laws, they need to be drafted comprehensively to safeguard the buyer's interests. Finally, the buyer should prepare early for the post-acquisition period to smooth out the integration process.

The aim for any potential acquirer is to establish a realistic assessment of the risks inherent in the target company and the individual CEE market, then negotiate an appropriate price or walk away. Sophistication is becoming more evident in the region, but serious pitfalls are still prevalent. Local advice and meticulous investigation is the best way to uncover transactional risks. ■

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