German public takeover rules protecting minorities increasingly invite event-driven interlopers – advisors

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- Large takeovers less successful post-Stada sale
- Takeover cost averages 40% above market value - ParkView
- Gaining "toehold" stake key to acquirer success

The rate of success for German public company takeovers has declined in recent years, in part due to the market becoming a playground for activist and event-driven hedge funds, according to a banker and a lawyer specialising in the area.

Germany's takeover regime seeks to protect minority shareholders by requiring acquirers to compensate them above and beyond the initial takeover premium, for instance via payments or dividends given in return for control of the company, by Domination and Profit & Loss Transfer Agreement (DPLTA) or squeeze-out.

Arbitrage opportunities, as well as legal challenges to the adequacy of those payments, are a natural consequence of these laws and have been increasingly taken advantage of by sophisticated investors and, in some cases, created an impediment to deals being completed.

Successful closing of deals involving companies valued at more than EUR 1bn is down 28%, comparing the period from 2005 to 2017 with the two year period since, said Cai Berg, senior managing director at **ParkView Partners** in Frankfurt, who specialises in public takeovers.

ParkView's research (in collaboration with the **HHL Leipzig**) indicates that just 43% of deals in that top echelon have been successful since 2017, noting that **Bain Capital** and **Cinven's** takeover of **Stada Arzneimittel** in 2017 marked a seachange for how professional investors view Germany's minority shareholders protections.

Only recently, on 9 June, Bain/Cinven's acquisition vehicle, **Nidda Healthcare**, announced that it would be squeezing out the remaining Stada shareholders at a price to be determined by Nidda and "confirmed by a court-appointed expert auditor".

The squeeze-out move represents one of the final steps in a process that saw the acquirer fail in its initial offer, refile it with new conditions, then offer compensation in exchange for a DPLTA, and then a delisting. The level of squeeze-out compensation can be, and is often, challenged in court.

The Stada process exemplifies the cost of doing public company M&A in Germany, or the "total cost of ownership," as Berg and ParkView term it.

The average total weighted cost of ownership is about 40% on top of the company's undisturbed share price, according to ParkView's research. On average, around 25% of that cost is represented by the initial takeover offer premium, an additional increase of 10% through the DPLTA, squeeze-out and delisting processes (the "back-end game"), and a further increase of 7% due to the court proceedings challenging those processes. Fewer shareholders participate in each round, hence the weighting towards the initial phases.

The investment community's growing visibility of the capital flowing through this back-end game is one reason for the difficulty in getting such a deal successfully completed, said Berg in a sentiment echoed by Michael J. Ulmer, a partner at **Cleary Gottlieb Steen & Hamilton** in Frankfurt.

Activist, event driven, M&A or arbitrage funds look differently at the question of whether to tender their shares in a takeover offer than a traditional retail shareholder or long-only institutional investor, said Berg.

"They do not approach from the viewpoint of whether it's an attractive premium and price, and whether they make a good return out of it, but from the angle of 'Do I get more out of it if I stay in the back-end?'," he added.

If the deal fits the right criteria, arb funds will flood into the stock and exercise this short term mindset, he said.

This means an offeror will not usually get more shares than it asks for via the acceptance condition, which means there is a larger portion remaining in the back-end than there has been in the past, Berg said.

Thanks to the increasing activity of such funds, the average minimum acceptance threshold on deals has been lowered over time, which makes it even more attractive for these funds because they can retain more shares for any eventual back-end game, said Ulmer.

The influence of such investors is compounded by the traditional unwillingness of many German index-tracker funds to tender their shares into the primary stage of a tender offer, even if they are fully supportive, because they are restricted by their own compliance rules.

Mitigation and messaging

There is no doubt that reaching for a DPLTA is very beneficial for the bidder, considering it will be able to dominate decision-making and access 100% of the target's cashflow if successful, said Berg.

However, it is not really possible to completely protect against event-driven interlopers, so it's more about mitigating their presence, Berg and Ulmer agreed.

In order to understand the risks, deal parties first need to be able to put a price tag on the respective steps from initial premium to legal actions, the pair said.

Beyond acknowledging the full cost of the transaction being embarked upon, parties can help their cause by securing as much of a "toehold" shareholding as they can, prior to the announcement of an offer. This includes buying shares on the market and attracting irrevocable undertakings from shareholders to tender into the offer once it's opened.

"You need to send a message to the market that this deal will go through, that management is on board and you are a big shareholder already," said Ulmer.

The parties should demonstrate that the risk/reward relation is not good for arbitrageurs, and that there is no potential of "blackmailing" the bidder because he will simply not do the DPLTA or squeeze-out if it's too expensive, said Berg.

But there is also a risk for the acquirer that it may be left with a less-than-controlling stake, because it is difficult to influence company strategy and implement synergies with only a "no man's land" stake of around 60%, Ulmer said. This, however, can be avoided via a higher minimum acceptance threshold as a condition, said Berg.

Without a DPLTA, the majority shareholder may still be able to win resolutions at an AGM, but there is no guarantee. Germany's two-tier board system makes it more difficult for investors to influence management, and it takes time to replace supervisory board members because individual elections are staggered over alternating years.

With all of the negative consequences of an offer failing, it can be tempting to revise the offer to a higher price and/or a lower acceptance threshold, but that is often a mistake, said Berg. Such moves on their own do not necessarily increase the likelihood of success for the offer, he noted.

Deal-makers should remember that all parties - even the funds withholding shares from the offer - want the deal to succeed eventually, said Berg. They might let the offer fail by not tendering sufficiently, and then hope that the bidder will come back with a lower threshold as happened with Stada, "but that's a risk", he said.

by William Mace in London