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Italy's the new merger magnet

A burst of reform is changing the country's reputation as a clubby, protectionist economy.

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HISTORICALLY, ITALY HAS NOT been a global magnet for mergers and acquisitions (M&A) activity. The country is largely made up of small and midsize, family-run businesses. Markets tend to be fragmented and localized. Business circles are clubby. National and local legislation often discourages foreign ownership and investment. Political maneuvering is always a threat. In short, Italy has traditionally used, to varying degrees, both legislative regulation and political intervention in foreign investments involving prized Italian assets to foster economic protectionism.

All that is changing, however, as Italy in recent years has occupied the center stage of Europe as the theater for record high M&A activity. Consolidation has become the mantra for Italian competitiveness globally. Foreign competition, particularly from China, is fierce. The government has implemented legal and structural reforms to foster cross-border investment. And the European Union has taken a more activist approach to enforcement of rules on the freedom of establishment and movement of capital. Strategic Italian players understand the need to work with foreign partners in order to survive in a competitive global market, and this realization has been accompanied by a wave of private equity capital inundating Italy's borders as the pressure for consolidation continues to escalate.

As a result, there has been a dramatic increase in M&A in Italy, and the trend seems certain to continue. In 2006, Italy accounted for 48% of total M&A activity in Europe and represented more than 50% of the top 10 deals by value. Indeed, eight of the top 20 European deals in 2006 involved Italian targets, with a total value of approximately 62.7 billion euros. Private equity investment represented approximately 10% of all M&A activity in Italy, with a total investment of about 7 billion euros. "2006 Mergers and Acquisitions per Hundreds of Billions of Euro," KPMG corporate finance report, Dec. 15, 2006, at 3. See www.kpmg.it/ita/advisory/generic.-aspx?TRS_ID=1610000&ID=3967.

In recent years, Italy has significantly reduced or abolished regulatory obstacles to cross-border M&A activity and has worked hard to encourage foreign investment by limiting protectionist policies and adopting investment-friendly legislation. This has been particularly apparent in the banking sector, which was beset by public scandals over the past few years involving flagrant political and regulatory abuses to promote and favor Italian control in connection with Dutch ABN AMRO Holding N.V.'s takeover of Italy's Banca Antonveneta SpA and Spanish Banco Bilbao Vizcaya Argentaria S.A.'s contemplated acquisition of Banca Nazionale del Lavoro SpA. Tobias Buck in Brussels and Leslie Crawford, "Brussels to put heat on Bank of Italy," Fin. Times, May 3, 2005. See http://search.ft.com/ftArticle?queryText=Brussels+to+put+heat+on+Bank+of+Italy&aje=true&id=050523009528.

One important, symbolic change, for example, has been the recent appointment of a new governor of the Bank of Italy, Mario Draghi, and the replacement of the governor's life tenure with a six-year term of office. This was accompanied by the transfer from the Bank of Italy to the Italian Antitrust Authority of the power to authorize bank mergers for antitrust purposes (thus minimizing the Bank of Italy's role in the predisclosure phase of acquisitions and avoiding political involvement). On a broader scale, the political shift in Italy favoring cross-border investment has been supported by forceful and express statements from Prime Minister Romano Prodi and the foreign ministry, clearly setting the tone for a strong investment climate and the opening of Italy's doors to cross-border transactions. Tony Barber, "Europe: Italy coalition leaders try to agree on policy reforms," Fin. Times, Jan. 12, 2007. See http://search.ft.com/ftArticle?queryText=Italy+Coalition+leaders+try+to+agree+on+policy+reforms&aje=true&id=-070112000918.

Private equity behemoths are moving in.

In 2004, Italy implemented several significant reforms designed to simplify corporate legislation, enhance transparency and restore investor confidence. The enactment of the Italian Corporate Law Reform Act, Law No. 366, Oct. 3, 2001 (enforcement date Jan. 1, 2004, significantly increased contractual freedoms in Italy (for example, with respect to drafting or amending corporate bylaws); eliminated certain limitations imposed on companies for issuing bonds; expanded new issuances of various classes of shares by corporations (including tracking stock); and expanded flexibility with respect to company capital structures. These included the legalization of new hybrid financial instruments to finance the two principle types of Italian limited liability corporations: the SpAs (societa per azioni or Italian limited liability companies) and the Srls (societa a responsabilita limitata or Italian joint stock companies).

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Corporate reform

The legislative reforms also expanded governance systems for Italian companies and streamlined certain merger procedures used in some acquisition structures, with the aim of fostering competitiveness of Italian companies. Perhaps most importantly, the reforms expressly created a safe harbor for leveraged merger acquisitions. The new legislation accordingly fostered the opening of the Italian marketplace to private equity behemoths, like The Carlyle Group, Permira, 3i, Fortress, BC Partners and Apax Partners, which have opened local offices in Italy to take advantage of burgeoning opportunities there.

In 2005, the Italian parliament implemented in domestic legislation the Market Abuse Directive, which had been promulgated by the European Union, and which is aimed at providing market players with access to equal information in order to make investment decisions. Law No. 62/2005, April 19, 2005; directives 2003/125/EC, 2003/124/EC, 2003/125/EC and 2004/72/EC. Among other things, the directive generally requires issuers and their controlling companies to publicly disclose "inside information" made available to third parties as well as certain transactions conducted by designated interested persons and insiders. In addition, the new rules impose harsher sanctions for insider trading and market manipulation and grant broader investigative authority to CONSOB (Commissione Nazionale per la Societa e la Borsa), the Italian version of the U.S. Securities and Exchange Commission, in connection with such offenses.

Investor confidence has also been bolstered by corporate and securities law reforms promulgated in 2006 by the Investor Protection Act, also known as the "Savings Law," Law No. 262, Dec. 28, 2005. These additional reforms were designed to enhance the rights of minority investors; the accountability of corporate directors and officers; and the reliability of financial information of Italian listed companies. Among other things, the Investor Protection Act has empowered minority shareholders of Italian listed companies by requiring that at least one director and one statutory auditor be appointed by minority shareholders and lowering the threshold to bring liability actions against directors. Today, shareholders representing at least 2.5% of the capital stock of an Italian listed company can directly add new matters to the shareholders' meeting agenda or bring derivative actions against company directors.

Italian companies are looking abroad for acquisition targets.

To induce greater transparency and enhance internal controls, the reforms require listed Italian companies to appoint independent directors to sit on the board and a designated accounting officer responsible for the preparation of financial information. The accounting officer as well as the general manager (direttore generale) of the company is required to certify the accuracy of the financial information contained in any public document or statement. The reforms also modified the liability regime and increase penalties applicable to officers and external auditors and granted broader supervisory and enforcement powers to CONSOB. In short, the Italian Corporate Law Reform Act, the Market Abuse Directive and the Investor Protection Act have provided significant protections and comfort to potential investors interested in consummating M&A transactions with Italian companies.

Outlook for M&A in Italy

There is good reason to believe that the outlook for cross-border M&A and private equity investment in Italy will continue to be bullish for the sophisticated investor (though somewhat moderated from a U.S. buyer perspective due to the strong euro and related adverse foreign-exchange dynamics). There are still many profitable incentives to do good deals in Italy. Both strategic and private equity players agree that ongoing pressure for consolidation will continue to drive deals in Italy, which is expected to foster both domestic and cross-border M&A. PricewaterhouseCoopers, "Financial Services M&A: Going for growth in Europe," at 10, April 17, 2007. See www.pwc.com/extweb/pwcpublications.-nsf/docid/E029C8E2B9030625852572C-90006E749/$file/2007_euro_manda.pdf. Italy is rife with attractive targets with historically strong balance sheets, but that need fresh financial and managerial resources to face the challenges of global competition. Middle-market transactions (generally defined as family-owned or closely held businesses with revenues in the $50 million to $500 million range) are expected to provide sustained and alluring M&A opportunities.

Conversely, there are a handful of large Italian companies that are teaming with foreign partners in an effort to expand outside Italy through strategic acquisitions abroad. In the short term, the most attractive sectors for cross-border M&A transactions could well be in the luxury goods, fashion, apparel, furniture, design, insurance, real estate and financial services industries and, to a lesser extent, the telecommunications, sports, automotive, food and construction sectors.

Seasoned players generally agree that private equity groups will continue to play an increasingly significant role in cross-border investment in Italy as the cost of capital continues to be relatively cheap and the rules of private equity in Italy become better known. This view is bolstered by the recent announcement on June 1 that Permira Advisers LLP, Europe's largest buyout fund, has agreed to pay 782.6 million euros for a majority stake in Valentino Fashion Group SpA, valuing the clothing company at 2.6 billion euros (or approximately $3.5 billion), and further plans to launch a tender offer for the remaining Valentino shares this summer and also to buy the 20% of Hugo Boss A.G. that the company does not already own. Kenneth Maxwell, Permira gets closer to buying Valentino," Wall St. J., June 2, 2007. See http://online.wsj.com/article/SB118074050681722071-search.-html?KEYWORDS=Permira+gets+-closer+-to+buying+Valentino&COLLECTION=wsjie/6month. The massive funds flowing into buyout groups comes at a time when Italy's luxury sector is ripe for consolidation and Italian luxury-goods firms are facing increased competition from emerging Asian markets.

All that said, Italy is not an easily accessible market, and M&A players would be unwise to play in the Italian sandbox without doing their homework. While most experienced experts agree that the recent reforms in Italy have had a stabilizing effect and will continue to engender increased M&A activity, interested investors still need to adjust their expectations for the Italian market. KPMG, Global M&A Spotlight, "Cross-border deals: Increasing globalization v. Increasing nationalism," at 1, November 2006. See www.kpmg.or.jp/resources/newsletter/financial/globalma200611_e.pdf. Political intervention will continue to be a concern for flagship Italian companies and in certain industries and markets, as evidenced most recently by the Italian government's intervention in the proposed merger of Italy's Atlantia SpA (formerly known as Autostrade) and Spain's Abertis Infraestructuras S.A. See European Commission press release, IP/07/117, "Mergers: Commission sends new preliminary assessment to Italy on measures blocking Abertis-Autostrade Merger," Jan. 31, 2007.

The U.S. ambassador to Italy, Ronald Spogli, recently criticized obstacles to foreign investment in Italy, after AT&T Inc. walked away from a proposed deal with Telecom Italia SpA. Adrian Michaels, "Italy hostile to foreign investments," Fin. Times, April 19, 2007. See http://search.-ft.com/ftArticle?queryText=Italy+hostile+-to+Foreign+Investment&aje=true&id=-070419010164. Successful veteran players in Italy stress the need to understand the Italian cultural, political, business and legal environment, which are not easy to navigate for the inexperienced investor. Personal relationships are often key drivers to completing deals. And dealmakers need to understand Italian sensitivities to know which deals are likely to run into political or regulatory obstacles.

As a general matter, the Italian business community comprises sophisticated and shrewd dealmakers unmatched in creativity and determination. The primary cause for cross-border deal failure involving Italian companies is often the lack of full information and understanding regarding linguistic, cultural and political sensitivities and transaction processes and goals. To safeguard against these risks, it is imperative for investors to use seasoned and experienced experts familiar with the business, financial and legal terrain in Italy. Armed with these protections and the right outlook, Italy promises to be full of exciting stories and thrilling opportunities for M&A players over the next few years. NLJ